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

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- Currently, Punjab is struggling to meet its urban citizens' local service delivery needs. There are significant deficits in areas such as access to clean water, sanitation, local public transport, affordable housing, and pollution.
- Punjab's demographic transformation led to a rise in property values, which offers an opportunity to use property tax as an instrument of sustainable financing to meet the growing public service needs.
- The contribution of property taxes in Punjab at 0.05% of GDP is much lower than the average for low- and middle-income countries (LMICs). We analyse and compare the average tax rates for property holders occupying properties of different values in Lahore and find that these fall as the assessed values of properties increase within tax value bands.
- This policy brief explores some of the challenges related to Punjab's property tax, analyses their implications for tax utilisation and equity, and examines future policy directions.

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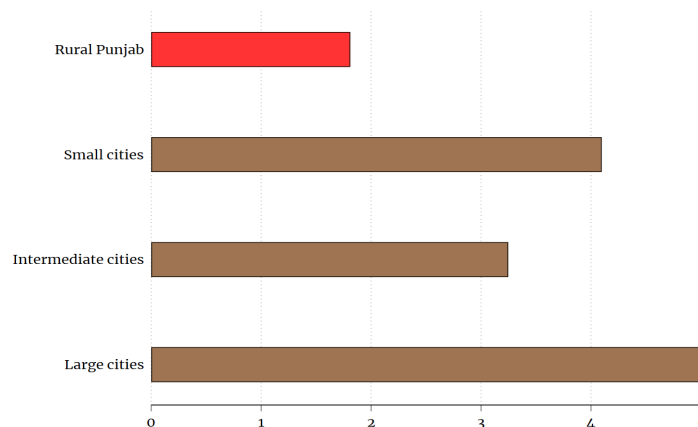


Urbanisation and local public service delivery gaps in Punjab¹

Punjab's urban transformation

Between 1998 and 2017, the number of people living in officially designated urban areas in Pakistan increased by thirty million, which is 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. Urbanisation in Punjab is not driven by the growth of a handful of large cities. Over time, urban areas have proliferated throughout the province. Figure 1 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 1: Annual population growth rate (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 one million as “large”. **Source:** Government of Pakistan Census 2017, Pakistan Bureau of Statistics.

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Urban local service delivery deficits in Punjab

Currently, Punjab is struggling to meet its urban citizens' local service delivery needs. There are significant deficits in access to clean water, modern sanitation, local public transport, affordable housing, and pollution abatement in Punjab's cities. Recent estimates suggest that 4 in 10 households in urban Punjab do not have toilets connected to sewers and a similar proportion lack access to underground and covered drains (Mansuri et.al., 2018). The 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 (Urban Unit, 2022).² Punjab's urban areas have emerged as global hotspots of air pollution (Greenstone & Fan, 2019) and there is evidence that modernising intra-city transport infrastructure promises significant labour market returns (Majid et. al., 2018). Local public investments directed toward closing these deficits promise substantial benefits in terms of citizens' liveability, health, and livelihoods. Financing these local public investments is a major development challenge for Punjab's urban administrations and local governments. This challenge is likely to worsen over time, given Punjab's rapid pace of urbanisation, which will place additional stress on the local public infrastructure and lead to environmental degradation, with a direct impact on citizens' lives.

Property taxes as a source of finance for urban services: Potential and performance

Punjab's demographic transformation provides a real opportunity for it to capture the gains from urbanisation. One consequence of Punjab's urban transformation is the robust increase in land and property prices (Figure 2) due to population pressure in urban areas, the development of real estate markets and significant public investments. This 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.

² Based on the underlying assumption that one household requires one housing unit.

Figure 2: Percent increase in property values in Lahore (2013-18).



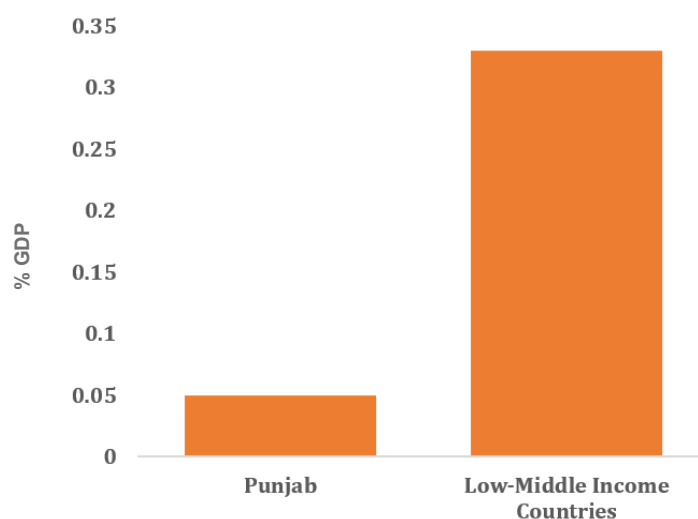
Source: (Wani et. al., 2020)

Understanding the performance of Punjab's property tax (see box for its features) in terms of utilisation and tax equity 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 urbanising population.

The utilisation of property taxes in Punjab

Figure 3 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).

Figure 3: Punjab's property tax utilisation compared to low-middle-income countries



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

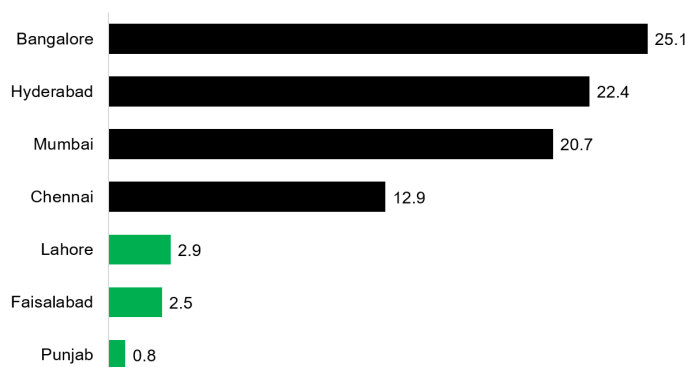
What is the Punjab urban property tax?

The Punjab property tax is an annual levy on urban properties across Punjab's officially designated rated areas 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. 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, as the provincial government at present determines the base and rate of the tax.

Property tax liability is assessed on the annual rental value (ARV) of properties and applies to both commercial and residential properties. The Punjab valuation system uses a banding system that places every property into one of seven tax value bands. Property tax valuation is not based on actual rental values. Instead, it uses presumptive rental values of the land and built areas of properties, which are based on periodic rental value surveys conducted by the E&T department.

Figure 4 shows that the utilisation 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).

Figure 4: Urban property tax collection per capita in South Asian cities (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 utilisation 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 utilisation. Figure 5 compares the property tax liability of two equally valued properties managed by the two taxation authorities in Lahore in 2021. The tax liability of the property regulated

by the E&T department is less than half the liability in areas under the jurisdiction of the Lahore Cantonment Board.

Figure 5: Tax utilisation 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**

Source: E&T and the Urban Unit

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**

Property tax equity in Punjab

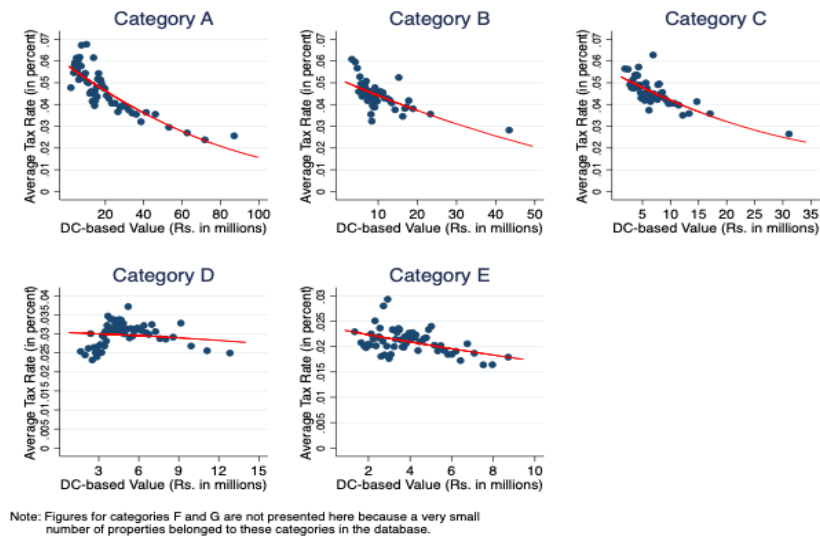
While data constraints preclude an exhaustive analysis of tax incidence, we provide suggestive evidence by analysing and comparing the average tax rates borne by property holders occupying properties of different values in Lahore, within a tax value band. We focus our analysis on the metropolitan city of Lahore, given its status as the most populous urban centre of Punjab, and its large share (40%) in Punjab's property tax collection.

Figure 6 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 properties³ 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 for residential properties in Punjab is regressive, with holders of higher-valued residential properties facing a lower tax rate on average. While the property tax

³ 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.

is regressive for residential properties, we do not find a similar pattern for commercial properties in Lahore.

Figure 6: Relationship of average tax rates with DC-based capital values (residential, self-occupied)



Source: E&T's Property Database

Problems with Punjab's urban property tax policy

This section discusses the problems with Punjab's property tax along the policy dimensions of valuation, rate setting and exemptions and analyses their implications for tax utilisation and equity.

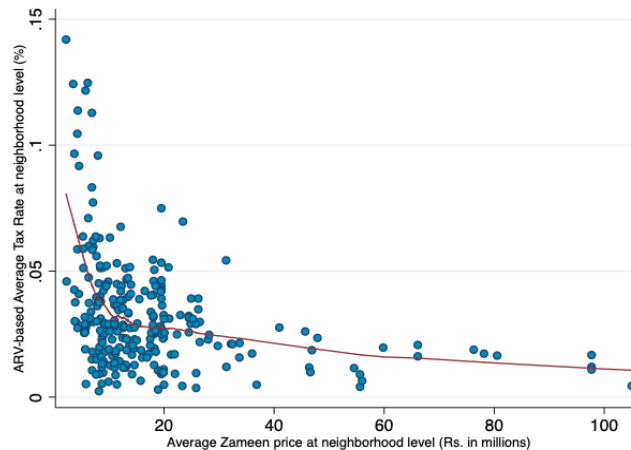
Valuation: Problems with the current ARV methodology

The current valuation methodology relies on presumptive annual rental values (ARV) estimates based on administratively costly door-to-door rental value surveys conducted by the E&T department. To be a good proxy for true rental value, the ARV requires a thick rental market and the government's access to data on a high volume of rental contracts at a low cost. These conditions are not prevalent in Punjab. Analysis of E&T's property tax cadastre 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 actual rental values.

Figure 7 presents the correlation between property-level average tax rates based on E&T's annual rental value estimates and property values listed on Zameen.com (Pakistan's largest real estate portal), for residential properties in 269 of Lahore's neighbourhoods in 2018-19. We find that ARV-based average tax rates fall as the market value of properties increases in a neighbourhood,

suggesting that the current ARV methodology is under assessing residential properties in high-value neighbourhoods and is therefore, vertically inequitable. 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 similarly valued properties.

Figure 7: Relationship of average tax rate with average Zameen price



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

The current valuation formula adversely affects utilisation and tax equity by under assessing the contribution of land area to a property's value. The current valuation formula assigns a disproportionately high weight to the built area of a property (90 percent). 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.

Additionally, the current valuation is based on a long time-lag in property revaluations. The law requires the E&T department to conduct new valuations with a gap of at least five years and this, by design, lowers the buoyancy of the tax. In practice, governments tend to delay revaluations for much longer than five years to avoid political backlash. There have only been two property tax valuations in Punjab in the past twenty years. 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.

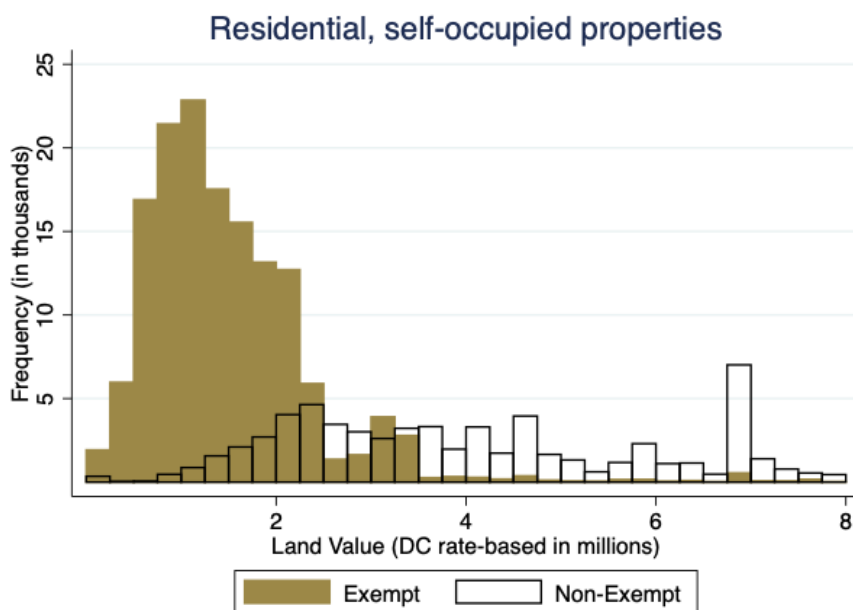
The ARV methodology makes it difficult for the provincial government to develop a harmonised policy for all property-related taxes that would allow it to reduce distortions in the property market resulting from overlapping recurrent and non-recurrent property tax regimes. This is because the non-recurrent taxes on property (stamp duty, tax on transfer of immovable property, capital

value and capital gains taxes) use DC or FBR assessments of property values as their base, instead of rental values.

Widespread use of area-based exemptions

An analysis of E&T’s property tax cadastre for Lahore shows the 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) exempt from property taxation and 65% of purely residential-use properties are fully exempted. Figure 8 plots the distribution of exempted and non-exempted, self-occupied, residential properties that fall in different DC-rate assessed property value bands. It shows the significant overlap between the values of exempt and non-exempt properties within DC-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 further erosion of horizontal tax equity.

Figure 8: 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

Punjab’s property tax policy is adversely impacting utilisation and tax equity by giving a per unit tax discount to holders of larger properties. Figure 9 shows that the current valuation table gives a 20 percent discount on per unit tax rates for properties with land area greater than five hundred square yards and/or built area greater than 3,000 square feet.

Figure 9: 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

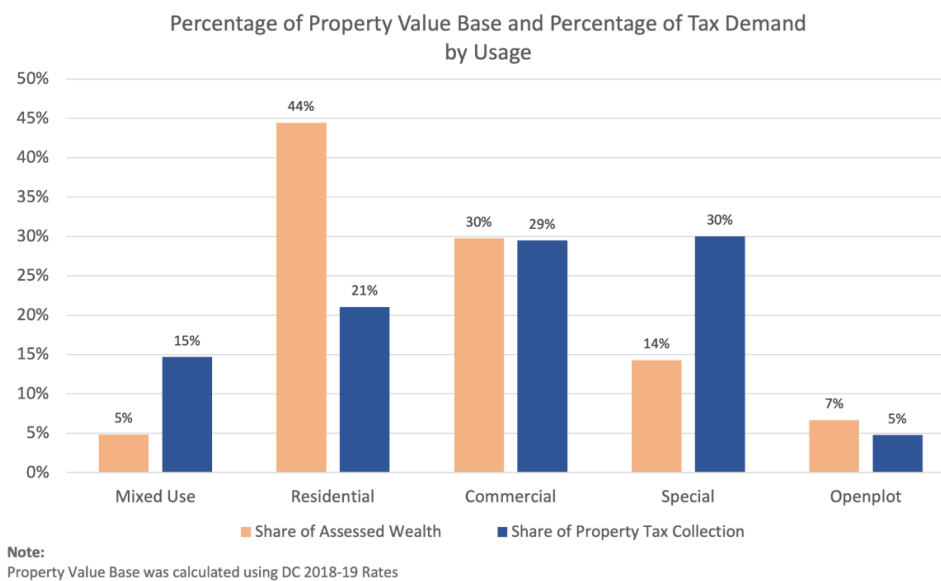
RESIDENTIAL									
Category		Rented				Self			
		Rate of Land Sq. Yd. (In Rs.)		Rate of Covered Area in Sq. Ft (In Rs.)		Rate of Land Sq. Yd. (In Rs.)		Rate of Covered Area in Sq. Ft (In Rs.)	
		Upto 500	Exceeding 500	Upto 3000	Exceeding 3000	Upto 500	Exceeding 500	Upto 3000	Exceeding 3000
A		23	18.40	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

Differential tax rates by land use

The current policy applies effective tax rates on commercial properties that are 2.5 to 5.2 times higher than residential properties, depending on their property valuation band and location. Higher effective rates are applied to commercial properties because their owners are assumed to have a higher ability to pay than owners of residential, self-occupied properties. This feature of the tax code combined with widespread exemptions on residential properties has effectively made the property tax a tax on commercial properties. Figure 10 shows that nearly three-fourths of Lahore's property tax is generated 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. This raises the concern that the current code may be weakening the benefit principle by placing a disproportionate burden of property taxation on owners of commercial properties and may be increasing social costs by distorting the economic choice of businesses.

Figure 10: 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)

Differential tax rates by occupancy

Under 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. The differential has been introduced to bring untaxed rental income into the revenue net. However, senior tax officials suggest that this benefit is not realised 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 taxpayers who are dependent on rent as an important source of income.

Problems with tax rates and rate-setting powers

Shared rate-setting powers between the provincial assembly and the local councils weakens fiscal accountability of local governments. As property tax is a local tax, political accountability is stronger when local governments have the power to set rates 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 levied 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 the law for local councils to pass a rate-setting

motion as part of the budget process. In practice, 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 are essentially not setting 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).

Citizens' poor understanding of the tax system

Taxpayers' ability to understand the tax system is considered a crucial factor for fiscal accountability and voluntary compliance (Taylor, 2002; Cvrlje, 2015; Machu & 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. Only 3% of our survey respondents knew that their property tax valuation was based on presumed rental values and 96% of respondents did not know the basis of valuation used to compute their taxes. Similarly, 96% of our respondents did not know whether the base consisted of land area, built area or both.

An extremely small number of respondents knew about the differential rates on rented and self-occupied properties and among those who knew, no one was able to report the current differential correctly. There was a similar lack of knowledge among taxpayers about differential rates between commercial and residential properties. These findings suggest that taxpayers lack an understanding of the main policy parameters, and the concern is that this is likely to erode fiscal accountability.

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

Punjab's local government structure involves a duality in revenue and expenditure functions at the local level (Haque 2020, Cheema 2020). The responsibility for 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 reduces local government mandates and weakens the benefit linkage associated with local taxes. Khwaja et. al (2020) show that urban property taxpayers in the Punjab find the benefit linkages associated with taxation to be weak and this friction may be lowering trust in the fiscal system.

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 assignments and makes them dependent on provincial transfers (Haque 2020, Cheema 2020). The devolution literature shows that partial decentralisation – where expenditure decentralisation is not complemented by strong own-source revenue bases – can weaken local government accountability and benefit linkages with adverse consequences for service delivery (Ahmed and Brosio 2022, Khemani 2015, Devrajan et al. 2009).

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 current framework of valuation, rate-setting, exemptions and local expenditure and revenue assignments.

Reforming the valuation approach

The introduction of an effective valuation approach is the most critical component of property tax policy reform in Punjab. The current valuation methodology, which relies on presumptive rental values (ARV) is likely to be inaccurate and distortionary in a context where data on rental contracts is thin. Moving to a hybrid points-based approach is the most feasible way forward for Punjab, given its current capacity for property tax administration. The literature suggests that a hybrid system that uses surface area, location, and other property characteristics to assess the tax base at a locality level performs better on accuracy than a pure area-based approach. It also does better at meeting transparency and capacity constraints compared to approaches that use the market value of properties as a base, provided it uses a minimal set of other property characteristics (Ahmad & Brosio 2022, Collier et. al 2018).

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 eight different location bands. However, this approach does not perform well on utilisation and equity because the accuracy of assessments is low. The effectiveness of the hybrid approach in Punjab can be improved by determining the value of location bands according to their current DC- or FBR-assessed capital values and shifting away from the ARV system.

Shifting to a capital value system will also allow the government to develop a harmonised policy for all property-related provincial taxes that aims to minimise the distortions in the property tax market that result from overlapping recurrent and non-recurrent property tax regimes. It will be more transparent as DC-rates

are understood by taxpayers because they are used as a base for a number of non-recurrent provincial property taxes and duties.

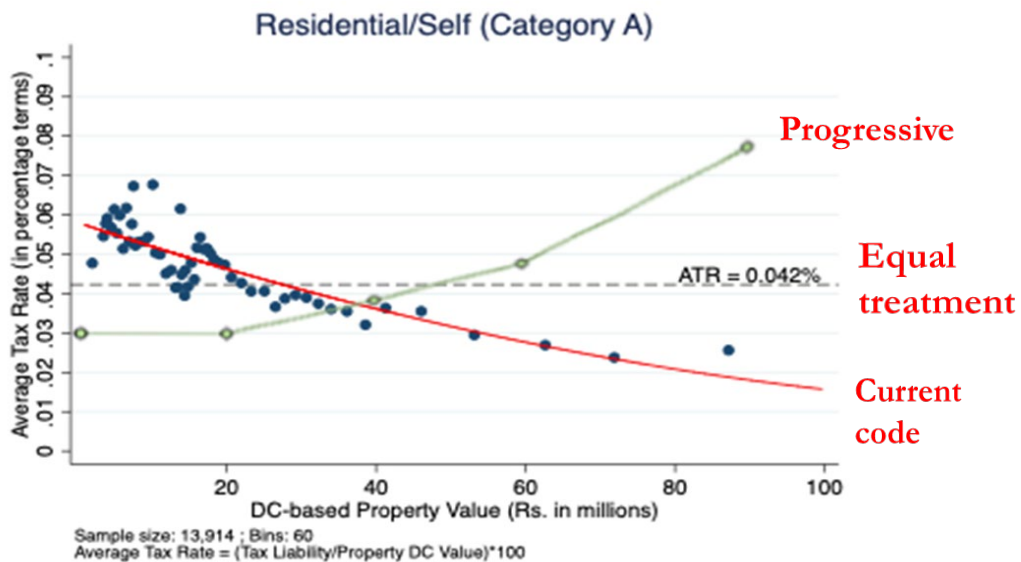
Addressing tax equity

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, and by giving a higher weight to land area in a reformed valuation formula. To minimise public backlash to reform, it is important to generate evidence on 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 discussion about setting of rates and bands in relevant forums.

Reforming the exemptions regime

Basing exemptions on value rather than size can increase tax equity and utilisation. A key challenge for recurrent policy tax reform is the political opposition from groups that own high-value assets but do not earn a 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. 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.

Figure 11: Making Punjab's property tax more progressive



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

Differential tax rates on occupancy and use

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. The government could use taxpayer surveys to elicit taxpayer preferences about differential treatment. It 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 production process of a business and taxing it may create distortions in the business' 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. The government needs 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 how they can be rationalised to improve efficiency.

Devolving rate-setting powers

The current system in Punjab involves shared rate-setting powers between the provincial assembly and local councils. This has created an equilibrium where neither party has an incentive to change the current tax rate that has been

legislated as part of the UIPT law. Accountability will be strengthened if UIPT reforms do not stipulate a tax rate as part of the UIPT law and the reforms of the local government law require the provincial finance commission to determine tax brackets and require local councils to set rates within these brackets, as part of their budgetary process.

Strengthening the benefit linkage

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.

Earmarking is an instrument that is used by many governments to strengthen the benefit linkage (Ahmed and Brosio, 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 of its impact is limited (Prichard et. al. 2019) 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 well-designed evaluations before institutionalising it as part of the system.

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 administrative costs by eliminating the burden on the E&T of conducting regular revaluations. DC-rate assessments are already done regularly for non-recurrent provincial property taxes and duties. The government can also reduce compliance costs for taxpayers by institutionalising the self-declaration of the parameters used in the points-based system and complementing this with random audits, complemented with satellite technology and simple field-based verifications. This will decrease taxpayer costs by creating an arms-length relationship between taxpayers and tax collectors. The current state of poor taxpayer knowledge suggests that compliance costs can also be reduced by instituting a meaningful taxpayer education programme that provides information about property tax policy.

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