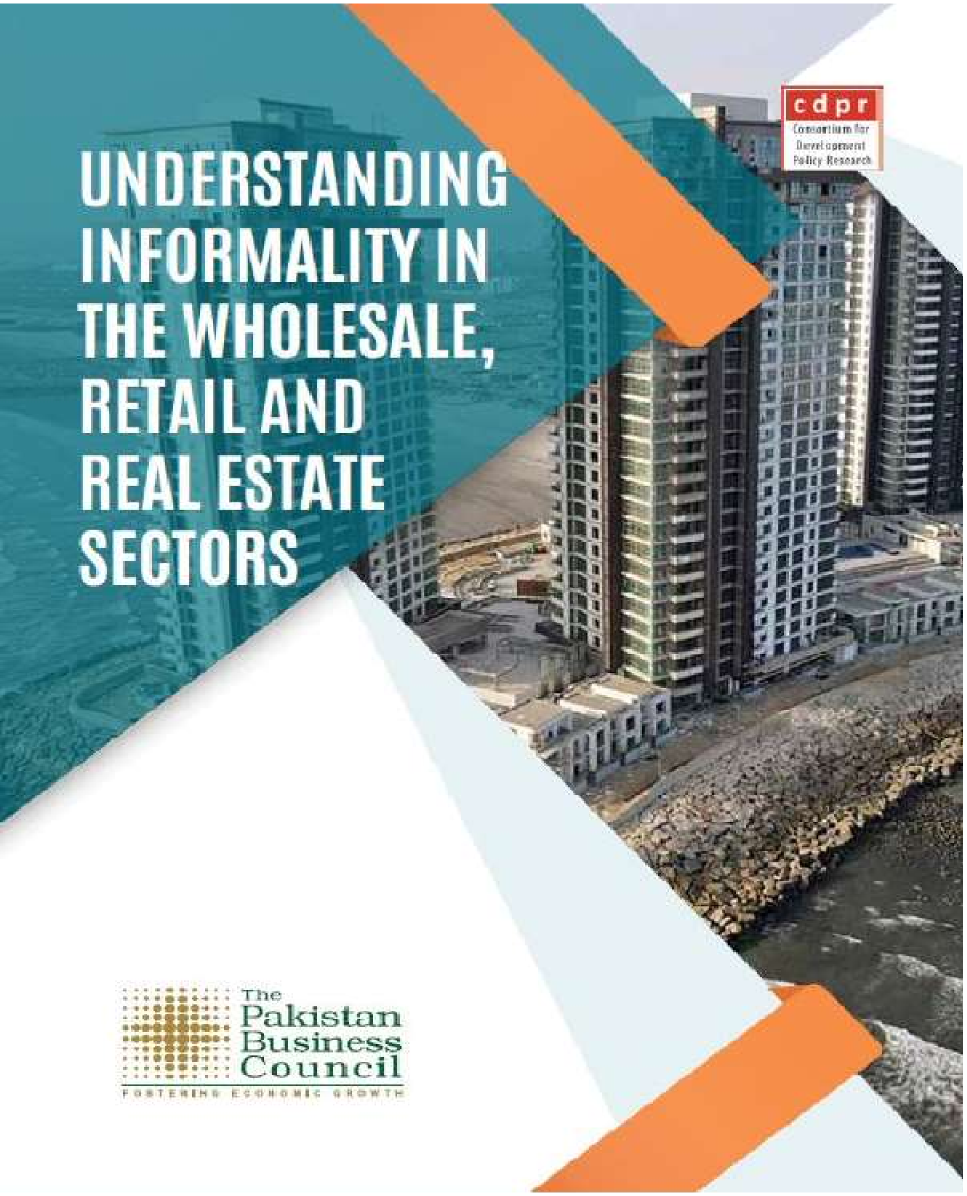


UNDERSTANDING INFORMALITY IN THE WHOLESALE, RETAIL AND REAL ESTATE SECTORS

The Pakistan Business Council
FOSTERING ECONOMIC GROWTH
(A Company set up under Section 42 of the Companies Ordinance 1984)

cdpr
Consortium for Development Policy Research

Introduction

- The persistence of informality is a major developmental challenge for Pakistan’s economy.
- The study focused on a **tax-based analysis of informality** and its consequences due to lack of large, up-to-date survey data on the size and other key characteristics of firms.
- Informality weakens fiscal foundations of the state by placing constraints on overall amount of taxable revenue available for spending.
- High returns in sectors such as Wholesale and Retail Trade (WRT) because of informality, attract a growing share of private savings and investment, dampening manufacturing and exports.

Pakistan’s Unrealized Tax Potential

WRT sector could amount to **PKR 277 bn**, or **PKR 234 bn greater than** its current contribution.

Potential tax collection from real estate activities for FY21 **could be upto PKR 620 bn**, out of which **only PKR 107 bn is collected** under various real estate-related taxes.

Etimated aggregate tax potential between the WRT and Real Estate sectors is **PKR 747 bn** which amounts to **12.2%** of Pakistan's current aggregate tax collection.

Wholesale and Retail Trade Sector

Key Statistics - WRT

- WRT contributes 32% within the services sector and 18% to overall GDP
- Share in total employment is 14.4%, amounting to 10 mill individuals.
- Formalization and corporatization within WRT activity is in its infancy, with no more than 3 to 5% of all value-added taking place through fully formal entities

Type of WRT Business	Number
Wholesalers	96,000
Sale/Maintenance/Repair of Motor vehicles	262,000
Retail Establishments	2,000,000

Tax Implications of Informality

Share of manufacturing sector in direct taxes is 34.5%, full 22% greater than its share in GDP.

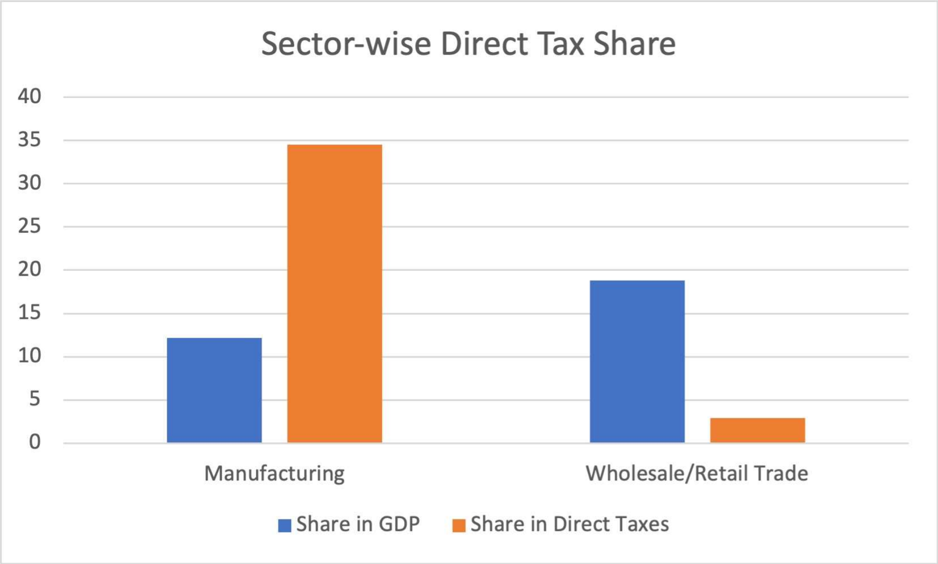
While WRT contributes just **2.9% towards direct taxes, 15% less than its share in GDP**.

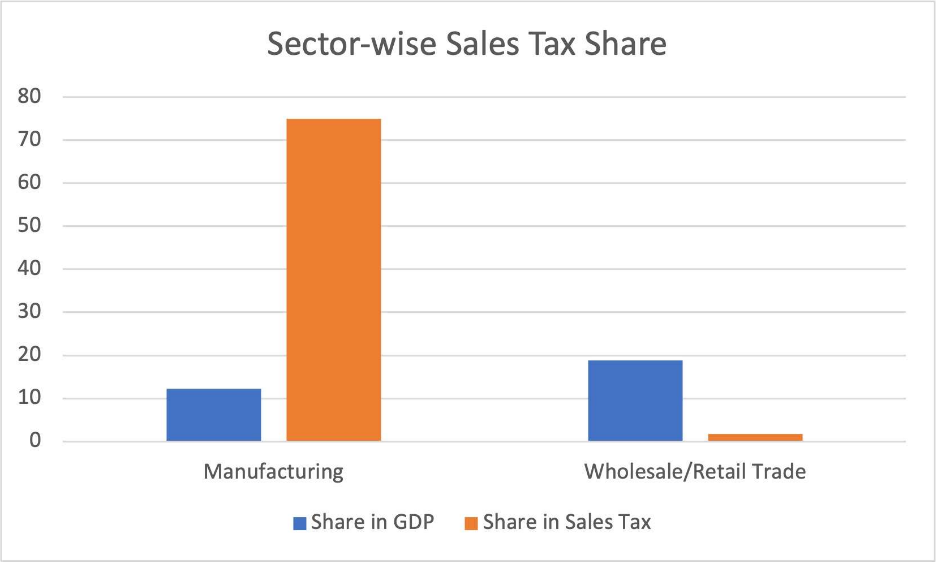
A proportionate revenue obligation on WRT sector would amount to **PKR 277 bn, i.e. PKR 234 bn greater than its current contribution**

WRT's overall percentage contribution to sales tax collection amounts to **a negligible 1.65% compared to manufacturing sector's contribution of 75%+**.

Ballpark estimates from key informants suggest **a 15-20% advantage** gleaned from tax-based informality.

Sector-wise Tax Shares





Political Economy Factors

Since 1990s, associational WRT actors have thwarted several reform efforts to expand documentation of the economy through protests and lobbying.

This prevents any capture of the true extent of economic activity in the WRT sector.

Constant engagement with political and bureaucratic actors for purposes of financing elections, exchanging rents, and safeguarding their economic interests bestows them with political influence.

Proposed Reforms to Tackle Informality

No.	Reform type	Stakeholders	level of likely opposition
1	Real time integration of FBR, SBP, NADRA data; incentives for digital payments	FBR, SBP, NADRA, Min of Finance/ Financial Monitoring Unit; Banks and Fintech firms	Low – may require legislative approval
2	Reinstatement of CNIC condition for B2B and B2C transactions above PKR 200,000, with 50,000 reduction in the threshold in the subsequent 3 years to provide initial relief to small traders	FBR, NADRA	High; requires onboarding of reform-oriented actors in WRT such as the Chain store Association of Pakistan (CAP)
3	Withdrawal of tiered system of registration in a phased manner over a three-year period. Simplified registration systems can be introduced for small traders	FBR, CAP	High

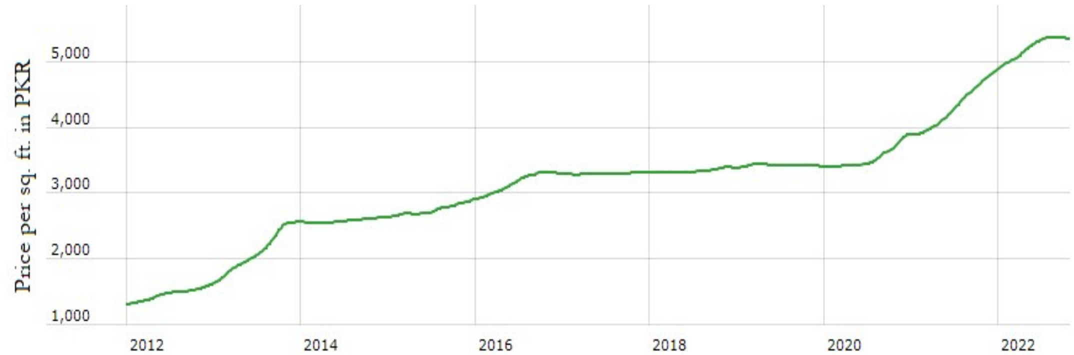
Real Estate Sector

Key Facts – Real Estate

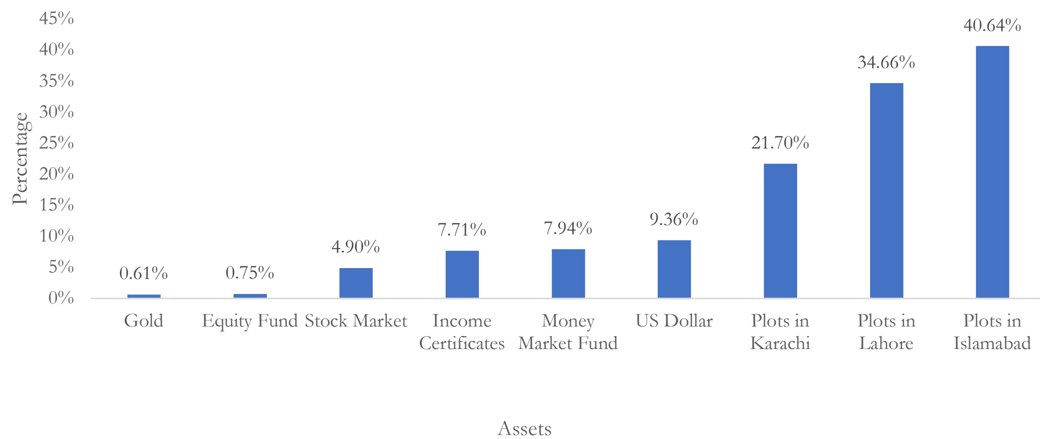
- Growth in real-estate sector can arise due to a thriving economy and contribute to other allied industries such as cement, steel, bricks, building materials, etc., leading to job creation and economic growth.
- However, this growth-led/growth-promoting feature of real estate is compromised if growth is mainly driven by investment in empty plots of land without linkages to other productive sectors of the economy.
- Informality, inefficient tax structure, and lack of regulation contribute to perverse growth in the sector at the expense of overall economy.

Excessive Returns in Real Estate

- Property prices have almost quadrupled in the previous decade.
- Compared with return on other instruments, investment in real estate offers a lucrative return



Data source: Zameen.com



Real Estate Investment Hampers Economic Growth

Investment in Real Estate displaces capital away from the productive sectors of the economy into the unproductive empty plots of land.

Overzealous investment in real estate in Pakistan is counterproductive for agriculture sector and food security.

Speculation in real estate market and resulting boom have pushed housing prices beyond lifetime income of an average citizen, worsening access to affordable housing

Low effective tax on real estate leads to direct burden on the formal sector.

Challenges in Real Estate

Problem with Property Valuation

- Fragmented bases: ARV for property tax, DC Rate for provincial transaction taxes, and FBR rate for federal taxes.
- For select urban centers, FBR rate is on average half the market value, and the DC rate is one-fifth.

Undocumented Transactions

- Unofficial arbitrage of (open) plot files, exchange of plot files on agreement-to-sell (Bayana) without original seller, overselling of available plots leading to fraud and losses for investors, use of fake Power-of-Attorney to acquire and sell land on behalf of original owner.

Lack of Regulatory Framework

- mushrooming of unapproved development projects, false advertising to lure foreign and domestic investors and unprofessional practices by realtors and developers

Avenue for laundering black money

- Due to lack of regulatory oversight and lower effective tax rates; thousands of unregistered real estate investors and property dealers continue to trade unregistered open files, affidavits and certificates.

Distorted Policy Framework

- Real estate activities subject to favorable tax treatments in Pakistan which creates a strong incentive to invest in real estate over other productive sectors of the economy.

Low performance of Property Taxes

Property taxes contribute less than 1% to overall tax collection in Pakistan comparing dismally to other low- and middle-income countries.

Key challenges in collection of property taxes in Pakistan include:

- Highly undervalued ARV for assessment of tax base.
- Widespread use of exemptions.
- Political interference.
- Differential in ARV of rental and owner-occupied properties.
- Lack of incentive to collect taxes by district governments.
- High level of collusion between tax-collectors and taxpayer
- Low stakes of local government.
- Lack of tax-benefit linkages at the local level.

Political Challenges to Reform Efforts

- The real estate sector has been subject to political favors and politicking by powerful interest groups that have resulted in favorable tax treatments, multiple amnesty schemes, resistance to updating property valuations, and adherence to archaic zoning laws.
- Powerful lobbies and interest groups include land developers, real estate tycoons, senior bureaucrats, army generals, and judges.
- A pragmatic real estate reform agenda would require political ownership from these stakeholders.
- Need to raise awareness in beneficiaries of real estate that if money is routed away from real estate to productive sectors, the profits will likely accrue to the them and their generations, and everyone benefits from the transition.
- Need to have a collective conversation on these issues to make the sum bigger than the parts.

Proposed Reforms to Tackle Informality

NO.	REFORM TYPE	STAKEHOLDERS	LEVEL OF LIKELY OPPOSITION
1	Introduce an effective valuation system for recurrent and non-recurrent taxes	FBR, Provincial BORs, Provincial ET&NCD	Low; may require legislative approval
2	Tax capital gains from property just like other forms of income, with no exemption for the holding period.	FBR	High; requires onboarding of association of developers, real estate agents, and powerful elite.
3	Register and regulate real estate agents by establishing real estate regulatory authorities.		Low – require legislative approval by the provincial assemblies.
4	Review and strictly enforce the Zoning laws.	District Development Authorities	High; from the powerful elite
5	Remove the differential between owner-occupied and rented properties	Provincial BORs, Provincial ET&NCD	High; political opposition from the respective localities but establishing tax-benefit linkages can address that.
6	Earmark a portion of property tax revenue to be spent on neighbourhoods from which the corresponding revenue is collected.	Local Governments, Provincial Governments, Provincial BORs, Provincial ET&NCD	Low; require amendment in PFCs. May face resistance from provincial assemblies.
7	Devolve the property tax rate setting power to the local level	Local Governments, Provincial Governments	Low; require legislative approval. May face resistance from provincial assemblies.
8	Establish a body for coordinating the policy and enforcement of taxes by each level of government.		High; require onboarding by each province, local governments, and central government.