

Property tax utilisation and equity in Punjab: Policy challenges and reform options

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Property Tax Utilization and Equity in Punjab: Policy Challenges and Reform Options¹

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Executive Summary

This report examines the policy challenges that are hindering the recurrent Urban Immovable Property Tax (UIPT) from acting as an instrument of sustainable financing for urban public services in Punjab, Pakistan. It also discusses policy reform options to get the property tax policy back on track to enable it to act as a source of effective and equitable financing for local public services.

There is an urgent need for reforming UIPT because Punjab's high urban growth rates (Figure E.1) are creating challenges for the province in meeting the local service delivery needs of its growing urban population. This is manifested in urban citizens' poor access to improved sources of water and sanitation, unaffordable and congested housing conditions, environmental degradation, and poor access to local public transport. Recent estimates suggest that 4 in 10 households in urban Punjab do not have toilets connected

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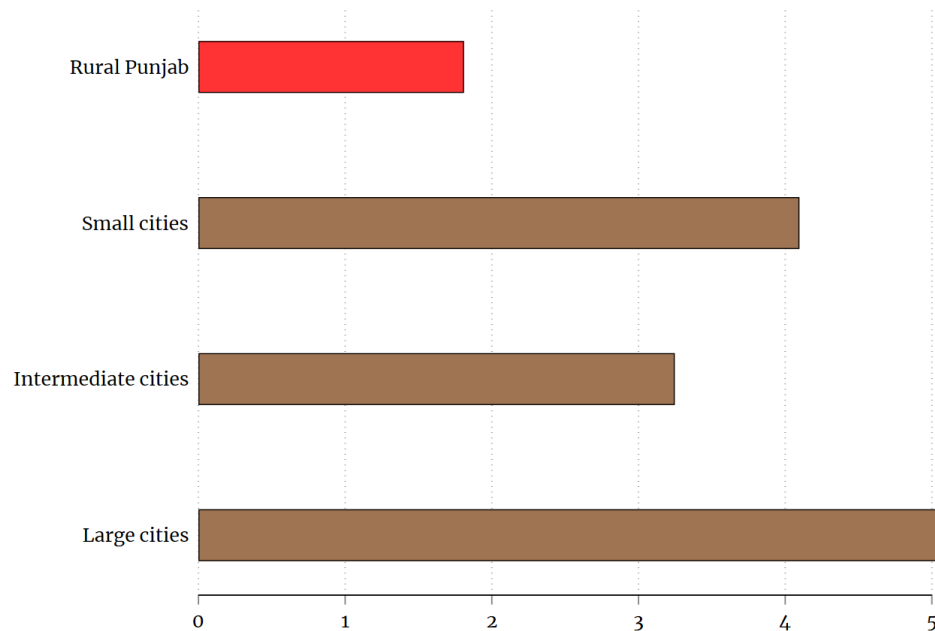
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to sewers and a similar proportion lack access to underground and covered drains.¹² Lack of decent and affordable housing has emerged as a serious challenge and a recent estimate suggests that a deficit of 6.4 million housing units exists in urban Punjab.¹³ Punjab’s urban areas have emerged as global hotspots of air pollution¹⁴ and there is evidence that modernizing intra-city transport infrastructure promises significant labour market returns.¹⁵

Figure E.1: Annual population growth rate in Punjab (1998-2017)



Notes: Cities with a population between 100,00 and 250,000 are classified as “small”, those with a population between 250,000 and 1 million as “intermediate”, and those with a population greater than 1 million as “large”.

Source: Government of Pakistan Census 2017. Pakistan Ministry of Statistics, Pakistan Bureau of Statistics, Pakistan.

¹² Mansuri, G., Sami, M. F., Ali, M., Doan, H. T. T., Javed, B., & Pandey, P. (2018). *When water becomes a hazard: A diagnostic report on the state of water supply, sanitation and poverty in Pakistan and its impact on child stunting* (No. 131860, pp. 1-151). The World Bank.; Cooper, R. (2018). Water, sanitation, and hygiene services in Pakistan. *K4D Helpdesk Report*. Institute of Development Studies: Brighton, UK.

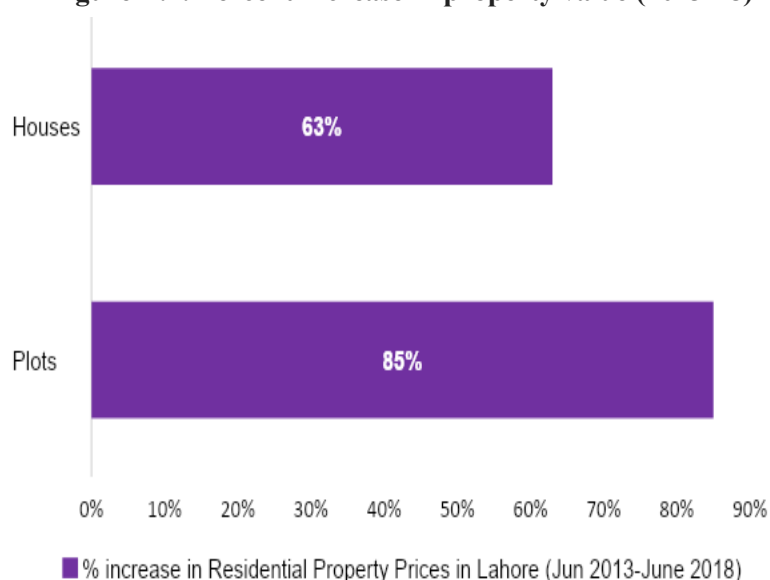
¹³ Based on the underlying assumption that one household requires one housing unit. See Housing and Land Supply. (n.d.). *Punjab Spatial Strategy 2047. Urban Unit: Lahore, Pakistan*. Retrieved on 20th September 2022. <https://pbit.punjab.gov.pk/system/files/11.%20Housing.pdf>.

¹⁴ Greenstone, M., & Fan, Q. (2019). Pakistan’s Air Pollution Challenge & Potential for Longer Lives. *Air Quality Life Index*, 1-8.

¹⁵ Majid, H., Malik, A., & Vyborny, K. (2018). *Infrastructure investments and public transport use: Evidence from Lahore, Pakistan* (Working Paper No. C-89231-PAK-1). International Growth Center. <https://www.theigc.org/wp-content/uploads/2018/06/Majid-et-al-2018-Working-paper.pdf>.

Addressing these persistent service delivery deficits requires a range of reforms, including the creation of sustainable sources of financing for urban public investments. The robust increase in real estate values (Figure E.2) due to rapid urbanization provides an opportunity for the Punjab government to use the urban immovable property tax as an instrument of sustainable financing to meet the growing service delivery needs of its urban population. The benefits of property taxation have been documented extensively – if carefully designed, the tax has the potential to enhance efficiency, act as a beneficial tax that provides a direct public service delivery benefit to those bearing the burden of the tax, and increase progressivity with its incidence being borne by owners of land and capital.¹⁶ A robust property tax system also allows local governments to leverage the municipal bond market for financing critical public investments.

Figure E.2: Percent increase in property value (2013-18)



Source: (Wani et al., 2020)

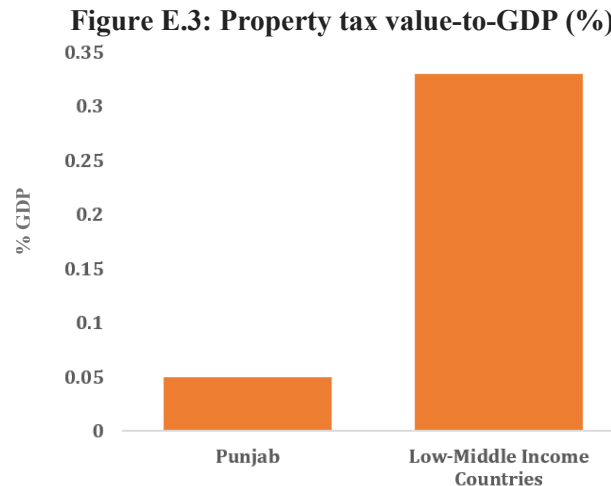
¹⁶ Ahmad, E., Brosio, G. (2022). *Beneficial Property Taxation for Emerging Market Countries Addressing Climate Change and Post-Pandemic Recovery*. Palgrave Macmillan; Khwaja, A., Haq, O., Khan, A. Q., Olken, B., & Shaukat, M. (2020). *Rebuilding the social compact*. 3ie Impact Evaluation Report 117. International Initiative for Impact Evaluation (3ie). New Delhi, India. Available at: <https://doi.org/10.23846/DPW11E117>; Prichard, W., Custers, A., Davenport, S. Roscitt, M. (2019). *Innovations in Tax Compliance* (Policy Research Working Paper 9032). World Bank Group. Available at: <https://openknowledge.worldbank.org/bitstream/handle/10986/32492/WPS9032.pdf?sequence=4&isAllowed=y>; Bird, R. M., & Slack, E. (2014). Local Taxes and Local Expenditures in Developing Countries: Strengthening the Wicksellian Connection. *Public Administration and Development*, 34(5), 359-369. <https://doi.org/10.1002/pad.1695>; Marshall, A. (1890). *Principles of economics*. Palgrave Macmillan.

How does urban immovable property tax work in Punjab?

The UIPT is an annual recurrent tax that is levied on both urban residential and commercial properties across Punjab's officially designated rated areas¹⁷ under the Punjab Urban Immovable Property Tax (UIPT) Act of 1958. All properties in rated areas are currently taxed at a rate of 5 percent unless they are specifically exempted. The main exemptions are granted to widows, government-owned buildings, and the owners of parcels of land with an area up to 150 square yards. The UIPT uses presumptive annual rental values (ARV) of the land and built area of properties – estimated through periodic rental value surveys - to assess the base. The tax is administered and collected by the Government of Punjab's Excise, Taxation and Narcotics Control Department (E&T) on behalf of local governments except in Cantonment areas where the regulating authorities are the Cantonment Boards.¹⁸

How is UIPT performing in Punjab?

Punjab's property tax utilization compares poorly to other low-middle income countries (Figure E.3). The province is currently collecting 0.05 percent of its GDP as property taxes, which is nearly seven times lower than the average utilization in low-middle income countries. The utilization of the property tax in Punjab is also much lower than cities in neighboring India. The utilization challenge is particularly acute in areas regulated by the Government of Punjab; we find that annual property tax liabilities of equivalently valued properties are nearly double in Lahore's Cantonment areas compared to the liabilities in the government-regulated areas of the city.



Sources: World Bank Atlas, IMF, Punjab Annual Budget Statement (2021-22)

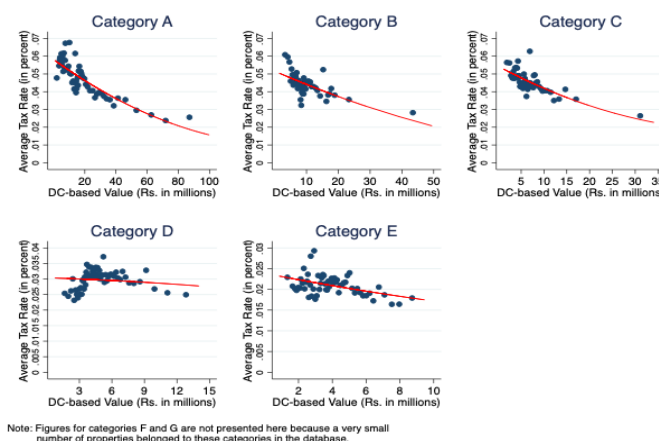
Punjab's residential property tax is regressive with holders of higher valued residential properties facing a lower tax rate on average. Figure E.4 compares the average tax rate borne by holders of self-

¹⁷ Rating areas are taxable, urban areas that are notified by the provincial government and officially brought into the property tax base by the E&T department of Punjab.

¹⁸ In cantonment areas, the property tax is administered by the Cantonment Boards that come under the jurisdiction of the Military Lands and Cantonment Department of the Ministry of Defense.

occupied, residential properties of different values within different tax value bands¹⁹ in the capital city of Lahore. It provides strong suggestive evidence that the property tax on residential properties is regressive within tax value bands. While the property tax is regressive for residential properties, we do not find a similar pattern for commercial properties in Lahore.

Figure E.4: Relationship of average tax rate with DC-based capital values (residential, self-occupied)



Source: E&T's property database

Policy challenges

Policy challenges in the areas of valuation, exemptions and rate-setting are contributing to the poor performance of the property tax in terms of utilization and equity. These challenges are made more acute by a complex tax code that is poorly understood by taxpayers. The consequences of the challenges in these areas are summarized below.

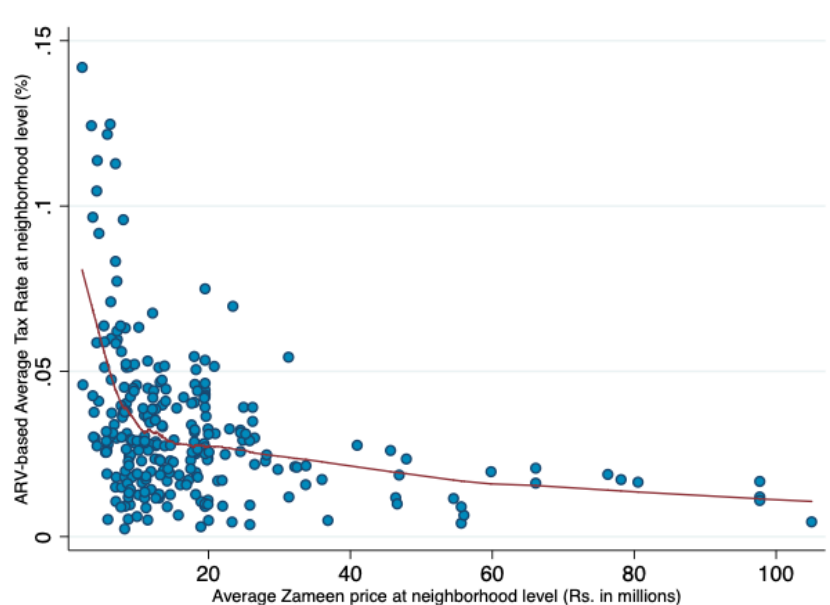
Valuation challenges: UIPT's current ARV-based valuation system is contributing to the underperformance of the tax in terms of utilization and tax equity for a number of reasons. To be a good proxy for true rental value, the ARV requires a thick rental market and the government having access to rental contract data in high volume and at low cost. These conditions are not prevalent in Punjab; an analysis of E&T's property tax cadaster for Lahore shows that only 14 percent of properties are registered as purely rented. The lack of robust data on rented properties reduces the effectiveness of rental values as a base for valuations. The current valuation policy is also adversely affecting utilization by creating a long time-lag in property revaluations, in effect of more than a decade.

A comparison of ARV-based average tax rates against market-listed residential property values (listed on Zameen.com, Pakistan's largest real estate portal) for 269 neighborhoods of Lahore raises concerns about

¹⁹ In Punjab, property tax operates by placing every property into one of seven tax value bands ranging from A to G, with band A representing properties of the highest value. The higher the band, the higher the assessed value of a property falling in it. The valuation bands are based on the annual rental value survey conducted by the E&T Department in 2013-14.

inequities in valuation (Figure E.5). The figure shows that the ARV-based average tax rate in a neighborhood falls with the listed market value of the average property in it. This suggests that the current ARV-based rates are under-assessing residential properties in high value neighborhoods of the city. The figure also raises concerns about horizontal inequity as there is great variation in the average tax rates borne by taxpayers in neighborhoods with similarly valued properties.

Figure E.5: Relationship of average tax rate with average Zameen price (Residential)



Source: E&T's Property Database, Zameen.com property listings (2018-19)

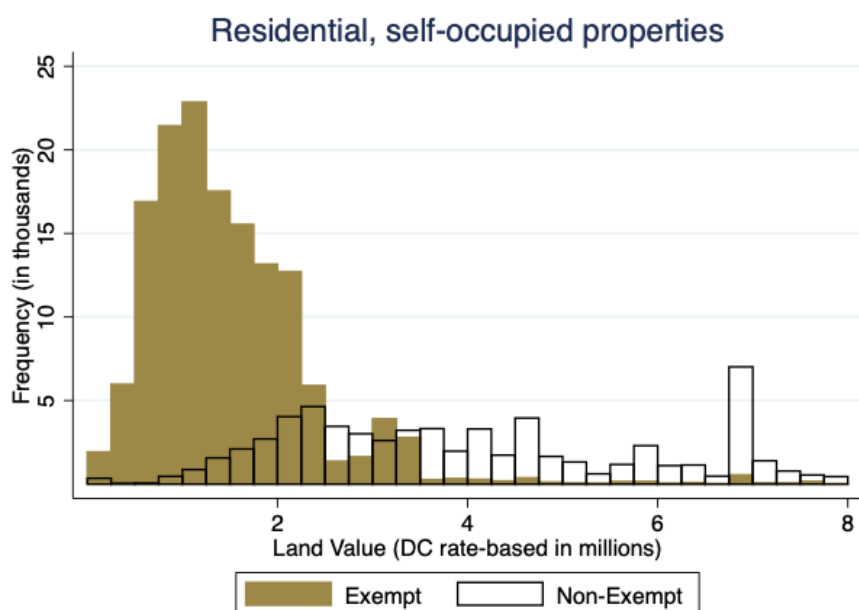
The current valuation formula is also negatively affecting utilization and tax equity by underassessing the contribution of land area to property value. It does this by assigning a disproportionately higher weight to built area (90 percent) in property valuations. This is likely to worsen tax equity by lowering the effective tax rate on high value properties built on large parcels of land, and on vacant large and high value parcels of land.

Finally, the use of the current ARV methodology for property tax purposes makes it difficult for the provincial government to develop a harmonized policy for all property-related taxes that would allow it to reduce distortions in the property market resulting from overlapping recurrent and non-recurrent property tax regimes. This is because non-recurrent property taxes don't use the ARV as the base.

Widespread use of area-based exemptions: The current tax code offers widespread area-based exemptions to holders of properties with a land area of up to 150 square yards. Analysis of E&T's cadaster for Lahore shows that 45 percent (7.5 percent) of all registered properties in Lahore are fully (partially)

exempted from property taxation and 65% of purely residential properties are fully exempted. We also find a significant overlap in the exemption status of similarly valued properties in Lahore (Figure E.6), which suggests that this exemption is eroding horizontal equity. Furthermore, the area-based exemption does not account for the taxpayers’ income-based “ability-to-pay”, resulting in unjustified tax expenditure.

Figure E.6: Area-based exemptions under the current property tax code



Source: E&T's property database, DC property valuation list (2018-19)

Rate discounts for larger properties: The current policy is negatively affecting utilization and inducing regressivity by giving a per unit tax rate discount to holders of property with a land area greater than 500 square yards and/or built area greater than 3,000 square feet.

Differential tax rates by use and occupancy: The current policy applies a much higher effective tax rate on commercial properties relative to residential properties. This feature of the code combined with widespread exemptions on residential properties has effectively made the UIPT a tax on commercial and special use properties. Three-fourths of Lahore’s property tax is contributed by commercial, special, and mixed used properties. We find that the contribution of residential properties to property tax collection is much lower than their share in Lahore’s assessed property wealth. Widespread exemptions and low rates on high value residential properties compromise utilization and weaken the benefit principle by placing a disproportionate burden of property taxation on owners of commercial properties. It is also likely to increase social costs by distorting the economic choice of businesses.

The current policy also taxes rented properties at a much higher rate than self-occupied properties. The differential has been introduced to bring untaxed rental income into the revenue net. However, senior tax

officials suggest that this benefit is not being realized because it is easy for taxpayers to conceal rental contracts and avoid the tax. In addition, the large differential on rented properties turns the property tax into a form of double taxation on taxpayers who are declaring their rental income for income tax purposes. This is particularly onerous for income tax compliant asset-rich and cash-poor tax payers who are dependent on rents as an important source of income..

Shared rate-setting powers: The power to set property tax rates is shared between the provincial assembly and local governments under the current system. The provincial assembly sets a fixed benchmark rate as part of the UIPT law, whereas the local government law gives local councils the power to alter the rate. However, the provincially set tax rate is the one used in practice as local governments are reluctant to use their rate-setting powers in the presence of a low benchmark rate set by the province. This means that local councils in Punjab do not set the property tax rate or base, which effectively makes the property tax a provincial transfer to local governments, weakening the fiscal and accountability benefits associated with own-source local taxation (Gadenne, 2017).

Taxpayers' poor understanding of the system: A survey of six hundred taxpayers in the low, medium, and high-density areas of Lahore reveals that taxpayers have a poor understanding of Punjab's property tax code. Over 90 percent of respondents could not correctly identify the base of the valuation, the weight assigned to land and built area in the formula or the differences in effective tax rates by use and occupancy status of properties. This is likely to weaken the tax system because the literature suggests that taxpayer understanding, and transparency are important factors for fiscal accountability and voluntary compliance.²⁰

Distortions due to the duality in revenue and expenditure functions at the local level: The structure of urban local governance in Punjab and Pakistan has created a system of partial decentralization by institutionalizing a duality in revenue and expenditure functions (Haque 2020, Cheema 2020). Currently, the responsibility for delivering municipal functions, such as land use, building controls and water and sanitation is divided between provincial development authorities, municipal agencies of the province and urban local governments. This weakens accountability by limiting the ability of local governments to respond to the service delivery needs of local voters and their taxpayers. Similarly, part of the productive tax base of cities remains under the control of development authorities and cantonment boards. The loss of productive tax bases for local governments creates a mismatch between their expenditure and revenue assignments and makes them dependent on provincial transfers (Haque 2020, Cheema 2020). The devolution literature shows that partial decentralization – where expenditure decentralization is not complemented by strong own-source revenue bases – can weaken local government accountability and the benefit linkage with adverse consequences for service delivery (Ahmad and Brosio 2022, Khemani 2015, Devrajan et al. 2009).

²⁰ Taylor, N. (2002). Understanding taxpayer attitudes through understanding taxpayer identities. *V. Braithwaite, Taxing Democracy*, 71-92.; Cvrlje, D. (2015). Tax literacy as an instrument of combating and overcoming tax system complexity, low tax morale and tax non-compliance. *The MacrotHEME Review*, 4(3), 156-167.; Machgu, C. G., & Amayi, J. B. (2013). The Effect of Taxpayer Education on Voluntary Tax Compliance, Among Smesin Mwanza City-Tanzania.

Reform Options to get the Property Tax Back on Track

The policy challenges discussed above are inhibiting the potential of the property tax to serve as an effective instrument for financing local public services in Punjab's cities and towns. Getting the property tax to generate sustainable financing for urban public investments in an equitable manner requires policymakers in Punjab to reform the following areas of tax policy:

- **Reforming the valuation system:** The introduction of an effective valuation system is the most critical area of reform. In a thin rental market with poor quality of rental contract data, the current valuation methodology that relies on presumptive rental values (ARV) is inaccurate and distortionary. Moving to a capital value-based system that estimates property value using a hybrid, points- and area-based approach is the most feasible way forward for Punjab, given its current capacity for property tax administration. Leveraging existing capital value-based systems - used for non-recurring property taxes (DC or FBR rates) - as the base for the points-based approach has the potential to increase the utilization of the recurring property tax, strengthen vertical and horizontal equity and allow for harmonization of all property-related provincial taxes. The government can also reduce the compliance costs for taxpayers by institutionalizing the self-declaration of the parameters used in the points-based system and complement this with random audits based on satellite technology and simple field-based verifications.
- **Policies to strengthen tax equity:** Abolishing the discount given to properties with larger land and built area and placing a larger weight on land area in the valuation formula will increase the economic efficiency of the system and enhance tax equity by making the tax more progressive. The government should consider institutionalizing surveys to elicit taxpayer preferences over the degree of progressivity in the tax schedule and use this evidence to inform the rate-setting process. Building reforms on feedback from taxpayers will minimize public backlash and improve the buy-in of citizens.
- **Removing distortions associated with differential tax rates:** Reforming the differential tax treatment in favor of owner-occupied, residential properties may improve the economic efficiency of the property tax. The preferential treatment of owner-occupied housing can lead to tax avoidance through under-declaration of rental contracts. On the other hand, higher taxation of commercial units – presumably due to the higher liquidity amongst their owners – acts as a de facto income tax and is likely to distort investment decisions since property is an input in the productive process of a business. It is important for the government to conduct analytical work to assess the cost of distortions associated with differential rates and rationalize these differentials with an aim to increasing efficiency and improving tax equity.
- **Reforming area-based exemptions:** Basing exemptions on value rather than size can increase tax equity and utilization. To provide relief to asset-rich/cash-poor property owners, the use of tax deferral schemes, or tax credits that offset provincial recurring property taxes in federal income taxes, can both

satisfy political economy constraints and strengthen tax enforcement across the provincial and federal levels.

- **Devolving rate-setting powers:** Effective devolution of rate-setting powers to local councils will enhance accountability by strengthening hard budget constraints for local governments. This can be achieved if UIPT reforms do away with the power of the provincial assembly to set a flat tax rate as part of the UIPT law. In addition, the local government law should require the provincial finance commission to determine progressivity by establishing different tax rate bands for the property tax with local councils required to set rates within these brackets as part of their budgetary process.
- **Ending the duality in revenue and expenditure functions at the local level:** Strengthening fiscal accountability and the benefit linkage of property taxes requires ending the duality in local revenue and expenditure functions. This would mean bringing development authorities and provincial agencies discharging overlapping local functions under the control of their respective urban local governments.
- **Pilot the use of earmarking to strengthen the benefit linkages of the property tax:** Earmarking is an instrument that has been used by many governments to strengthen the benefit linkage (Ahmad and Brosio 2022, Khwaja et. al. 2020, Prichard et. al. 2019). Earmarking can take the form of tying property tax revenues to key public services or allocating a share of the taxes collected from a local area to finance services in it. While earmarking is a promising instrument in contexts where fiscal accountability is low, the evidence on its impact is limited and it involves risks, e.g., worsening fiscal inequity between local areas and the welfare losses associated with the government picking the wrong services to earmark. We recommend that the government carefully pilots different designs of earmarking with independent oversight but uses rigorous evaluations before institutionalizing it as part of the system.

The structure of the report is as follows. Section 1 describes the local service delivery deficits in Punjab in the context of rapid urbanization. Section 2 analyzes the performance of Punjab's property tax system in terms of utilization and equity. Policy parameters that are weakening the performance of the system are discussed in Section 3, followed by a discussion in Section 4 of future policy directions that can enable the property taxation to act as a sustainable source of financing for urban public services.

1. Urbanization and Local Public Service Delivery Gaps in Punjab

I. Punjab's urban transformation

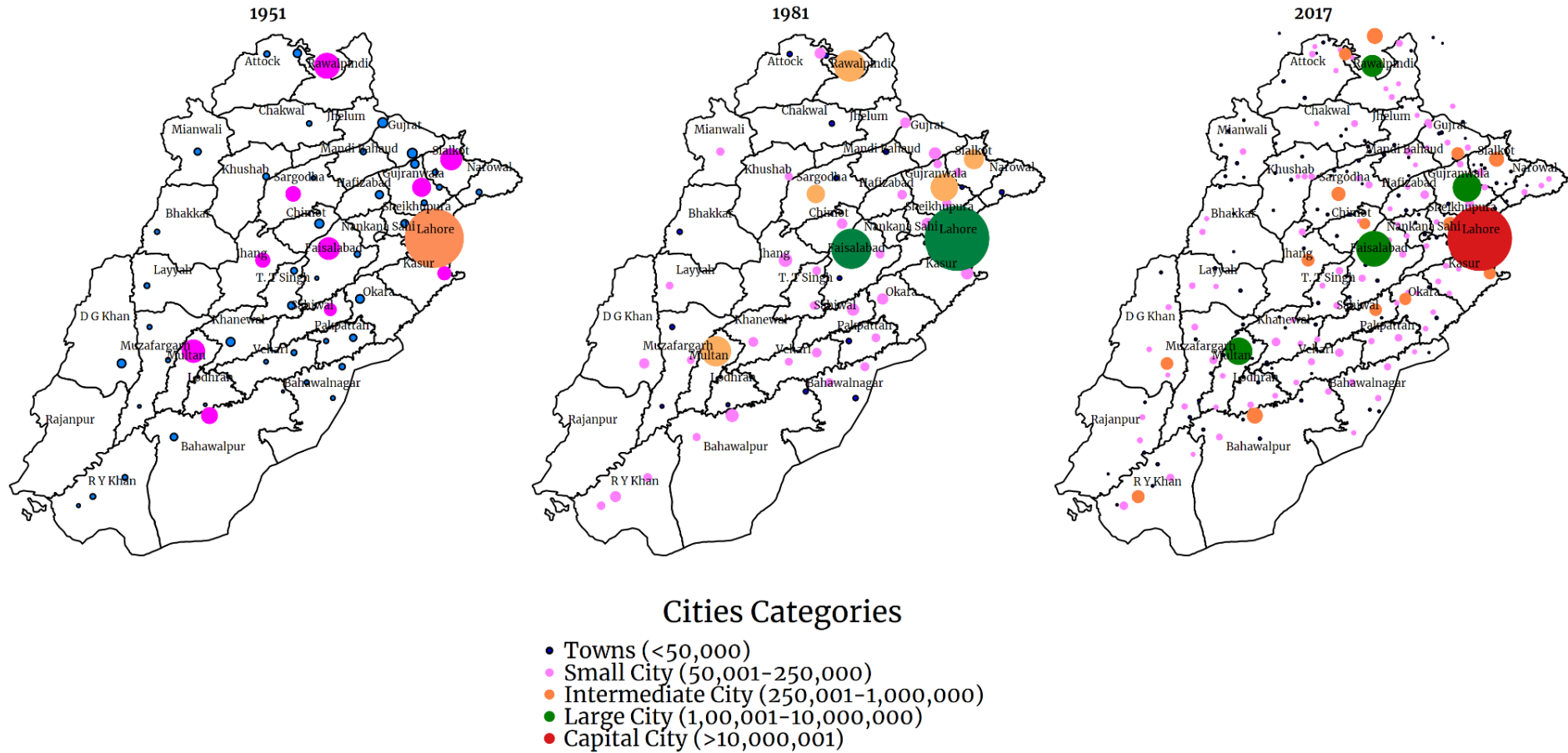
Between 1998 and 2017, the number of people living in officially designated urban areas in Pakistan increased by 30 million, which is nearly equivalent to the population of countries like Nepal, Malaysia, and Saudi Arabia. Punjab, the largest province in Pakistan and home to 110 million people has been at the forefront of this demographic transformation. Today, Punjab's urban population is close to the entire population of Sindh, Pakistan's second-most populous province.

There is a consensus in the urbanization literature on Pakistan that official figures significantly underestimate the real scale of urbanization in the country (Ali, 2013; Ellis & Roberts, 2015; Hasan, 2021; Khan & Adeel, 2017; Ullah, 2022). This is due to definitional issues; the census uses an administrative definition of urban areas, instead of using objective measures of urban characteristics to define these areas (Ali, 2013; Ellis & Roberts, 2016). This creates "hidden urbanization" that is not detected by official measures. In particular, official statistics fail to capture the growth of peri-urban localities on the periphery of officially designated city boundaries and along highways (Ali, 2013; Ellis & Roberts, 2016). The literature shows that Punjab is in fact an urban majority province once objective measures are used to account for hidden forms of urbanization (Ali, 2013; Hasan, 2021; Khan & Adeel, 2017; Ullah, 2022).²¹ These measures also place Punjab and Pakistan ahead of India, Sub-Saharan Africa, and East Asia and Pacific in terms of the rate of urbanization (Ellis & Roberts, 2016).

Urbanization in Punjab is not confined to the growth of a handful of large cities. Over time, urban areas have proliferated throughout the province. Figure 1 shows the spread of new urban areas across all parts of the province between 1951, 1981 and 2017. It also shows that urban areas have steadily grown in size across all regions of the Punjab.

²¹ Ellis & Roberts (2016) use the World Bank's agglomeration index (AI) to provide a more objective measure of urbanization in South Asian countries. The World Bank's AI index uses three parameters - population threshold, population density and maximum travel time to a large urban center, to define urbanization.

Figure 1: Spread of urbanization in Punjab (1951-2017)

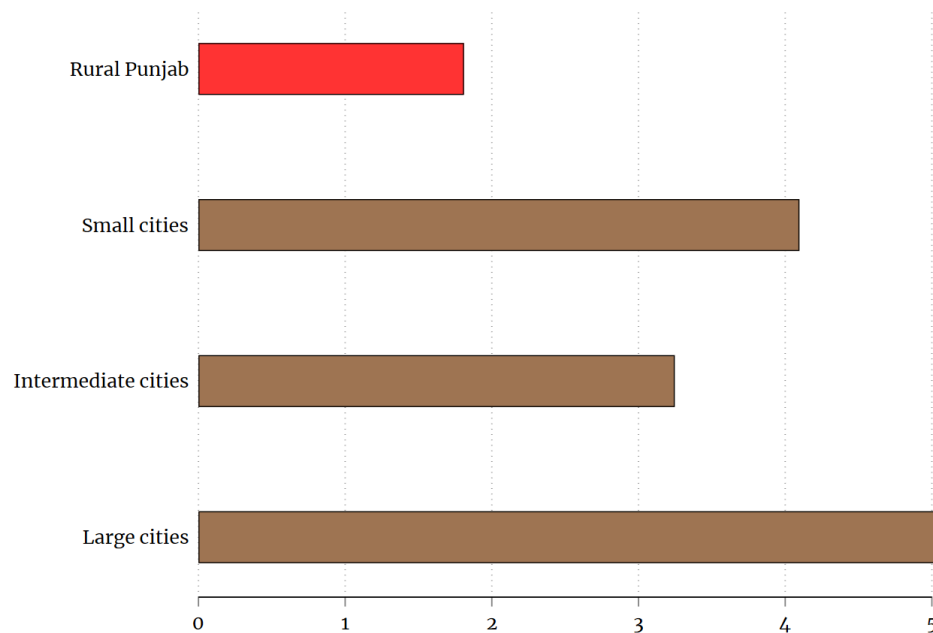


Notes: Towns are areas with a population less than 50,000. Cities with a population between 50,000 and 250,000 are classified as “small”, those with a population between 250,000 and 1 million as “intermediate”, and those with a population greater than 1 million as “large”. The capital city of Lahore is shown separately.

Source: Urban Unit and Government of Pakistan census 1951, 1981 and 2017.

Figure 2 shows that urban areas of all sizes are growing faster than rural areas. Today, the province is home to over fifty officially classified urban areas with a population of over a hundred thousand, and five large cities with a population of over one million. With the rapid spread and growth of urban areas in Punjab, financing and servicing the increasingly large public service delivery needs of urban citizens has emerged as an important development challenge.

Figure 2: Annual population growth rate in Punjab (1998-2017)



Notes: Cities with a population between 100,00 and 250,000 are classified as “small”, those with a population between 250,000 and 1 million as “intermediate”, and those with a population greater than 1 million as “large”.

Source: Government of Pakistan Census 2017. Pakistan Ministry of Statistics, Pakistan Bureau of Statistics, Pakistan

II. Deficits in urban local service delivery in Punjab

Urban areas in Punjab have seen a rapid decline in poverty during the past decade and poverty in these areas has continued to be significantly lower than that in rural areas (Mansuri et al., 2018). Recent research also shows that poverty has fallen faster in the more rapidly urbanizing districts. However, despite these gains, Punjab continues to struggle with a range of service delivery challenges that are adversely affecting the welfare of its urban citizens. This failure is reflected in the poor performance of the province’s most populous and affluent city, Lahore, in international rankings of cities on livability (Dawn, 2016).

Districts with large cities such as Faisalabad, Rawalpindi and Lahore tend to have higher levels of within-district income inequality relative to other districts, and a significant number of their citizens continue to live in poverty (Mansuri et al., 2018; Cooper, 2018). While residents of urban areas tend to do much better than their rural counterparts in terms of access to piped water and improved sanitation facilities, significant deficits remain. Recent estimates suggest that nearly two-thirds of Punjab’s urban citizens lacked

access to piped water and around 40 percent of these households had toilets that were not connected to sewers (Mansuri et al., 2018). Over 40 percent of households in urban Punjab with piped water connections had water available for less than 6 hours a day and a similar proportion of households lacked access to underground and covered drains. The literature shows that these deficits are associated with poor health and nutritional outcomes (Mansuri et al., 2018).

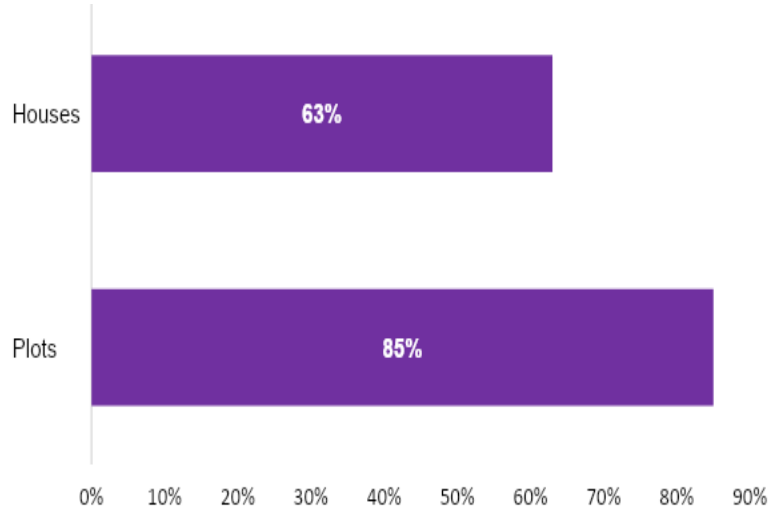
Congested land and housing markets are also adversely affecting the livability of Punjab's urban citizens (Ellis & Roberts, 2016). The lack of decent and affordable housing for urban dwellers has emerged as an important public policy issue in Pakistan and a recent estimate suggests that a deficit of 6.4 million housing units exists in urban Punjab²² (State Bank of Pakistan, 2019; Housing and Land Supply, n.d., p.313). Recent evidence indicates that Pakistan was the fifth-most polluted country in the world and districts with large cities in Punjab have emerged as pollution hotspots in the country (Greenstone & Fan, 2019). Urban Punjab's poor air quality is adversely affecting the health of urban residents and has reduced their life expectancy (Greenstone & Fan, 2019). Finally, emerging evidence shows that public investment in modernizing city-level transportation in urban Punjab can reduce monetary and time-costs of commuting and broaden opportunities for citizens in the labor market through increased integration (Majid et al., 2018; Altaf, 2014).

Local public investments that can address these service delivery deficits promise significant benefits in terms of citizens' livability, health, and livelihoods. Financing these local public investments is a major development challenge for Punjab's urban administrations and local governments (Piracha 2021, Haque 2020). This challenge is likely to compound over time, given Punjab's rapid pace of urbanization that will place additional stress on local public infrastructure and lead to environmental degradation, with direct impacts on citizens' lives.

However, Punjab's demographic transformation provides a real opportunity for it to capture the gains from urbanization. One consequence of Punjab's urban transformation is the robust increase in land and property prices (Figure 3) due to population pressure in urban areas, the development of real estate markets and significant public investments. This robust rise in property values offers governments the opportunity to use property tax as an instrument of sustainable financing to meet the growing public service needs of the province's urban population.

²² Based on the underlying assumption that one household requires one housing unit.

Figure 3: Percent increase in property value (2013-18)



Source: (Wani et. al., 2020)

2. Property Taxes as a Source of Finance for Urban Services: Potential and Performance in Punjab

In developed economies, the recurrent immovable property tax forms a bedrock of local financing for municipal services and public investments (Ahmad & Brosio, 2022; Collier et al., 2018). This tax has historically been important for financing public investments in clean water, sanitation, and education in the cities of US and UK (Alsan & Goldin, 2019; Chapman, 2019; Cutler & Miller, 2006; Hunt, 2004; Szeter, 2002; Fraser, 1979; Lindholm, 1970). Financing local public investments through property taxes is seen to proffer a number of benefits. Recurrent immovable property tax is considered an efficient form of taxation as the relatively immovable nature of its base makes its taxation less distortionary for labour supply and investment decisions compared to other taxes (Norregaard, 2013; Mirrlees et al., 2011, p.368-405). OECD's (2008, 2010) tax and growth ranking finds recurrent taxes on immovable property to be the least distortionary tax instrument in terms of its effect on long-term growth.

The tax is argued to have the potential of being seen as a “beneficial tax” by taxpayers as it is typically used to finance local public goods that provide a direct benefit to those bearing the burden of the tax (Ahmad & Brosio, 2022; Khwaja et al., 2020; Prichard et al., 2019; Bird & Slack, 2014; Marshall, 1890). It can lead to improvements in the overall quality of public financing by strengthening political accountability (Norregaard, 2013; Bahl, 2009). Additionally, effective expenditure on local public services – such as schools, fire protection, and clean water and sanitation – financed by a property tax is likely to be capitalized in property values and this is expected to confer a direct benefit on owners of property even when they have not borne the full cost of this public investment (Ahmad & Brosio, 2022; Collier et al., 2018; Mirrlees et al., 2011, p.368-405; Oates, 1972). The expectation is that sustainable financing of urban public investments will build resilient cities by strengthening the local fiscal compact between taxpayers and governments in urban areas.

The new view of property taxes argues that it is a fair and progressive tax because its incidence is borne by owners of land and capital who belong to relatively higher-income groups (Norregaard, 2013; Mieszkowski, 1972). Sennoga, Sjoquist and Wallace (2008) provide evidence to support the view that most of the burden of the tax is typically borne by middle- and high-income earners. Furthermore, as many wealthy and high-income groups are in hard-to-tax sectors in developing countries, property taxes could be beneficial in terms of strengthening vertical equity by making these individuals contribute to the tax system. To the extent that the property tax acts as a user charge for local public services, it is considered to be fair based on the benefit principle (Norregaard, 2013).

However, despite these benefits, the performance of property taxes has been dismal in most developing countries (Ahmad & Brosio, 2022; Brockmeyer et al., 2022; Weigel, 2020; Collier et al., 2018; Khan et al., 2016; Norregaard, 2013; Bird, 2011; Bahl & Wallace, 2008). Recent work in the area attributes this under-performance to political economy constraints. Property tax is an obtrusive tax, whose salience makes it politically disliked by voters (Cabral & Hoxby, 2012). Political opposition from fixed income households to adjustments in valuations adversely affects its performance and potential (Ahmad & Brosio, 2022; Collier et al., 2018). Political economy constraints can lead to the evolution of a property tax system that underutilizes the tax base, and compromises on efficiency and fairness.

How effectively is Punjab's urban immovable property tax performing? This section describes the main features of Punjab's urban property tax and provides evidence on its performance in terms of utilization and tax equity. Understanding the performance of the tax is important because an effectively functioning property tax system is necessary for governments in Punjab to meet the growing local service delivery needs of its rapidly urbanizing population.

I. What is the Punjab Urban Property Tax?

The Punjab property tax is levied on urban properties across Punjab's officially designated rated areas²³ under the Urban Immovable Property Tax (UIPT) Act of 1958. The Government of Punjab's Excise, Taxation and Narcotics Control Department (E&T) collects the tax on behalf of local governments and is responsible for enforcement and policy formulation. The provincial assembly sets the tax rate as part of the UIPT Act with local councils having the power to alter it. Although legally UIPT is a local government tax, in practice it functions as a provincial tax, subject to revenue-sharing with urban local governments and several provincially controlled agencies.²⁴

Property tax liability is assessed on the annual rental value (ARV) of a property and applies to both commercial and residential properties. Property tax valuation is not based on actual rental values. Instead, it uses presumptive rental values for properties, which are based on periodic rental value surveys conducted

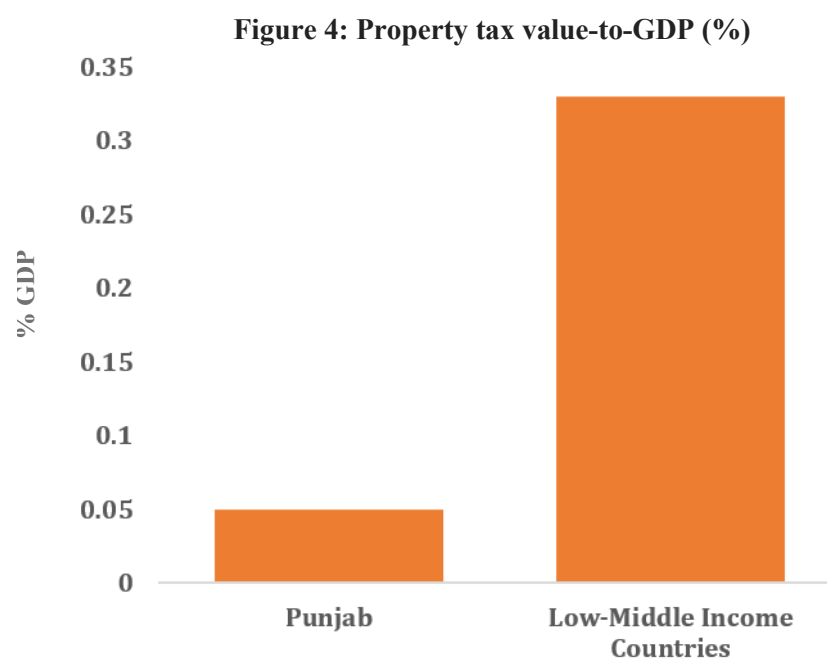
²³ Rating areas are taxable, urban areas that are notified by the provincial government and officially brought into the property tax base by the E&T department of Punjab. In cantonment areas the property tax is administered by the Military Lands and Cantonment Department of the Ministry of Defense.

²⁴ In Lahore, this includes agencies such as the Water and Sanitation Authority (WASA).

by the E&T²⁵ Department. Following these surveys, the tax base is assessed in a banded system²⁶ according to provincially notified ARV valuation tables. Properties are assigned a value based on the band they fall under, their proximity to main roads, type of occupancy and use. The base consists of the combined ARV of the land and built area of each property and the tax rate is set at 5 percent. All properties in rated areas are taxable unless they are specifically exempted.

II. The Utilization of property Taxes in Punjab

How does the utilization of property taxes in Punjab's rated areas compare to comparators at similar levels of income? Figure 4 shows that the contribution of recurrent property taxes in Punjab at 0.05 percent of GDP is much lower than the average for Low- or Middle-Income Countries (LMICs).



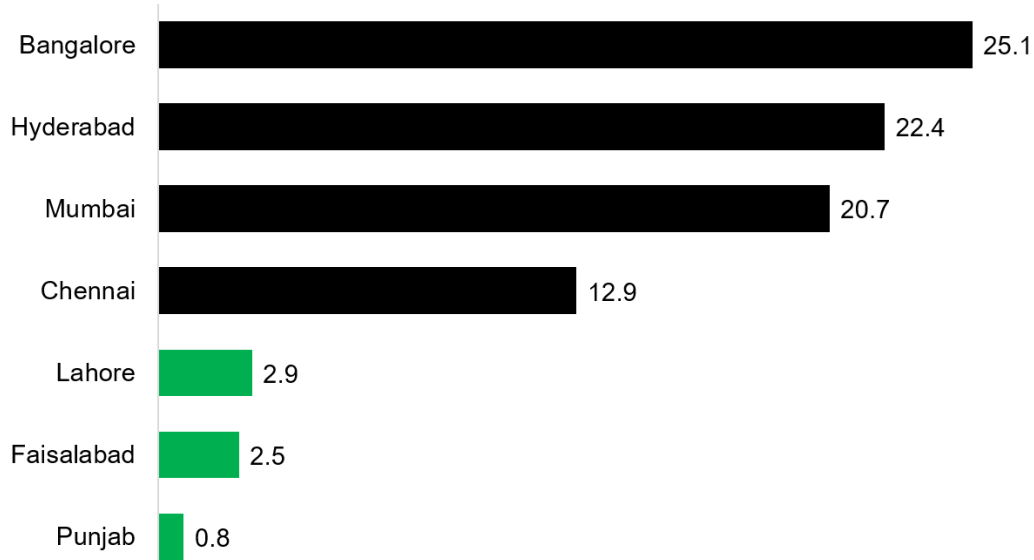
Sources: World Bank atlas, IMF, Punjab annual budget statement (2021-22)

Figure 5 shows that the utilization of property taxes in Punjab and in its largest cities of Lahore and Faisalabad is much lower than comparator cities in India, which have better performing property tax systems in India (Ahmad & Brosio, 2022; Awasthi & Nagarajan, 2021). These findings are in line with evidence from recent studies of property tax in Pakistan (Piracha 2021).

²⁵ The official name for the government department responsible for property taxes is Excise, Taxation and Narcotics Control (ET&NC). However, for this report Excise and Taxation or E&T has been used instead.

²⁶ In Punjab, property tax operates by placing every property into one of seven tax value bands ranging from A to G, with band A representing properties of the highest value. The higher the band, the higher the assessed value of a property falling in it. The valuation bands are based on the annual rental value survey conducted by the E&T Department in 2013-14.

Figure 5: Urban property tax collection per capita (2015-16, USD)



Source: Awasthi & Nagarjan, 2021 and Punjab E&T

A novel feature of property taxes in Punjab is that property tax policy and administration is not under the purview of the Government of Punjab in cantonment areas where the property tax is administered by the Cantonment Boards. The difference in tax utilization between properties managed by E&T and the Cantonment Boards can provide insights into the performance of the government's property tax system in terms of utilization. Figure 6 compares the property tax liability of two equally valued properties managed by the two taxation authorities in Lahore in 2021. It shows that the tax liability of the property regulated by the E&T department is less than half the liability of the property under the jurisdiction of the Lahore Cantonment Board.

Figure 6: Tax utilization in E&T and Cantonment Areas



Rating Area: Excise and Taxation
Plot size: 1 Kanal
Built area: 4,500 sq ft
DC Value (2021): 2.5 crore
Tax Demand (UIPT): **Rs. 11,675**



Rating Area: Cantonment Board
Plot size: 1 Kanal
Built area: 4,500 sq ft
DC Value (2021): 2.88 crore
Tax Demand (Cantt): **Rs. 25,493**

Source: E&T and the Urban Unit

This highlights the scale of the utilization challenge in Punjab, which persists despite improvements in tax capacity due to recent initiatives that include the digitization of property records and the partial digitization of processes related to tax administration (Profit, 2020). However, this evidence also points to the enormous potential of property tax reforms in providing sustainable financing to build resilient cities in Punjab (Piracha 2021, Khwaja et. al. 2020).

III. Property Tax Equity in Punjab

How well does Punjab's property tax perform in terms of tax equity? While data constraints preclude an exhaustive analysis of tax incidence, we provide suggestive evidence on this question by analyzing and comparing the average tax rates borne by property holders occupying properties of different values in Lahore within a tax value band. We compute average tax rates by dividing properties' tax liabilities under the current tax system by an estimate of their property value. We focus our analysis on the metropolitan city of Lahore, given its status as the most populous urban center of Punjab, and its large share (40%) in Punjab's property tax collection.

Since there has been no revaluation of the annual rental value of properties between 2013-14 and 2022, the E&T's valuations can be misleading when measuring current property values. We address this challenge by imputing current property values for Lahore based on property value assessments conducted by the Deputy Commissioner's (DC) office that are published on an annual basis in the form of DC-rate lists. These lists provide area-based property value assessments for different localities of the city for a given

year. The DC rates are computed for different localities based on information collected from sample surveys of property sales in specific localities. Each property's estimated value is used for the valuation of immovable properties for nonrecurrent levies such as stamp duty on sale of property, tax on transfer of property, and the provincial capital value tax. These rates, which are assessed per unit of area, when combined with a property's land and built area provide an estimate of the property's value.

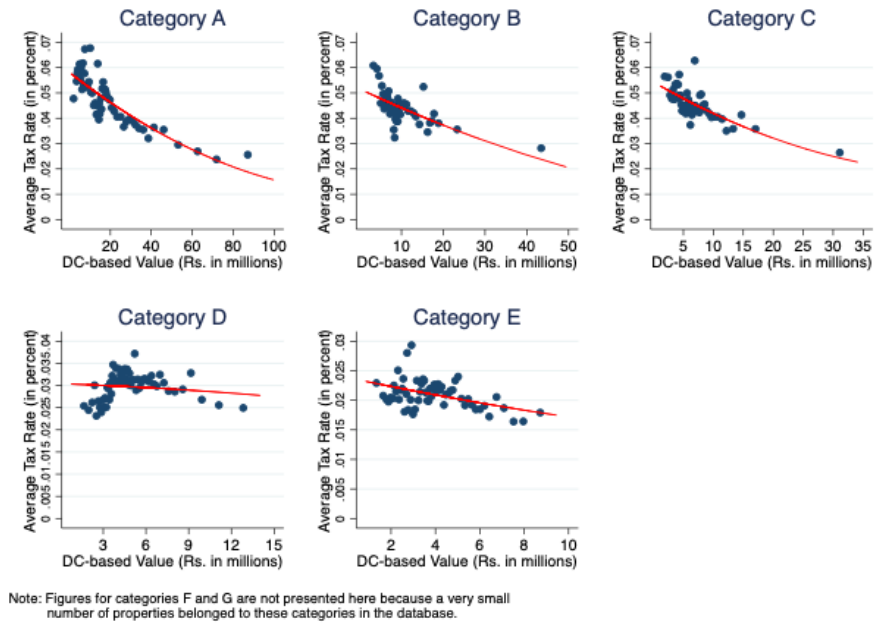
To provide a rough measure of the accuracy of our DC-rate based value estimates, we analyze the correlation between the DC-rate assessed values and property values listed on Zameen.com – Pakistan's largest property sales portal – for 2018-19 in 306 localities of Lahore and find that DC-rates significantly underassess market value. Importantly however, we find that the two values tend to be significantly correlated, increasing our confidence in our comparative analysis of average tax rates across properties (Figure A.1).

The Government of Punjab's Urban Unit has created a dataset that merges DC-rates for specific properties in the E&T's property tax cadaster for Lahore for 2018-19. The E&T's cadaster has annual property level data on land and built area of properties, their usage, occupancy and exemption status, and their tax bills and payments. The merged dataset consists of nearly one-third of Lahore's one million properties that are registered with the E&T for recurrent property tax purposes. We use this merged dataset for 2018-19 to analyze the differences in average tax rates borne by taxpayers occupying properties of different values within a given tax value band.

Figure 7 provides the results of this analysis for self-occupied, residential properties that comprise 47% of all properties in Lahore. We find that average tax rates fall as the assessed values of properties²⁷ increase within a given tax value band. This correlation is strong for all tax value bands except band D. This serves as strong, suggestive evidence that the property tax system on residential properties in Punjab is regressive, with holders of higher valued residential properties facing a lower tax rate, on average.

²⁷ We use the property value assessment done by the Deputy Commissioner's (DC) office for 2018-19 and published in the form of the DC-rate list to measure the assessed value of properties. We use this measure as E&T has not published new rental values since 2013-14. DC rates are computed for different localities based on information collected from sample surveys of property sales in specific localities and use as the valuation for nonrecurrent levies.

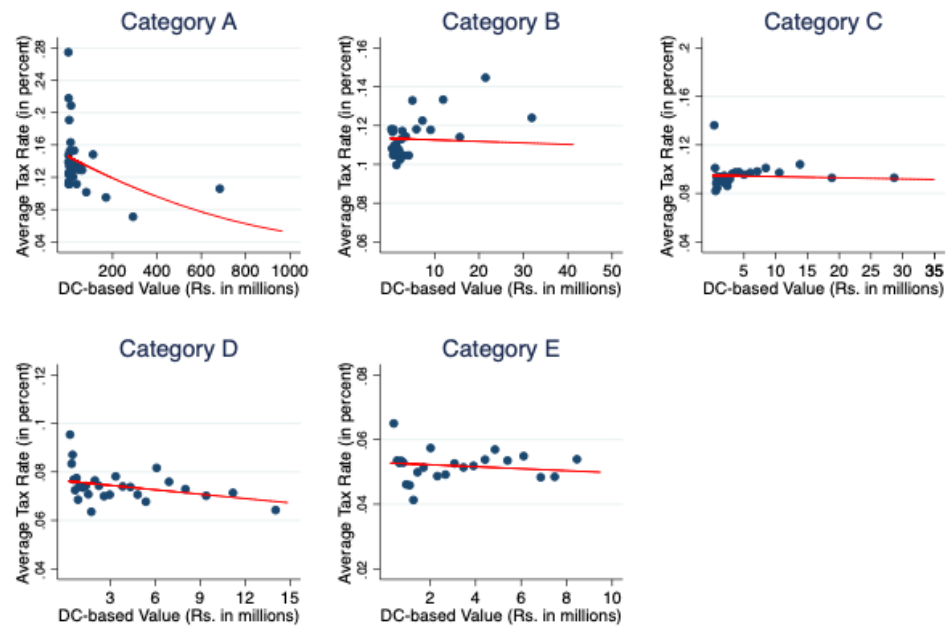
Figure 7: Relationship of average tax rate with DC-based capital values (residential, self-occupied)



Source: E&T's property database

However, Figure 8 shows that property tax on commercial properties applies equal treatment, with properties within a tax value band facing the same average tax rate irrespective of their value. The exception is category A commercial properties (the highest value band), which show evidence of regressivity and the existence of horizontal inequity as properties of similar value face significantly different average tax rates. Although property taxes on commercial properties within a band are not progressive, they don't reveal the strong pattern of regressivity found in residential properties.

Figure 8: Relationship of average tax rate with DC-based capital values (commercial, self-occupied)

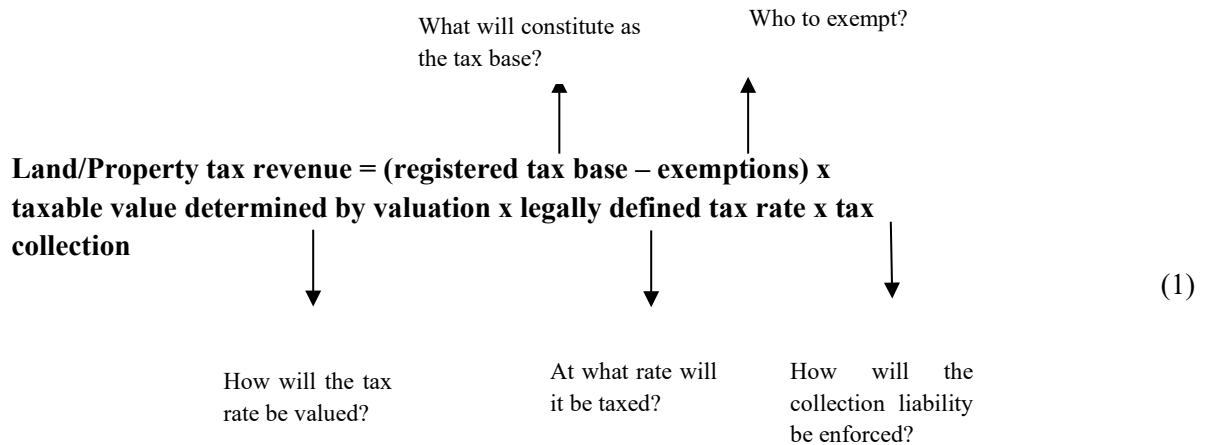


Note: Figures for categories F and G are not presented here because a very small number of properties belonged to these categories in the database.

Source: E&T's property database

3. Problems with Punjab's Urban Property Tax Policy

The choice of policy variables and their implementation affects the performance of the property tax along several dimensions that are summarized in Eq. 1. This section discusses the problems with Punjab's property tax along the policy dimensions of valuation, rate setting and exemptions and analyzes their implications for tax utilization and equity.



Source: Wani et. al., 2020.

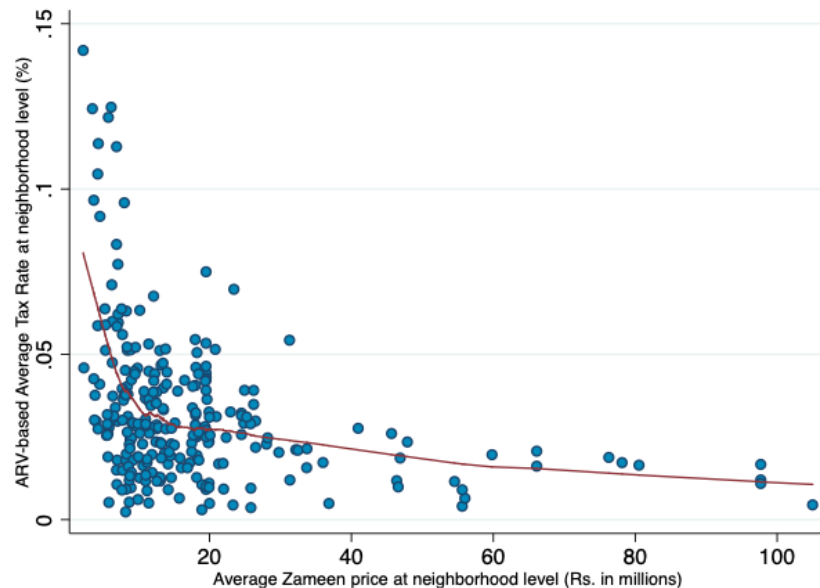
I. Valuation: Problems with the Current ARV Methodology

Several problems contribute to the underperformance of property taxes in Punjab, the foremost among these are related to the current valuation methodology. This methodology relies on presumptive annual rental values (ARV) being estimated on the basis of administratively costly door-to-door rental value surveys done by the E&T department. To be a good proxy for true rental value, the ARV requires a thick rental market and the government having access to rental contract data in high volume and at low cost. These conditions are not prevalent in Punjab. Analysis of E&T's property tax cadaster for Lahore shows that only 14 percent of properties are registered as purely rented, this low percentage raises the concern that the ARV's presumptive rental value estimates may not be a good proxy for rental values of properties. The low percentage of rented properties in the cadaster could reflect thin rental markets and/or the fact that the absence of a registry of rental contracts makes it easy for landlords and tenants to avoid revealing rental contracts. **The lack of availability of data on rental contracts makes it difficult for E&T's ARV estimates to reliably capture the changes in rental values within different locations and across different types of property.**

Figure 9 presents the correlation between property-level average tax rates, for residential properties, based on E&T's annual rental value estimates and property values listed on Zameen.com for 269 of Lahore's neighborhoods. We find that ARV-based average tax rates fall as the market value of residential properties in a neighborhood increases, suggesting that the current ARV methodology is vertically inequitable, and therefore, regressive. The figure also shows that the current ARV methodology is prone to horizontal inequity as there is considerable variation in the ARV-based average tax rates borne by property

holders in similarly valued neighborhoods. This provides strong suggestive evidence that E&T's ARV valuations are likely to exacerbate the problem of vertical and horizontal inequity in property valuations.

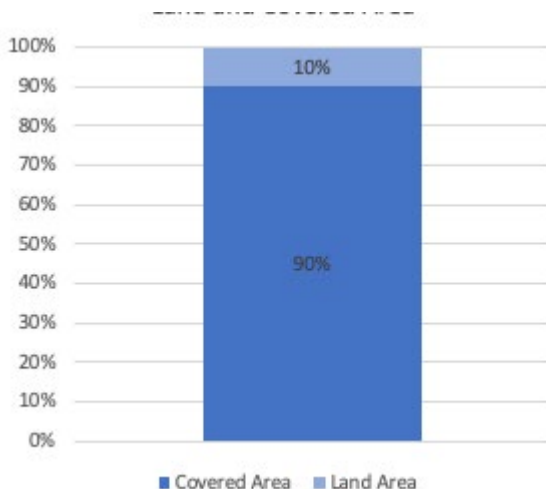
Figure 9: Relationship of average tax rate with average Zameen price (Residential)



Source: E&T's property database, Zameen.com property listings (2018-19)

The current valuation formula adversely affects utilization and tax equity by under assessing the contribution of land area to a property's value. Figure 10 shows that the current valuation formula assigns a disproportionately higher weight to the built area of a property. This is likely to worsen tax equity by lowering the effective tax rate on high value properties built on large parcels of land and high value vacant parcels of land. It is also affecting utilization because tax inspectors don't appear to be allocating sufficient effort to monitor changes in the land use of vacant plots. A survey of 991 properties in the low-, medium-, and high-density areas of Lahore conducted by the authors in 2022 shows that the largest mismatch between the information recorded in the E&T cadaster and that collected in the survey relates to property usage. This mismatch was primarily driven by structures having been constructed on plots that are recorded as vacant in the cadaster.

Figure 10: Relative weights assigned to land and covered area in the valuation formula



Source: E&T's property valuation table

Another problem with the current valuation is the long lag in property revaluations. The law requires the E&T to conduct new valuations with a gap of at least 5 years and this lowers the buoyancy of the tax by design. In practice, political governments tend to delay revaluations for much longer than 5 years to avoid political backlash. There have only been two property tax valuations in Punjab in the past twenty years. The increase in taxes that was to result from the 2013-14 revaluation still hasn't been fully realized because the increase in property values following the revaluation has still not been fully passed through to taxpayers. Interviews with politicians and E&T officials suggest that political governments are reluctant to implement steep increases in property values that are a consequence of revaluations being conducted with a lag and this creates incentives to delay the passthrough after a revaluation.

The ARV methodology makes it difficult for the provincial government to develop a harmonized policy for all property-related taxes. This is because the non-recurrent taxes on property (stamp duty, tax on transfer of immovable property and capital value taxes) use DC-rate assessments of property values as their base, instead of rental values. Similarly, federal property-related taxes use FBR-assessed property values instead of rental values as their base. This makes it challenging for the government to set a harmonized policy for property-related taxes that would allow it to reduce distortions in the property market, which result from overlapping recurrent and non-recurrent property tax regimes.

II. Problems with Tax Rates and Rate-Setting Powers

The problem of low utilization is worsened by the government applying relatively low tax rates to an inert base that is not effective at capturing the current market value of properties. Currently, the E&T is applying a tax rate of 5 percent on properties within localities that fall under its jurisdiction in Lahore, compared to a tax rate of 15 percent that is applied by the Lahore Cantonment Board on equivalently valued properties under its jurisdiction. It is not surprising that governments servicing these localities are unable to provide services at the same standard as the Cantonment Boards.

Shared rate-setting powers between the provincial assembly and the local councils weaken fiscal accountability of local governments. As property tax is a local tax, political accountability is stronger when local governments have the power to set the rate of taxation on the margin, within brackets determined by the provincial government (Ahmad & Brosio, 2022). Devolved rate-setting powers are an important precondition for hard budget constraints at the local level. However, under Punjab’s existing system, a fixed flat rate of 5% on ARV has been enacted by the provincial assembly as part of the UIPT Act. Although the local government law allows local councils to alter the provincially set property tax rate, there is no requirement in this law for local councils to pass a rate-setting motion as part of the budget process. Interviews with local and provincial politicians and E&T and local government officials reveal that local councils are reluctant to exercise their power to set the tax rate in the presence of a low provincially set rate. This means that local governments in Punjab do not set the rate or the base, which in effect makes property tax revenue a provincial transfer to local governments, weakening the fiscal and accountability benefits that are associated with own-source taxation (Gadenne, 2017).

The current property tax valuation tables worsen tax equity by giving a per unit tax rate discount to properties with large land and built areas within a tax value band. Figure 11 shows that the current policy gives a 20 percent discount in the per unit tax rate applied to the land area of a property in excess of 500 square yards and built area in excess of 3,000 square feet. This policy is likely to worsen tax equity because property size is correlated with property value within localities.

Figure 11: Official valuation table based on the Annual-Rental Value (ARV) system

VALUATION TABLE									
COMMERCIAL									
Category		Rented				Self			
		Rate of Land Sq. Yd. (In Rs.)		Rate of Covered Area in Sq. Ft (In Rs.)		Rate of Land Sq. Yd. (In Rs.)		Rate of Covered Area in Sq. Ft (In Rs.)	
		Upto 500	Exceeding 500	Upto 3000	Exceeding 3000	Upto 500	Exceeding 500	Upto 3000	Exceeding 3000
A	Main	120	96	120	96	24	19.20	24	19.20
	Off	96	76.80	96	76.80	19.20	15.36	19.20	15.36
B	Main	80	64	80	64	16	12.80	16	12.80
	Off	64	51.20	64	51.20	12.80	10.24	12.80	10.24
C	Main	56	44.80	56	44.80	11.20	8.96	11.20	8.96
	Off	44.80	35.80	44.80	35.80	8.96	7.17	8.96	7.17
D	Main	40	32	40	32	8	6.40	8	6.40
	Off	32	25.60	32	25.60	6.40	5.12	6.40	5.12
E	Main	30	24	30	24	6.00	4.80	6.00	4.80
	Off	24	19.20	24	19.20	4.80	3.84	4.80	3.84
F	Main	20	16	20	16	4.00	3.20	4.00	3.20
	Off	16	12.80	16	12.80	3.20	2.56	3.20	2.56
G	Main	15	12	15	12	3.00	2.40	3.00	2.40
	Off	12	9.60	12	9.60	2.40	1.92	2.40	1.92
RESIDENTIAL									
Category		Rented				Self			
		Rate of Land Sq. Yd. (In Rs.)		Rate of Covered Area in Sq. Ft (In Rs.)		Rate of Land Sq. Yd. (In Rs.)		Rate of Covered Area in Sq. Ft (In Rs.)	
		Upto 500	Exceeding 500	Upto 3000	Exceeding 3000	Upto 500	Exceeding 500	Upto 3000	Exceeding 3000
A		23	18.40	23	18.40	4.60	3.68	4.60	3.68
B		17	13.60	17	13.60	3.40	2.72	3.40	2.72
C		14	11.20	14	11.20	2.80	2.24	2.80	2.24
D		11	8.80	11	8.80	2.20	1.76	2.20	1.76
E		8.20	6.56	8.20	6.56	1.64	1.31	1.64	1.31
F		6.50	5.20	6.50	5.20	1.30	1.04	1.30	1.04
G		4	3.20	4	3.20	0.80	0.64	0.80	0.64

Source: E&T official notification SO.TAX. (E&T) 3-38/2014, 2014

III. Widespread use of area-based exemptions

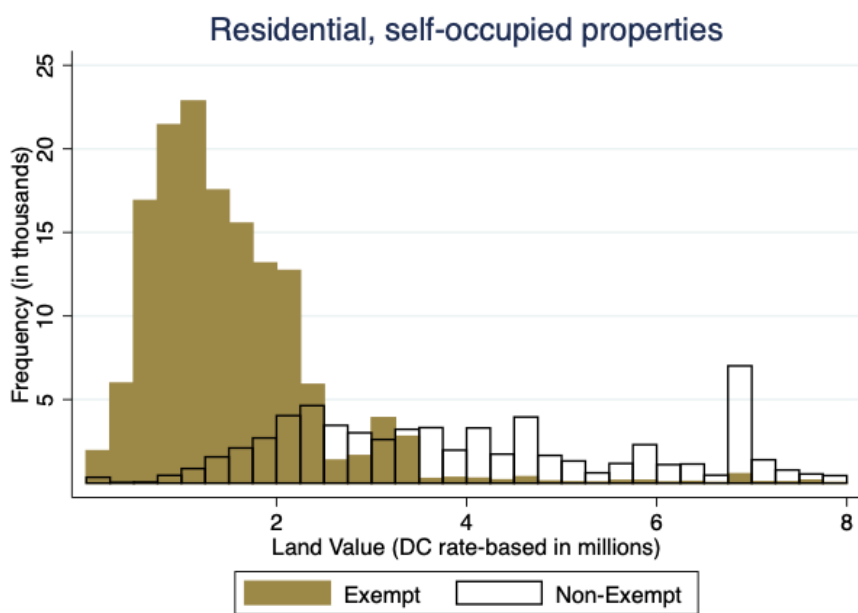
Exemptions not only distort the choice of location and the economic behavior of taxpayers; they also impose a disproportionate burden on certain sets of taxpayers. If property taxes are seen as a “benefit tax” (Ahmad et al., 2019) - where the property tax is a user fee paid by residents for the use of municipal services - exemptions for small houses, government offices, schools, and religious institutions shift the burden of user fees that they should be paying for the services they receive to other non-exempt taxpayers.

An analysis of E&T’s property tax cadaster for Lahore shows widespread use of area-based exemptions that exempt plots up to 150 square yards from property taxation irrespective of their value. The data shows that 45% (7.5%) of all properties in Lahore are fully (partially) exempted from property taxation and 65% of purely residential-use properties are fully exempted. Figure 12 plots the distribution of exempted and non-exempted, self-occupied, residential properties that fall in different DC-rate assessed property value bands.²⁸ It shows significant overlap between the values of exempt and non-exempt properties within DC-

²⁸ Please see Appendix B for details on how property is valued using DC-rate methodology.

rate bands. The area-based exemption on small-sized plots does not account for the “ability-to-pay” of taxpayers based on income and results in unjustified tax expenditure and a further erosion of horizontal tax equity.

Figure 12: Area-based exemptions under the current property tax code

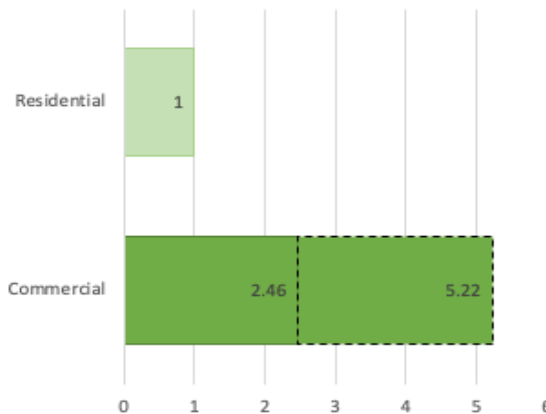


Source: E&T's property database, DC property valuation list (2018-19)

IV. Differential Tax Rates by Land Use

The current policy applies higher assessment factors to commercial properties, which increases their effective tax rate compared to residential properties. Effective tax rates for commercial properties are 2.5 to 5.2 times than residential properties depending on their property valuation band and location (Figure 13). Higher effective rates have been applied to commercial properties because they are assumed to have a higher ability to pay than residential, self-occupied properties.

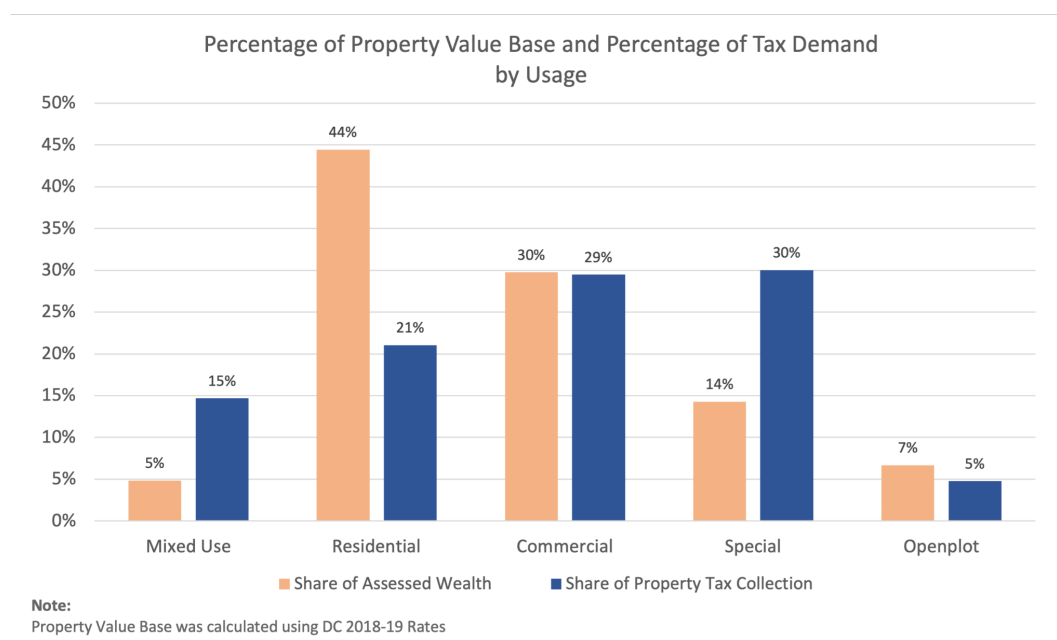
Figure 13: Effective tax rate differentials by usage



Source: E&T's property valuation table

Widespread exemptions and low rates on self-occupied residential properties and higher tax rates on commercial and special use properties have effectively made the UIPT a tax on commercial and special use properties in Punjab. Figure 14 compares the share of different types of properties in the assessed wealth base of Lahore with their share in the city's property tax liabilities. We estimate the city's assessed wealth by multiplying the land and built area of each property by the 2018-19 DC-assessed values and aggregating the values for all of Lahore's properties in E&T's property tax cadaster. The share of different types of properties in aggregate tax liabilities in Lahore is calculated for 2021-22. The figure shows that nearly three-fourths of Lahore's property tax is contributed by commercial, special, and mixed-use properties. It also shows that residential properties contribute a much smaller share to property tax liabilities than their share in Lahore's assessed wealth base.

Figure 14: The Share of Different Properties in Lahore's assessed wealth and property tax liabilities



Source: E&T's property database, DC property valuation list (2018-19)

Widespread exemptions and lower rates on high value residential properties is an important cause of the low utilization of the property tax base. It may also compromise the benefit principle to the extent that it shifts the burden of financing municipal services in residential areas to owners of commercial and special properties. From an economic perspective, taxing commercial properties is distortionary, because it raises the cost of business as property is an input into the productive process of a business. Taxing commercial activities at high rates is likely to distort the choices businesses make about inputs into the production process and these economic costs need to be considered when setting differential rates for commercial and special use properties.

V. Differential Tax Rates by occupancy

Under the current policy, rented properties are taxed at higher rates compared to self-occupied properties. The difference in rates between self-occupied and rented properties currently stands at 1:5 (Figure 15). Higher rates have been applied to rented properties to bring untaxed rental income into the revenue net. However, senior tax officials are concerned that this benefit is not being realized because it is easy for taxpayers to conceal rental contracts and avoid the tax. This differential also results in double taxation on taxpayers who are declaring their rental income for income tax purposes. This policy is particularly onerous for income tax compliant asset-rich/cash-poor individuals who are dependent on rents as an important source of income.

Figure 15: Rate differentials by occupancy



Source: E&T's Property valuation table

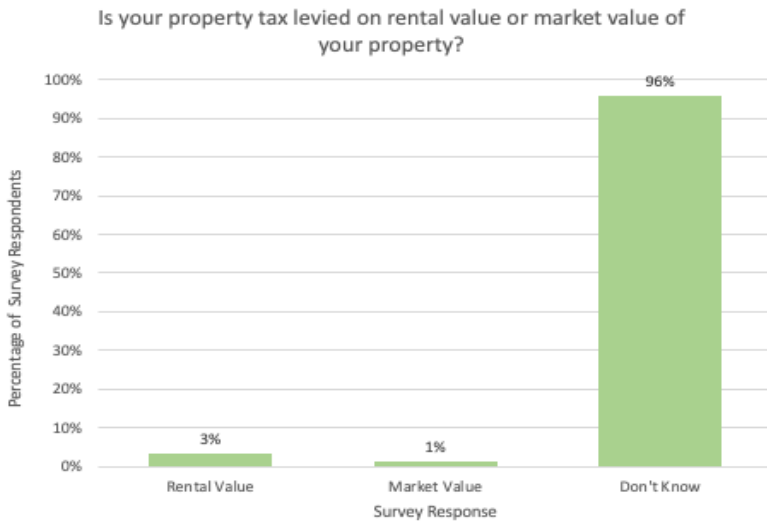
VI. Citizens' poor understanding of the tax system

Taxpayers' ability to understand the tax system is considered an important factor for fiscal accountability and voluntary compliance (Taylor, 2002; Cvrlje, 2015; Machgu & Amayi, 2013). Our 2022 survey of 604 property taxpayers in the low, medium, and high-density areas of Lahore reveals that taxpayers have a poor understanding of Punjab's property tax system. The survey assesses taxpayer knowledge by asking them questions about the basis of valuation; whether the tax base consists of only land, built area or both; and the rate differential by usage and occupancy.

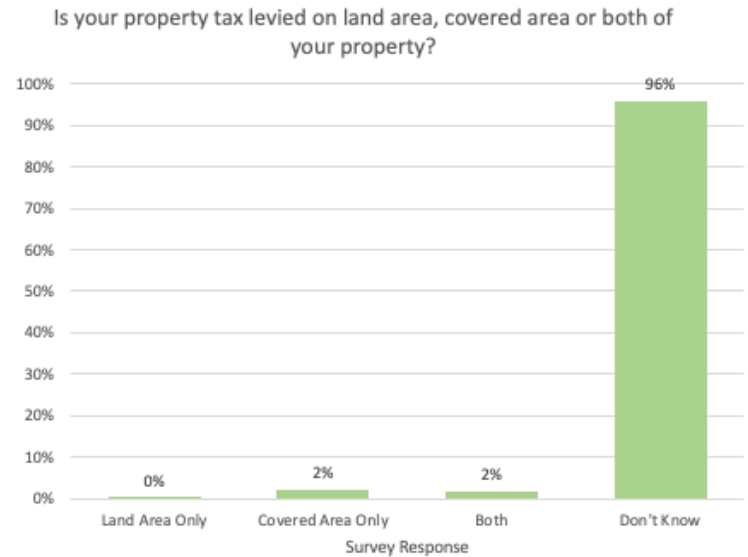
Only 3% of our survey respondents knew that their property tax valuation was based on presumptive rental values (Figure 16, Panel A) and 96% of respondents did not know the basis of valuation used to compute their taxes (Figure 16, Panel B). Similarly, 96% of our respondents did not know whether the base consisted of land area, built area or both.

Figure 16: Taxpayer knowledge about the:

Panel A: Valuation



Panel B: Property tax formula

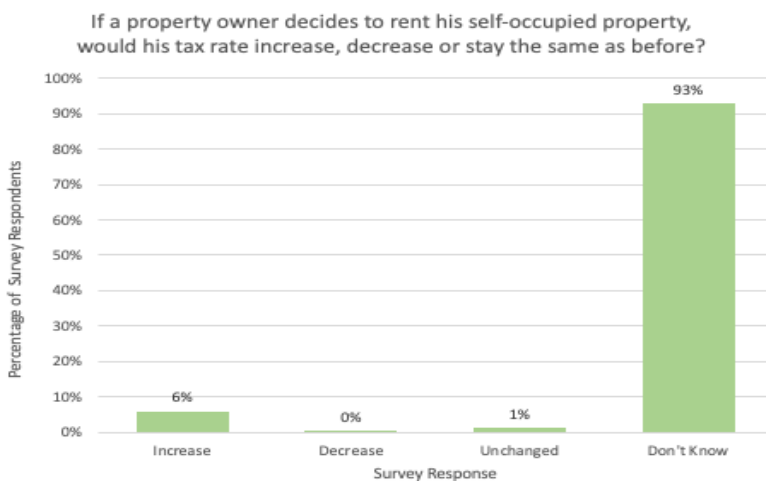


Source: IDEAS-LUMS Property Tax Survey 2022 Pilot. Total number of surveys: 991

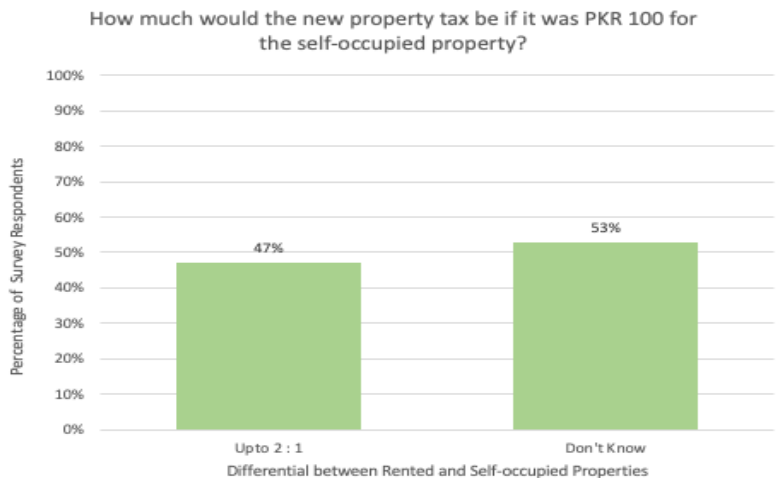
An extremely small number of respondents knew about the differential rates on rented and self-occupied properties (Figure 17, Panel A) and no one, among those who knew, was able to report the current differential correctly (Figure 17, Panel B).

Figure 17: Survey respondents' knowledge of rate differentials by occupancy

Panel A



Panel B



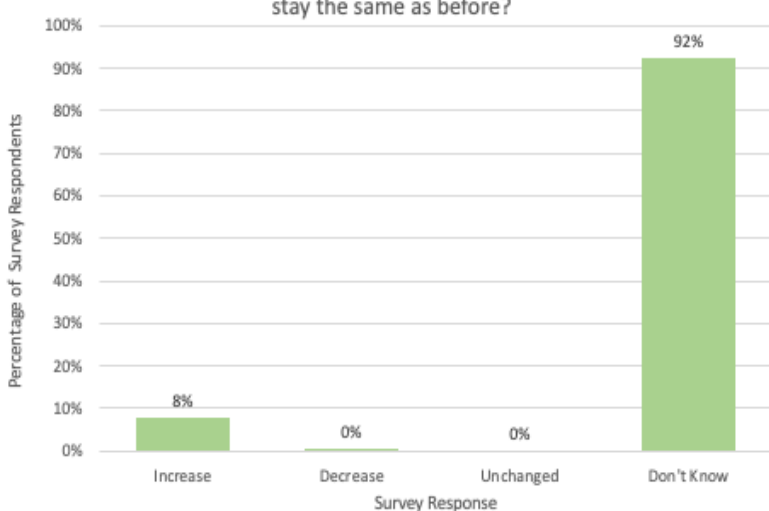
Source: IDEAS-LUMS Property Tax Survey 2022 pilot. Total number of surveys: 991

There was a similar lack of knowledge among taxpayers about differential rates between commercial and residential properties (Figure 18). These findings suggest that taxpayers lack a good understanding of the main policy parameters, and the concern is that this is likely to erode fiscal accountability.

Figure 18: Survey respondents' knowledge of rate differentials by usage

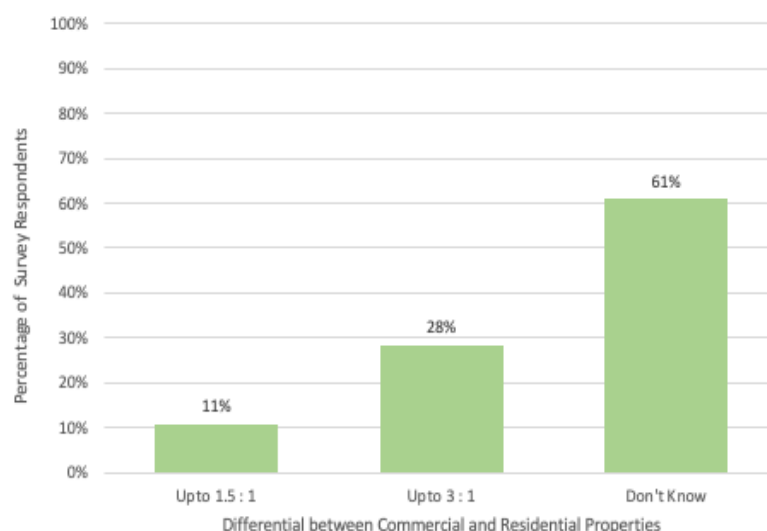
Panel A:

If a property owner decides to rent his residential property for commercial purposes, would his tax rate increase, decrease or stay the same as before?



Panel B:

How much would the new property tax be if it was PKR 100 for the residential property?



Source: IDEAS-LUMS Property Tax Survey 2022 pilot. Total number of surveys: 991

VII. Distortions due to the duality in revenue and expenditure functions at the local level

The structure of urban local governance in Punjab and Pakistan has created a system of partial decentralization by institutionalizing a duality in revenue and expenditure functions (Haque 2020, Cheema 2020). Currently, the responsibility for delivering municipal functions, such as land use, building controls and water and sanitation, is divided between provincial development authorities, municipal agencies of the province and urban local governments. This duality makes it difficult for urban local governments to respond to the service delivery needs of their voters and taxpayers. Similarly, part of the productive tax base of cities remains under the control of development authorities and cantonment boards. The loss of productive tax bases by local governments creates a mismatch between their expenditure and revenue assignment and makes them dependent on provincial transfers (Haque 2020, Cheema 2020).

The devolution literature shows that partial decentralization – where expenditure decentralization is not complemented by strong own-source revenue bases – can weaken local government accountability and lead to poor service delivery outcomes (Khemani 2015, Devrajan et al. 2009). The literature suggests that partial decentralization weakens accountability because citizens are not directly bearing the costs associated with their local service provision, or because the agency that is responsible for delivering services against their taxes is not politically accountable to the electorate of the local area.

The literature also argues that duality in functional assignments weakens the benefit linkage associated with property taxes, whereby a citizen pays taxes and receives an identifiable benefit in terms of public goods and services (Ahmad and Brosio 2022, Khwaja et. al. 2020). Khwaja et al.'s (2020) large-scale survey of property taxpayers in metropolitan Punjab shows that urban taxpayers in the province perceive benefit linkages associated with taxation to be weak and this friction may be lowering trust in the fiscal system.

4. Getting the Property Tax Back on Track: Future Policy Directions

Getting the property tax to generate sustainable financing for urban public investments in an equitable manner requires policymakers in Punjab to reform the existing policies of valuation, rate-setting, and exemptions. This section discusses different reform options in each of these areas and identifies the most appropriate pathways, given Punjab's existing administrative capacity and information infrastructure.

I. Reforming the Valuation Approach

The introduction of an effective valuation system is the most critical component of property tax policy reform in Punjab. The current ARV system is adversely affecting tax equity and utilization and making it difficult for the government to develop a harmonized policy for property-related taxes. There are several methods of valuation used around the world, but they broadly differ by whether they value the tax base in terms of the market value of properties ("value-based approaches") or in terms of their physical characteristics ("area-based approaches").

The main value-based approaches differ in whether they tax the **capital or rental value** of properties. **Capital value tax** values the tax base in terms of the market value of land and building improvements (Ahmad & Brosio, 2022; Wani et al., 2020; McCluskey, 2008). **Rental value tax** uses the market-based rental value of properties as a base rather than their capital values. Value-based approaches aim to capture the capitalization of the benefits of public investment in the market or rental value of properties. They work well where the valuation method is able to assess the market value of properties with accuracy. Countries with sophisticated administrations use Computer Assisted Mass Appraisal (CAMA) methods and economic modeling to determine the market prices of properties from the actual sales of a representative sample of properties. Countries with less sophisticated capacity use the traditional cadastral method that employs surveyors and tax officials to assess the market price of properties (Ahmad & Brosio, 2022).

Table 1: Trade-offs between different valuation systems and an assessment of Punjab's system

Type of assessment	Accuracy	Data requirements on transactions	Data requirements on land contents/ characteristics	Estimation capacity required	Transparency
Capital Value Tax	High – though requires regular reassessments	Significant (on asset transactions)	High for greater accuracy	Significant	Can be low
Rental Value	High (where rental values are available and rent controls are not applied)	Significant (on rental transactions)	High for greater accuracy	Significant	Can be low
Points-based system	Medium (depending on calibration to market values and number of proxies included)	None needed though helps in accuracy	Depends on number of proxies	Medium	High if a few easily understood proxies are used
Area-based	Low	None	Limited	Limited	High
Punjab's current ARV system	Low	None	Medium because requires data on use and occupancy status	Significant because it requires regular field-based reassessments by E&T staff	Low because taxpayers have a poor understanding of the ARV base and formula

Source: Wani et.al. (2020) and the authors

Value-based approaches are able to capture the market value of a property with accuracy in contexts with vibrant real estate markets and easily available data on a high volume of property or rental transactions. There are significant administrative costs associated with these approaches as they require regular reassessments and are demanding in terms of data requirements for property or rental transactions and the physical characteristics of properties (Table 1). They also require a significant investment in valuation and estimation capacity, and this is why they have been difficult to implement in developing country contexts (Ahmad & Brosio, 2022; Collier et al., 2018). Complicated estimation models make this approach difficult for taxpayers to understand and this makes the valuations less transparent.

The **simplest area-based approach** taxes properties based on their surface area by applying a fixed rate per unit of land and/or structure. This makes the approach highly transparent, and its effective implementation does not require sophisticated administrative capacity. However, the simple approach does not do well in terms of the accuracy of valuation or tax equity (Table 1). A **hybrid points-based system** is another area-based approach that uses surface area, location and other characteristics of properties that are effective predictors of property value to measure the tax base. It does better on accuracy compared to the simple approach because it combines area and capital-based valuation methods (Ahmad & Brosio 2022; Wani et al., 2020; Collier et al., 2018). It also does well on transparency without requiring the existence of sophisticated data infrastructure and estimation capacity (Table 1). **The hybrid approach is the most feasible approach for Punjab to follow given the current capacity of its property tax administration.**

The challenge is that Punjab already uses a hybrid points-based approach that uses a property's surface area, use, occupancy, contiguity to a main road and determines progressivity by assigning each property to 8 different location bands. However, this approach does not perform well on utilization and equity because the accuracy of assessments is low. This is because Punjab's current ARV system basis the values of the 7 different location bands on rental values estimated from E&T's rental value surveys. Using presumptive rental values is effective in contexts where a high proportion of properties are rented, and data is easily available on these properties. However, this is not the case in Punjab where there is no centralized database of rental contracts and only a small proportion of properties are declared as rented in the official record. **Punjab's current hybrid approach is also administratively costly as it requires regular reassessments by E&T, and it is not transparent to taxpayers (Table 1).**

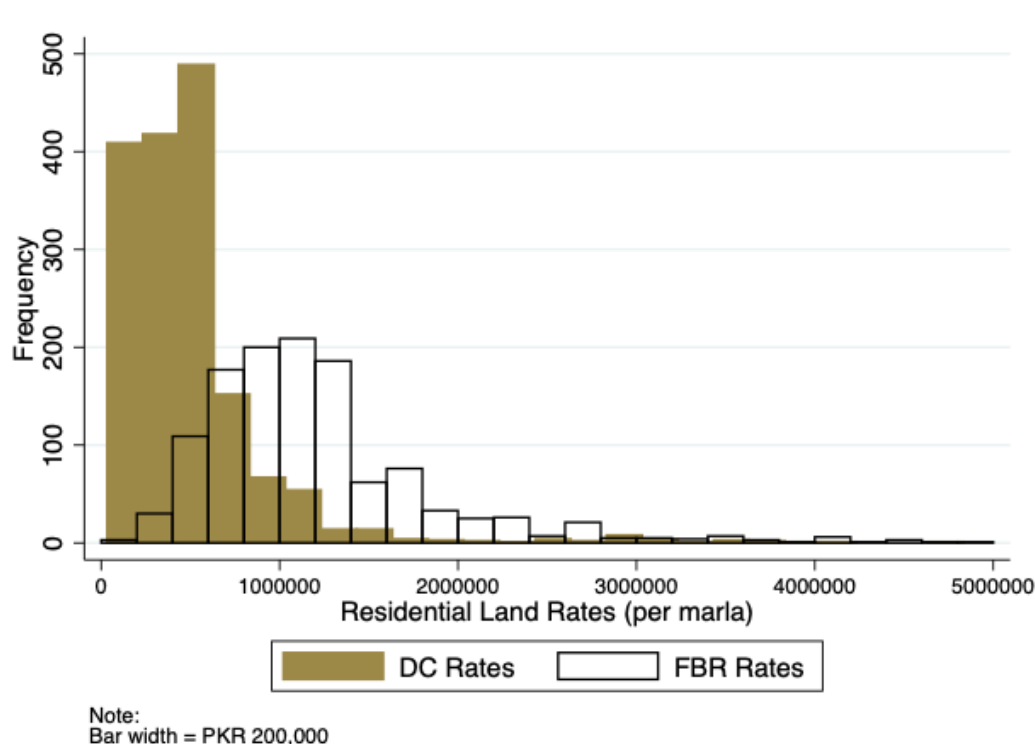
The effectiveness of the hybrid approach in Punjab can be improved by determining the value of location bands according to their current DC-assessed capital values and shifting away from the ARV system. This is possible in Punjab given investments made during the last decade in the digitization of properties and property sales transactions and e-stamping for the purposes of determining non-recurrent stamp duty, as well as a more regular updating of annual DC-assessed valuations. This reform can be complemented by basing annual adjustments to tax liabilities between reassessments on the year-to-year increase in the cost of living to ensure steady growth. Indexing will ensure buoyancy in the event that political economy constraints lead to delays in DC-based reassessments.

Shifting to a capital value system will allow the government to develop a harmonized policy for all property-related provincial taxes that aims to minimize the distortions in the property tax market that result from overlapping recurrent and non-recurrent property tax regimes. It will also

be more transparent as DC-rates are understood by taxpayers because they are used in the valuation of a number of non-recurrent provincial property taxes and duties.

The benefits of this transition can be increased by investments in strengthening DC-rate assessments of capital value that are used as the basis of assessments by the e-stamping system. Evidence from a comparison of property values listed on Zameen.com and the values given in the DC-rate list for 306 localities of Lahore indicates that the latter is capturing well below half of the market value of properties. Furthermore, a comparison of the 2021-22 DC values for Lahore with property values notified by the Federal Board of Revenue (FBR) for the city's localities in 2022 shows that FBR values are not only higher, but they also capture greater variation in property values within the city (Figure 19). This suggests that strengthening the DC-rate assessment's valuation and estimation capacity promises significant dividends in terms of improving the accuracy of the hybrid approach.

Figure 19: Comparison of properties valued through FBR and DC-based systems



Source: FBR Property valuation list, DC Property valuation list 2021-2022

II. Reforming Rate Setting Powers of the Provincial Assembly and Local Councils

The essence of accountability in a decentralized system involves local councils setting tax rates at the margin; this indicates whether the property tax is an own-source revenue and can be leveraged to access private finances to fund public investments (Ahmad & Brosio, 2022; Gadenne, 2017). The current system in Punjab involves shared rate-setting powers between the provincial assembly and local councils. It has created an equilibrium where neither has an incentive to change the current tax rate which has been legislated as part of the UIPT law. **Accountability will be strengthened if UIPT reforms do away with the power of the provincial assembly to set a flat tax rate as part of the UIPT law. In addition, the local government law should require the provincial finance commission to determine progressivity by establishing different tax rate bands for the property tax with local councils required to set rates within these bands as part of their budgetary process.** Ideally property tax rates should be in sync with resident incomes, and they should not force fire sales (Haque 2020).

III. Reforming the Exemptions Regime

Exemptions are usually introduced to provide tax relief to taxpayers who do not have the ability to pay the taxes. However, as discussed in the previous section, existing exemption rules are creating distortions and unjustified tax expenditure. Basing exemptions on value rather than size irrespective of the property's location has the potential to increase tax equity and utilization.

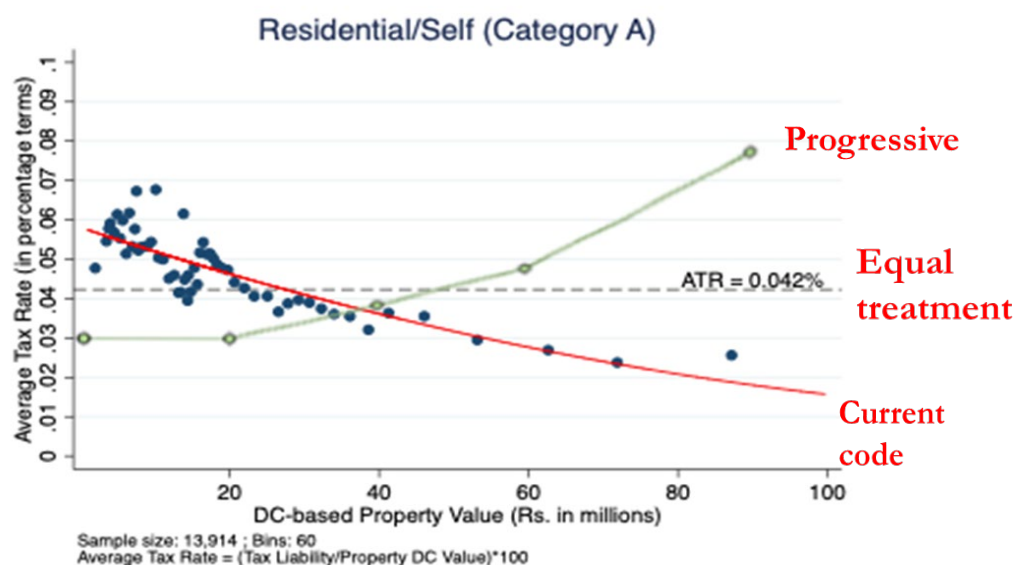
A key challenge for recurrent policy tax reform is the political opposition from groups that own high value assets but do not earn commensurately high income, such as certain retired individuals, pensioners, or low-income earners (Ahmad & Brosio, 2022; Collier et. al., 2018). This makes it hard for them to pay the tax. This problem can be addressed by introducing tax deferral schemes, which cap the annual property tax paid by these groups, with the outstanding tax liability adjusted at the time of transfer or sale of the property. Alternatively, this challenge can be addressed by targeted tax relief programmes that give low-income individuals tax credits that can be claimed as an adjustment in their income tax returns. The federal government can refund these credits and an adjustment can be made in resources being transferred to the provincial government. The FBR will benefit from the better information on property assets and from stronger incentives for taxpayers to file income tax returns. These measures will lead to cost-saving in terms of eliminating broad-based homestead exemptions and will reduce horizontal inequity in the property tax system.

IV. Addressing Tax Equity

The regressivity in Punjab's property tax regime can be addressed by abolishing the per unit tax rate discount enjoyed by properties with large land and built areas. The current system can be made more progressive by shifting to an equal treatment schedule that applies the same average tax rate irrespective of a property's value in a given tax band, or to a progressive schedule that increases the average tax rate with the value of properties. Figure 20 shows what the shape of the existing tax schedule looks like in terms of

the relationship between the average tax rate and DC-assessed tax values for residential self-occupied properties in the category A band. It also shows how the shape of the schedule would change if the government were to adopt an equal treatment or a progressive schedule. To minimize public backlash to reform, it is important to generate evidence to understand the fairness preferences of taxpayers and see if they prefer an equal or progressive rate structure. **An area of future analytical work is for the government to use taxpayer surveys to elicit taxpayers' preferred tax schedule and use this evidence to inform the deliberations about the setting of rates and bands in the relevant forums.**

Figure 20: Making Punjab's property tax more progressive



Source: E&T's Property Database, DC Property Valuation List (2018-19)

The tax code can be made more progressive by giving a higher weight to land area in the reformed valuation formula. The lower weight on land in the current code results in lower tax rates being applied to unused or undeveloped land and this is likely to create perverse incentives to use land inefficiently and for enforcement efforts by tax inspectors.

V. Differential tax rates on Occupancy and Use

Punjab's current tax code taxes owner-occupied housing at a higher rate than rental housing. The rationale for differentially taxing rental housing is based on the argument that it is an investment good that provides an income stream for the owner, in addition to the consumption benefits enjoyed by the tenant. However, owner-occupied housing also involves these features as it is also an asset and a consumption good for the owner. **The differential treatment between owner-occupied and rental housing creates a distortion in favour of owner-occupied housing and is possibly leading to under declaration of rental contracts. Ideally, treating all owner-occupied and rental housing consistently as a form of consumption and a**

type of investment good will remove these distortions. However, the government could also use taxpayer surveys to elicit taxpayer preferences about differential treatment. The government should also use analytical work to determine the extent of tax avoidance associated with differential taxation of rental incomes and estimate the burden and costs of the double taxation of rental incomes.

Punjab's current code also taxes commercial and residential properties at differential rates. Commercial property is an input into the productive process of a business and taxing it may create distortions in its production decisions. However, commercial properties also create congestion that places stress on the existing municipal infrastructure, which provides a rationale for taxing them at a higher rate. **It is important for the government to conduct analytical work to assess the cost of the economic distortions associated with differential rates being applied to commercial properties in the current code and assess if they require rationalization.**

VI. Lowering Administrative and Compliance Costs

A shift from ARV to the DC-based assessment as the basis for valuation for the hybrid points-based system will help reduce the administrative costs of the system. It will do this by eliminating the burden on the E&T for conducting regular revaluations. The shift to DC-assessed values will not add to the administrative burden as these assessments are already done regularly for non-recurrent provincial property taxes and duties.

International evidence shows that a combination of the satellite-based monitoring of size and location for the hybrid points-based valuation with a relatively simple door-to-door verification process can significantly reduce administrative costs (Ahmad and Brosio 2022, Collier et. al. 2018). This will, however, require the government to use a few meaningful and verifiable parameters of properties, such as area and location, in the points-based valuation.

The government can also reduce the compliance costs for taxpayers by institutionalizing the self-declaration of the parameters used in the points-based system and complement this with random audits based on satellite technology and simple field-based verifications. This will decrease taxpayer costs by creating an arm's length relationship between them and tax collectors. **The current state of poor taxpayer knowledge suggests that compliance costs can also be reduced by instituting a meaningful taxpayer education program that provides information about property tax policy.**

VII. Strengthening the benefit linkage of property taxation:

Strengthening fiscal accountability and the benefit linkage of property taxes requires ending the duality in local revenue and municipal functions. This would mean bringing development authorities and provincial agencies discharging overlapping local functions under the control of their respective urban local governments. While this principle was institutionalized as part of Punjab's Local Government Acts of 2019 and 2022 – passed by the PTI and PML-N governments, respectively – it has not been operationalized in practice.

Earmarking property tax revenues is an instrument that has been used by governments to strengthen the benefit linkage, particularly in contexts with weak fiscal accountability (Ahmed and Brosio 2022, Prichard et. al. 2019). England has a long history of using earmarking for property taxes and it has also been recently used in Bangalore India, Korea, and Ghana (Ahmed and Brosio 2022, Prichard et. al. 2019, Bird and Jun (2005). Earmarking can range from simple declarations to formal legal commitments by the government to tie specific revenues to the provision of key services or spend a share of the revenue collected from a local area to finance services in it (Khwaja et. al. 2020, Prichard et. al. 2019). However, the evidence on the success of earmarking is limited (Prichard et. al. 2019) and it has risks associated with, e.g., an increase in fiscal inequity between local areas and the welfare losses associated with governments picking the wrong services for earmarking. **We would recommend that the government carefully pilots different designs of earmarking with independent oversight as policy, but uses well designed evaluations before institutionalizing the use of this instrument.**

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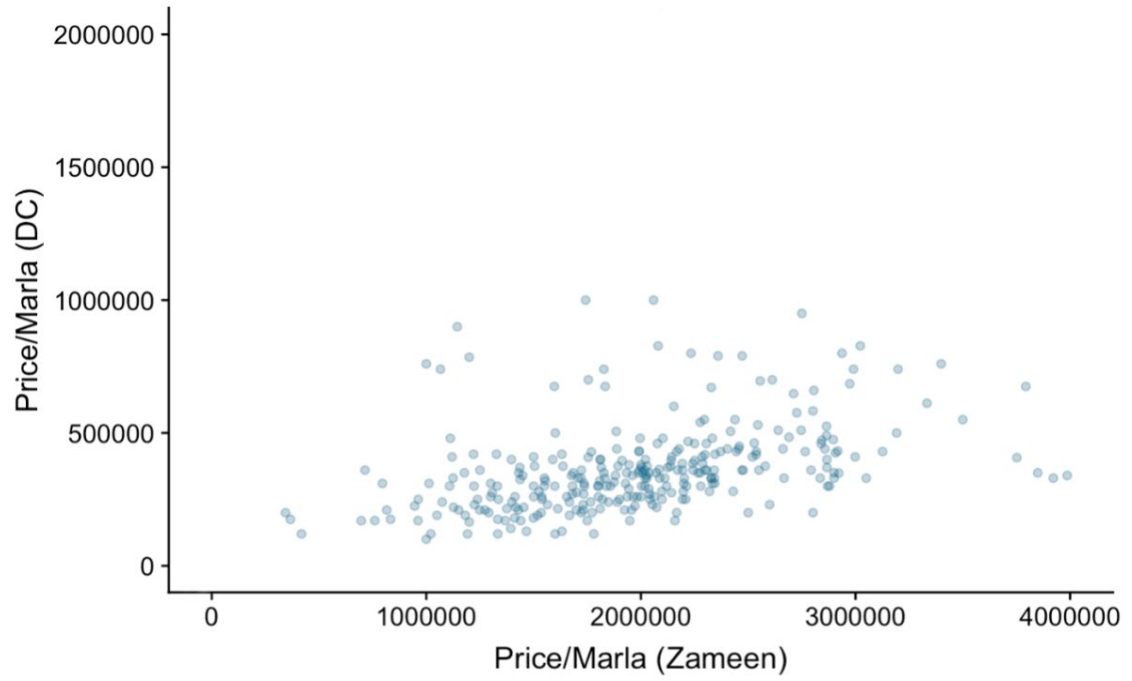
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Appendix A:

Figure A.1: Relationship of DC-based per marla prices with Zameen per marla prices



Source: DC Property Valuation List (2018-19), Zameen.com Property Listings (2018-19)

Appendix B:

Exhibit Box 1: Property valuation using DC-rate method

DC-based Property Value Calculation (2018-19)

Let's say there is a 10-marla residential house in Faisal Town, Lahore with a covered area of 3600 square feet.

This property's DC value will be computed as follows:

1. **Land Value**

DC land rate in Faisal Town = PKR 696,000/marla

Land value = $696,000 \times 10$
= PKR 6.96 million

2. **Structure Value**

DC structure rate in Faisal Town = PKR 880/sq ft

Structure value = 880×3600
= PKR 3.168 million

3. **Property Value**

Property value = land value + structure value
= $6.96 + 3.168$ million
= PKR 10.128 million

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