UNDERSTANDING INFORMALITY IN THE WHOLESALE, RETAIL AND REAL ESTATE SECTORS

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The Pakistan Business Council
FOSTERING ECONOMIC GROWTH

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The Pakistan Business Council (PBC)
and
The Consortium for Development Policy Research (CDPR)

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THE CONSORTIUM FOR DEVELOPMENT POLICY RESEARCH

Report commissioned by The Pakistan Business Council

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

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The Pakistan Business Council: An Overview

The Pakistan Business Council (PBC) is a business policy advocacy platform, established in 2005 by 14 (now 98) of Pakistan's largest private-sector businesses and conglomerates, including multinationals. PBC businesses cover nearly all sectors of the formal economy. It is a professionally-run organization headed by a full-time chief executive officer.

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The PBC works closely with relevant government departments, ministries, regulators and institutions, as well as other stakeholders including professional bodies, to develop consensus on major issues which impact the conduct of business in and from Pakistan. The PBC has submitted key position papers and recommendations to the government on legislation and other government policies affecting businesses. It also serves on various taskforces and committees of the Government of Pakistan as well as those of the State Bank, the SECP and other regulators with the objective to provide policy assistance on new initiatives and reforms.

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Acronyms

AMA	Accra Municipal Authority
AOP	Association of Persons
ARV	Annual Rental Value
BOR	Board of Revenue
B2B	Business-To-Business
B2C	Business-To-Consumer
CAMA	Computer-Assisted Mass Appraisal
CAP	Chain store Associate of Pakistan
CDA	Capital Development Authority
CGT	Capital Gain Tax
CNIC	Computerized National Identity Card
CTR	Currency Transaction Report
CVT	Capital Value Tax
DC	Deputy Collector
DMT	Domestic Missing Trader
DNFBP	Designated Non-Financial Businesses and Professions
ET&NCD	Excise, Taxation & Narcotics Control Department
FATF	Financial Action Task Force
FMU	Financial Monitoring Unit
FBR	Federal Board of Revenue
GDP	Gross Domestic Product
GST	General Sales Tax
GRA	Ghana Revenue Authority
ICBT	Informal Cross Border Trade
IGC	International Growth Center
KDA	Karachi Development Authority
LDA	Lahore Development Authority
MSME	Ministry of Micro, Small and Medium Enterprises
NADRA	National Database and Registration Authority
NEPRA	National Electric Power Regulatory Authority
PASPIDA	Pakistan Auto Spare Parts Importers and Dealers Association
PFC	Provincial Finance Commission
PoS	Point of Sale
PRA	Punjab Revenue Authority
PTSP	Pelayanan Terpadu Satu Pintu (Indonesian program)
RERA	Real Estate Regulatory Authority
RTO	Regional Tax Office
SBCA	Sindh Building Control Authority
SBP	State Bank of Pakistan
UIPT	Urban Immovable Property Taxes
VAT	Value Added Tax
WHT	Withholding Tax
WIEGO	Women in Informal Employment: Globalizing and Organizing
WRT	Wholesale Retail and Trade

Executive Summary

The persistence of informality remains a major developmental challenge for Pakistan's economy. Informal economy includes legal economic activity outside legal arrangements (such as through unregistered and non-tax compliant entities) as well as illegal and illicit activity (such as smuggling and the production, sale, and purchase of illegal, harmful, and unsafe goods and services).

Principally, informality limits economic efficiency by constraining entrepreneurial potential in sectors where firms remain small and unable to scale and thus make technological advances to become internationally competitive. Additionally, it undermines the competitiveness of the formal sector and deters foreign investment, amongst other reasons, due to infringement of intellectual property rights. It also weakens the fiscal foundations of the state by placing constraints on the overall amount of taxable revenue available for spending by the federal government and by placing disproportionate revenue obligations on the formal sector. Consequently, the government is left with fewer resources to spend on providing basic services (such as health, education, and social protection); maintaining and upgrading regulatory capacity in key sectors; and maintaining national security.

In this study, the analytical focus is on two key sectors: wholesale and retail trade (WRT) and real estate, which are, by most empirical estimates, the two largest sectors of Pakistan's informal economy. The high returns in these non-tradable sectors, in large part because of low tax incidence and absence of regulations, i.e., informality, attract a growing share of private savings and investment, dampening manufacturing and exports. This structural shift in the economy is one cause of our recurrent balance of payments crises.

Due to the absence of large, up-to-date survey data on the size and other key characteristics of firms, this study has focused on a tax-based analysis of informality and its consequences. The analytical method is to assess the tax potential of the sector based on market information (including electricity connection, labour force survey data, and market valuations) and then subtract from it the actual tax collected to arrive at an estimate of tax-based informality in the sector.

Our findings show that businesses in WRT remain small and 98% of all WRT businesses have five employees or less, while 90% have a declared annual turnover of less than PKR 1 million. The real estate sector operates through unregulated agents and developers that benefit from the lack of regulations and preferential policy framework. Key features of informality in both sectors include non-compliance with regulations, underreporting of business activities, lack of business registration, and utilization of informal finance for credit purposes.

Pakistan pays a high cost of informality. In rupee terms, a rough proportionate direct tax revenue obligation (compared to other sectors like manufacturing), excluding variations in tax rates and cost structures, on the wholesale and retail sector would amount to **PKR 277 billion, or PKR 234 billion greater than its current contribution.**[1] Suggested reform efforts offer the substantial potential to increase tax collection from WRT

1 In the absence of sectoral cost structure data and firm-level surveys, we opt for proportionate tax incidence.

and real estate activities. For example, it is estimated that the **potential tax collection from real estate activities for the fiscal year 2020-21 could be up to PKR 620 billion, out of which only PKR 107 billion is collected** under various real estate-related taxes. The estimated aggregate tax potential between the WRT and Real Estate sectors is **PKR 747 billion which amounts to 12.2% of the current aggregate tax collection in the country**.

Wholesale and Retail Trade

1. How does informality emerge and sustain itself in the WRT sector? Why do WRT firms choose to stay informal?

A key defining feature of WRT is that it consists largely of small and medium-sized enterprises operating in both the formal and informal economy.[2] Wholesale and retail trade (henceforth, WRT), contributes 32% within the services sector and 18% to overall GDP.[3] Based on Economic Census data, 98% of all WRT businesses have 5 employees or less, while 90% have a declared annual turnover of less than PKR 1 million.[4]

Commercial electricity connections allow an estimate of the total number of WRT establishments. Based on National Electric Power Regulatory Authority (NEPRA) data from 2022, the total number of commercial electricity connections across Pakistan were 3.984 million.[5] Using past data of WRT enterprises as a proportion of commercial electricity connections (around 60%), it can be estimated that the total number of wholesale and retail establishments in the country is 2.39 million. Of these, currently around 2 million are retail trade establishments, roughly 262,000 establishments involved in the sale, maintenance/repair of motor-vehicles, and 96,000 wholesalers.

The WRT sector is currently the fourth largest employer in the country, behind agriculture, community and social/personal services, and manufacturing. Its share in total employment is 14.4%, amounting to a total of 10 million individuals. Of these 10 million, more than 9.5 million are self-employed proprietors (such as small shopkeepers), contributing family workers, or sales workers working as employees in wholesale and retail establishments. The sector is almost entirely dominated by informal employment relations. Labour force estimates show that 97.7% of all persons (i.e., 9.77 million individuals) working in the WRT sector are informally employed.

The persistence of informality is partly related to economic incentives for greater profits. Formalization and corporatization within wholesale and retail activity is still in its infancy, with no more than 3 to 5% of all value-added taking place through fully formal entities. Many new businesses prefer to maximize autonomy and profit by operating as unregistered entities.[6] Common practices include smuggling and customs evasion, non or fake-invoiced business-to-business transactions, and under-declarations of stock and turnover.

Other reasons reported by sector actors include the failure of the state to keep up its end of the fiscal compact, onerous requirements for documentation, the difficulty of accessing formal sector finance, fear of predation on the part of tax authorities, and financial burdens. The informal WRT sector is also a source of subsistence for low-income groups and a source of poverty alleviation.[7]

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2 WRT businesses can also be characterized as 'semi-formal' in so far that they may be partially compliant with regulations and/or they may be dealing with formally registered and compliant firms through the value chain.

3 Economic Survey of Pakistan, 'Pakistan Economic Survey 2022', 2022, https://www.finance.gov.pk/survey/chapter_22/PES01-GROWTH.pdf.

4 Economic Census of Pakistan, Pakistan Bureau of Statistics, 2005

5 Govt of Pakistan NEPRA, 'State of Industry Report 2022.Pdf', 2022, https://nepra.org.pk/publications/State%20of%20Industry%20Reports/State%20of%20Industry%20Report%202022.pdf.

6 Colin Williams, Muhammad S. Shahid, and Alvaro Martínez, 'Determinants of the Level of Informality of Informal Micro-Enterprises: Some Evidence from the City of Lahore, Pakistan', World Development 84, no. C (2016): 312–25.

7 Rizwana Hayat and Abdul Rashid, 'Exploring Legal and Political-Institutional Determinants of the Informal Economy of Pakistan', ed. Miao Wang, Cogent Economics & Finance 8, no. 1 (1 January 2020): 1782075, https://doi.org/10.1080/23322039.2020.1782075.

Lastly, a tiered system of tax registration keeps a large segment of the sector in the informal sector. While the use of electricity bills to collect sales tax ensures a base level of collection from retail outlets, this mechanism also has the impact of neglecting documentation of a large number of retailers that do not fall under the tiered conditions.

2. What costs does WRT informality impose on the overall economy?

The persistence of informality limits economic efficiency-gains that are commonly associated with growth of firms at scale. Entrepreneurs that remain in the informal sector – due to financial exclusion, onerous documentation requirements, and other costs associated with formalization - are not realizing their true potential**.** However, there is a dearth of updated quantitative data that can help assess the growth-related loss to the economy on account of persisting informality.

As seen in foregone income tax revenue, informality in the WRT sector has significant fiscal implications, especially when compared to the more formalized manufacturing sector. The share of the manufacturing sector in direct taxes amounts to 34.5%, a full 22% greater than its share in GDP. On the other hand, wholesale and retail trade contributes a paltry 2.9% towards direct taxes[8], 15% less than its share in GDP. <u>In PKR terms, a proportionate revenue obligation on the wholesale and retail sector would amount to PKR 277 billion, or PKR 234 billion greater than its current contribution</u>**.**[9]

A similar imbalance emerges in the domain of domestic sales tax collection. Estimates of WRT's drawing on non-manufacturing, non-importing business sales tax returns from the Association of Persons (AOPs) and Individuals show that the **overall** percentage contribution to sales tax collection amounts to a nearly negligible 1.65%. In contrast, the manufacturing sector's contribution exceeds 75%.[10] Similarly, in 2015, the smuggling-to-GDP ratio for eleven highly traded commodities investigated accounted for 3.88% of the country's total GDP, and 9.46% of the total tax collected by the Federal Board of Revenue (FBR), or USD 2.38 billion.

The persistence of informality creates distortions in the returns offered by different sectors of the economy. Industry accounts identify the WRT sector as having an advantage over more formal sectors despite its lower productivity, thus drawing capital away from productive domestic and export-oriented sectors. Ballpark estimates from key informants suggest a 15-20% advantage that is gleaned from tax-based informality. This results in underinvestment and a long-term loss of international competitiveness.

The burden placed by such informality on the formal sector is also significant. As identified above, the formal manufacturing sector contributes 34% of all direct taxes and up to 75% of all domestic sales tax, despite having a 12% share in the economy.

3. What does the political economy landscape of informality in wholesale and retail trade look like?

Organizations representing the economic and political interests of the WRT sector have grown exponentially. Marketplaces are highly organized on an individual basis, with proprietors forming the constituent membership of a market association. At higher tiers, individual marketplace associations and businesses tie into networks with apex organizations based at the district, provincial, and all-Pakistan level.

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8 This includes all withholding tax deductions at the time of sales made to wholesalers and then onwards to retailers

9 In the absence of sectoral cost structure data and firm-level surveys, we opt for proportionate tax incidence.

10 A pertinent caveat here is that businesses registered as services falling in the categories of Others (AOPS and Individuals) will be paying sales tax on services to provincial revenue authorities. However, the overall number of such businesses is estimated to be a small percentage within these categories.

The sector's ability to mobilize effectively and utilize its 'shutter-power' remains a significant feature of contentious politics in Pakistan. Between 2005 and 2010, WRT traders were the second-most mobilized occupational group, after government employees, accounting for approximately 15% of all protests and strikes.[11] Despite significant internal heterogeneity, the activities of most WRT associations manage to traverse several domains and help consolidate political and social capital for traders.

Since the 1990s, associational WRT actors have thwarted a number of reform efforts to expand documentation of the economy through protests and lobbying and specifically prevented any capture of the true extent of economic activity in the wholesale and retail 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 that is used in a wide variety of circumstances, including for their own political ambitions.

4. What are some international and domestic lessons from history of WRT reform for Pakistan?

Countries that have successfully reduced informality in wholesale and retail trade have done so through a number of incentive and punitive-based interventions. These include heightening state capacity for market intelligence, enforce business registration and forced-adoption of value-chain documenting technologies. Greater incentives such as easier access to formal-sector finance, reduced tax rates, higher input-tax adjustments are also offered to improve compliance.

For Pakistan, for Year 1, the central initiative proposed here is the real-time integration of data between several federal government entities, namely FBR, State Bank of Pakistan (SBP), and National Database and Registration Authority (NADRA). Real-time banking data provides a key opening with which to document financial transaction patterns tagged with personal identifiers, drawing on existing machine-learning software such as those utilized by financial intelligence organizations elsewhere. There is good reason to believe that a part of these hefty cash transactions will eventually make their way into the banking system, which, with the help of appropriate pattern detection, can then be monitored and regulated.

For Year 2, it is proposed here that the Computerise National Identity Card (CNIC) condition for transactions above a certain threshold be reinstated in order to generate valuable information on the volume and identity of transactions in the WRT sector. Adequate safeguards such as protecting sellers against accidental/mistaken misreporting of buyer CNICs will have to be built into the arrangement. While acknowledging the political constraints of undertaking it, it is imperative to recognize that the institutional and technological base for a personal identifier-based initiative is already in place, given the prevalence of the CNIC as a personal identifier.

The Point of Sale (PoS) integration initiative is an important one for documenting WRT sales and carries significant potential, if pursued aggressively not just in the three major cities, but across all regional tax offices. The punitive conditions for failure to integrate with PoS systems are important, specifically the abeyance of up to 60% of input tax adjustment, but a more conducive incentive structure may also be offered, including the offsetting of any initial costs that smaller retailers, in particular, may be wary of.

In the view of this report, the cleavage between branded/Tier-1 retail and mass retail is an important one that is worth cultivating to develop a pro-reform lobby within the sector. Specifically, the Chain store Association of Pakistan (CAP) has emerged as a pro-reform voice for branded retail and is increasingly playing a leadership role, carrying out club good initiatives and representing the interests of documented sections of the sector. Greater engagement with such actors, rather than disruptive ones, is key to take the long-term reform effort forward.

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11 Ahsan I. Butt, 'Street Power: Friday Prayers, Islamist Protests, and Islamization in Pakistan', Politics and Religion 9, no. 1 (March 2016): 1–28, https://doi.org/10.1017/S1755048316000031.

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 PKR 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

1. What are the Key features of real estate activities in Pakistan?

Real estate activities involve the use, purchase, sale, development, and building of real estate for residential, commercial, or industrial purposes. The primary focus of this sector study is on real estate transactions; however, serious reform efforts must consider property transactions in harmony with property use.

Growth in the real-estate sector can arise due to a thriving economy that can further contribute to other allied industries such as cement, steel, bricks, building materials, etc., thereby leading to job creation and economic growth. However, this growth-led and growth-promoting feature of real estate is compromised if the growth in the sector is mainly driven by investment in empty plots of land without linkages to other productive sectors of the economy. This sector study focuses primarily on this latter aspect of real estate activities in Pakistan. It highlights how informality, tax structure, and lack of regulation contribute to perverse growth in the sector at the expense of the overall economy.

The real estate sector has attracted massive investment over the last decade due to excessive returns. Data from Zameen.com reveal that property prices have almost quadrupled in the previous decade. While part of this price increase is fuelled by genuine unmet demand for housing and remittance inflows, the speculative activity, and the belief that property prices will keep increasing have contributed substantially to this growth. The reason for the active investment in real estate is straightforward. Compared with return on other instruments, investment in real estate offers a lucrative return. Specifically, the return on investment in plots is unmatched by any other financial instrument.

Fragmented bases by the local, provincial, and federal governments characterize taxation of real estate activities. Specifically, urban immovable property taxes (UIPT) use annual rental values (ARV) as the base to determine property taxes, provincial transaction taxes, such as stamp duties and capital value taxes, use DC (deputy collector) rates, and finally, federal income taxes (including capital gain and withholding taxes) use FBR rates as the base. All these regulated rates are well below the market value of the respective properties, with consequences on the tax system's efficiency, horizontal and vertical equity, and fiscal stress.

2. What is the extent of informality and tax evasion in real estate activities, and how is black money parked in the sector?

A significant source of tax avoidance in real estate arises due to under-declaring property values. The FBR and DC rates are a fraction of market rates for both residential and commercial plots. For a sample of properties in most traded urban centres in Pakistan, the FBR rate is half the market value, and the DC rate is one-fifth. The extent of under-valuation indicates that the mechanical loss in tax revenue in the fiscal year 2020-21 could be as high as 61 billion rupees for federal advance income taxes, a hundred percent of the capital gain taxes, and five times the stamp duties and capital value taxes.

While property valuations are relevant for documented transactions, many transactions in real estate continue to operate outside the tax net. Here are a few standard practices.

1. It is prevalent for the (open) plot file to exchange hands without an official transfer of ownership or payment of associated taxes. Sometimes a file might be sold more than ten times before it is finally transferred to an end consumer. This arbitrage of plot files enables substantial gains for the intermediaries without contributing anything to the exchequer.

2. Another common practice some realtors employ is what is colloquially called "Bayane pe Bayana." This is when a real-estate agent arranges an agreement-to-sell (Bayana) between a buyer and a seller, where the buyer is typically an investor who wants to make quick money. The agreement-to-sell involves payment of some fraction of the agreed price to the seller and a promise to pay the remaining amount after typically 30 to 90 days. During this period, the real-estate agent finds a new buyer willing to pay more than the agreed price. The agent then sells the property to the new buyer and shares the difference in the price agreed with the seller and the price received from the new seller between the investor and themself. It is revealed that this difference could be up to ten percent of the property price if the market is active and go completely undocumented and untaxed.

3. Quite a few developers are engaged in overselling the number of available plots. While some developers engage in outright fraud and run away with the money of investors, few others are involved in an interesting practice where, after selling the plot, these developers float rumours in the market to create panic, encourage widespread selling, and reduce the market price. The developers then buy back these files at a rate lower than the initially received rate. This practice allows the developers to amass substantial gains for the land that never existed at the expense of the general population.

4. Another practice involves the use of fake "Power of Attorney" to acquire and sell land on behalf of the original owner. This fraud by some developers and real estate agents leads to loss, stress, and long litigation proceedings between the buyers and original owners while allowing substantial profits for the developers and the agents.

The outlined informality in the sector is enabled via real estate agents and developers that operate primarily outside any regulatory framework. The lack of an effective regulatory framework has led to mushrooming of unapproved development projects, false advertising to lure foreign and domestic investors, and unprofessional practices by the realtors and developers.

The real estate sector has provided opportunities to launder black money and conceal ill-gotten financial wealth. Lack of regulatory oversight and lower effective tax rates have allowed investors to use the real estate sector to park black money. This is mainly enabled due to many unregistered and unregulated real estate agents. In recent efforts to curb money laundering and counterterrorism, FBR is responsible for registering real estate agents (as designated non-financial businesses and professions (DNFBPs)) and ensuring the real estate activities are not used to launder black money. However, recent estimates suggest that out of the 500,000 property dealers and real estate agents, only 22,000 are registered as DNFBPs, and thousands of unregistered real estate investors and property dealers continue to trade unregistered open files, affidavits, and certificates.[12]

12 Iqbal Institute of Policy Studies. (2021, November 9). The Impact of Financial Action Task Force on the Real Estate Sector of Pakistan. Iqbal Institute of Policy Studies. Retrieved from https://iips.com.pk/the-impact-of-financial-action-task-force-on-the-real-estate-sector-of-pakistan/

3. How does the taxation of urban immovable property vis-à-vis corporate income affect the investment decisions in the country?

In addition to the outlined informality and the low property valuations, real estate activities have been subject to favourable tax treatments in Pakistan. There is an obvious disparity in how capital gains from real estate are taxed compared to income from other sources. The statutory tax on capital gains from real estate compares modestly to other income sources. This is striking if one compares the top capital gain tax from real estate of 15% with a 29% tax on corporate income. Also, capital gain tax is charged if the gains are realized within a certain number of years from the purchase of property, after which they are exempt from taxation. This creates a strong incentive to invest in real estate over other productive sectors of the economy.

Real estate activities have been the beneficiary of multiple amnesty schemes. The amnesties have allowed people to whiten the ill-acquired real estate (for example, via asset declaration schemes of 2019) or bring more money into the real estate (for example, via the construction package of 2020). In addition to highlighting the lack of state capacity, violating horizontal equity, and reducing incentives to pay taxes in non-amnesty times, these amnesties are responsible for distorting investors' incentives in favour of real estate at the expense of more productive sectors of the economy.

4. What is the cost of parking money in real estate (especially in empty urban plots) on investment and the overall economy?

The real estate sector is partly responsible for the low economic productivity of the country as it has displaced capital away from the productive sectors of the economy into the unproductive empty plots of land. This problem is so grave that even the manufacturing sector finds it in its best interest to invest in unproductive real estate rather than enhance its capacity. This directly impacts the country's economic growth and job creation in a negative way.

Overzealous investment in real estate in Pakistan is turning out to be counterproductive for the agriculture sector and the food security of the country. Acres of productive agricultural land is being converted into housing societies and empty plots, which has severe implications for the food sustainability of the country. This also poses balance of payment problems, as the scarce foreign reserves must be used to import staple crops that could have been home-grown with better land allocation.

The speculation in the real estate market and the resulting boom have pushed house prices beyond the lifetime income of an average citizen, thereby worsening affordable housing for the masses. With a housing backlog of 9 million homes and an annual housing shortfall of 270,000 homes, the need in Pakistan is enormous. Still, the rising price trend makes home ownership even further out of reach for the average Pakistani.

Low effective tax on real estate leads to a direct burden on the formal sector. Since Pakistan suffers from extreme fiscal stress and needs to increase domestic revenues substantially, the lack of proportionate contribution from the real estate puts extra burden on the manufacturing and other regulated sectors, further reducing their competitiveness and export potential.

The exorbitant capital gains from real estate have allowed many people to raise their living standards substantially. However, the anecdotal evidence suggests that the spending habits of the beneficiaries are focused on international travel and imported luxury items. These spending habits do not contribute to domestic employment-generating opportunities and instead further current account imbalances.

5. What are the potentials and challenges in collecting tax revenues from property taxes?

Despite the advantages of recurrent property taxes, there is a dismal collection of urban immovable property tax in Pakistan, with property taxes contributing less than a percent to overall tax collection in the country. Pakistan is an outlier in revenue collection from this source, even when compared to countries with a similar level of development. There is potential to raise revenues from Urban Immovable Property Tax (UIPT) to about 0.5 to 1% of GDP over the next 5 to 10 years while aiming for between 2 and 3% of GDP in the longer run.

There are many challenges in the collection of property taxes in Pakistan. These include reliance on highly undervalued annual rental values (ARV) for assessment of tax base, widespread use of exemptions, political interference, the differential in ARV of rental and owner-occupied properties, lack of incentive to collect taxes by the district governments, high level of collusion between tax-collectors and taxpayers, low stakes of local government, and lack of tax-benefit linkages at the local level.

6. What reform efforts in light of international best practices can help address some of the challenges in the real estate sector?

The most critical area of reform involves introducing an effective valuation system for recurrent and non-recurrent taxes. In the short term, using a capital value-based system (DC or FBR rates) as the base for all recurring and non-recurring taxes would strengthen vertical and horizontal equity and allow for harmonizing all property-related taxes. In the long run, Pakistan must reform the tax design to capture closer properties' actual value through satellite imagery and mass property valuations. Because property values change quickly, it is vital to update valuations regularly. This can be done at the beginning of each fiscal year with the annual budget statement. The government can also institutionalize a self-declaration system and complement this with audits based on satellite imagery and computer-assisted mass appraisal (CAMA) methods. Like in many countries, CAMA methods may be combined with maintaining proper cadastre.

Capital gains from property should be indexed and treated just like other forms of income, with no exemption for the holding period. The case of India is a good case to follow as (short-term) capital gains on immovable property in India are taxed like ordinary income, and the (long-term) gains are indexed for inflation. Removing the preferential tax rates for real estate will substantially level the playing field and may divert capital from real estate into productive sectors of the economy.

There is a pressing need to institute real estate regulatory authorities in each province. Provinces can take motivation from Real Estate Regulatory Authority (RERA) in Islamabad and ensure each real estate agent and developer in the province must be licensed and regulated by the authority to perform real estate activities. An overview of international best practices shows that a competent regulatory authority governs most countries with a mature and profitable real estate sector. For instance, the real estate sector of Dubai has been able to attract millions of dollars' worth of investment due to its highly regulated real estate sector. The establishment of real estate authority will also help to bring activities of informal real estate agents into the tax net and ensure they are adequately taxed.

Zoning laws need to be reviewed and strictly enforced to allow the vertical development of cities and discourage urban sprawl. In addition, land grabbing, particularly that of government-owned land, must be strictly curbed. The zoning laws are missing in most cases, and where they exist, they are flouted with impunity by influential people. The development authorities, such as CDA, LDA, SBCA and KDA, need to play a more active role in ensuring that the laws are strictly enforced.

Multiple reform efforts can be targeted toward improving the collection of urban immovable property taxes.

1. In the provincial tax law of UIPT, the rented property is taxed aggressively compared to owner-occupied property. For example, in the UIPT Act of Punjab, the ratio of the tax rates between the owner-occupied and rented properties is 1:5. This creates a strong incentive to declare rented properties as self-occupied by the owners. There is a need to harmonize these taxes since the income from the rented property is already taxed by the federal government, and property tax, which is the provincial jurisdiction, is not supposed to be the income tax, which is the federal jurisdiction.

2. In keeping with trends in modern tax administration, the colonial tax administration model should be replaced by a functional structure of the administration to minimize contact with taxpayers and limit rent-seeking opportunities. Administration of property taxes, facilitated by high-tech satellite imagery and direct payments through banks or smartphones, supported by low-tech verification, should help consolidate the system and prevent corruption. For example, one of the authors of this report is collaborating with the Urban Unit and Punjab's Excise Taxation & Narcotics Control Department to predict features of properties using a machine learning algorithm that can potentially reduce the discretion of the tax inspectors in assessing property values.

3. Unless the property tax is related to social services or benefits, it generates political resistance. In this regard, earmarking a portion of property tax revenue to be spent on neighbourhoods from which the corresponding revenue is collected can strengthen the tax-service delivery link. The political economy of linking taxes to local benefits is essential in aligning incentives and ensuring greater local accountability. Lagos's Governor Fashola successfully implemented property taxes to deliver public services and was re-elected in 2011. Public investment led to increased property values and shared financial benefits resulting in further public investment.

4. The rate-setting power must be devolved to the local level. Since the local government does not effectively set tax rates, the property tax is the same as a transfer from higher levels of government. This significantly weakens the fiscal and accountability benefits associated with own-source local taxation. 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. Local councils must set rates within these brackets as part of their budgetary process.

Successful implementation of the above reforms requires establishing a coordinating body with representations from each level of the government. This body should be responsible for streamlining the rules and regulations regarding the taxation of real estate activities. It can include the establishment of a data warehouse that allows the exchange of information between different levels of government and provides support for enforcing each tax. For example, this body can specify audit functions that are managed centrally. Additionally, the property tax valuations and transaction data at the provincial and local levels can be used to cross-check income tax statements at the federal level.

There are also political barriers to reforms*:* The reforms outlined above cannot be achieved satisfactorily without addressing the political economy concerns revolving around the sector. The real estate sector has been a victim of political favours and politicking by powerful interest groups that have resulted in favourable tax treatments, multiple amnesty schemes, resistance to updating property valuations, and adherence to archaic zoning laws. The powerful lobbies and interest groups include land developers, real estate tycoons, senior bureaucrats, senior serving and retired army officers, and judges. These groups have accumulated massive wealth due to abnormal growth in the real estate sector. A pragmatic real estate reform agenda would require political ownership from these stakeholders. These elites need to realize that the gains from moving away from real estate may be substantial in the long run. If the money is routed away from real estate to productive sectors, the profits will likely accrue to the elites and their generations. Everyone benefits from the transition away from real estate, but elites enjoy a disproportionate benefit. There is a need to have a collective conversation on these issues to make the sum bigger than the parts.

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.

Concluding Remarks

This report has highlighted various ways informality operates in WRT and real estate sectors and identified reform efforts to move towards the documented and regulated economy. The challenge of transitioning to the formal economy is immense and requires a concerted effort from policymakers, bureaucrats, industry, and academics. <u>Academics can play an important role in finding innovative and effective ways to implement the reforms</u>. For example, International Growth Center (IGC) has enabled collaboration between academics (that includes one of the authors of this report) and the Punjab Revenue Authority (PRA) to find creative ways of increasing formality in the services sector. Among other areas, the work looks at the role of competition as a force for preventing formalization and tests ways of increasing formality in the presence of competitive effects of tax compliance. Such engagements offer great potential to find long-term contextual solutions to some of the problems in the informal sectors.

1. Introduction

1.1 Context

The subject of this study is the economic and fiscal impact of Pakistan's informal economy, an umbrella term that covers a large cross-section of non-farm economic activity taking place in the country. The informal economy includes legal economic activity outside legal arrangements (such as through unregistered and non-tax compliant entities) as well as illegal and illicit activity (such as smuggling and the production, sale, and purchase of illegal, harmful, and unsafe goods and services).

For this study, the informal economy will be defined as "all economic activities by workers and economic units that are – in law or in practice – not covered or insufficiently covered by formal arrangements. In other words, such firms are operating outside the formal reach of the law – i.e. the law is not enforced".[13] The informal economy is an important site of subsistence for marginalized and low-income citizens and a key source of poverty alleviation, especially in the absence of high-coverage social protection schemes for vulnerable populations.[14] There is, thus, an important equity consideration when discussing reforms surrounding it, especially in terms of what can be done for informally employed labour.[15]

However, high-level informality in the non-farm economy also carries a number of economic costs that hinders socio-economic welfare. Principally, it limits economic efficiency by constraining entrepreneurial potential in sectors where firms remain small and unable to scale. It also results in higher burden of indirect, consumption-based taxation, as well as greater taxation and regulation on documented sectors, such as large and medium-scale manufacturing and formal services, (insurance, banking, and telecommunications). Thus, the formal large-scale manufacturing sector alone contributes upwards of 30% towards direct taxation despite contributing around 12% to the economy, thus undermining its long-term potential. The high-level of informality is also detrimental to the growth of formal businesses as it reduces their competitiveness vis-a-vis the informal firms that do not pay taxes or comply with the regulatory requirements.

The persistence of informality remains a major developmental challenge for Pakistan's economy. Principally, it weakens the fiscal foundations of the state, by placing constraints on the overall amount of taxable revenue available for spending by the federal government. Consequently, the government is left with fewer resources to spend on the provision of basic services (such as health, education, and social protection); maintaining and upgrading regulatory capacity in key sectors; and the maintenance of national security. The absence of a sound fiscal base also increases overall reliance on borrowing to meet basic expenditure needs. This facet is readily

13 Definition provided by the International Labour Organization (ILO).

14 Rizwana Hayat and Abdul Rashid, 'Exploring Legal and Political-Institutional Determinants of the Informal Economy of Pakistan', ed. Miao Wang, Cogent Economics & Finance 8, no. 1 (1 January 2020): 1782075, https://doi.org/10.1080/23322039.2020.1782075.

15 Sri Wening Handayani and Asian Development Bank, eds., Social Protection for Informal Workers in Asia (Mandaluyong City, Metro Manila, Philippines: Asian Development Bank, 2016).

visible in the growth of public debt in proportion to overall GDP, which has grown from 63% to 73% just in the preceding four years since 2018. Federal government's reliance on bank borrowing to meet expenditure requirements carries the added effect of crowding out credit disbursement to the private sector.

As per Government of Pakistan statistics, in 2019, 72% of all non-farm work takes place in the informal economy. Important sectors within this include wholesale and retail trade (WRT), construction and real estate, community and social services, and small-scale manufacturing.[16] In this study, our analytical focus is on two key sectors: wholesale and retail trade, and real estate, which are by most empirical estimates, the two largest sectors of Pakistan's informal economy. Due to the absence of up-to-date data regarding the size, firm-level characteristics, and equity impact of the informal economy, we focus on a tax analysis of informality and its consequences.

1.2 Sectoral focus

Case Study Sector 1: Wholesale and Retail Trade

The key characteristic of informal sector activity for this study is evasion and/or non-enforcement of sales and income tax laws. In WRT, one of the proposed areas of focus for this study, tax compliance is extremely low. Thus, despite contributing upwards of 19% to total GDP, contribution towards direct tax collection from the sector is under 3%.

Past efforts at enhancing documentation of the sector have been aborted repeatedly due to political backlash and public mobilization by WRT associations. The dynamics are largely similar in real estate as well, with realtor firms and actors avoiding documentation efforts. A central reason for this in WRT is that sales tax documentation provides reasonable estimates for turnovers and profitability of wholesale and retail businesses, which would increase the likelihood of business owners falling into the income tax net as well.

Case Study Sector 2: Real Estate

Real estate activities involve the use, purchase, sale, development, and building of real estate for residential, commercial, or industrial purposes. Growth in the real-estate sector can arise due to a thriving economy that can further contribute to other allied industries such as cement, steel, bricks, building materials, etc., thereby leading to job creation and economic growth. However, this growth-led and growth-promoting feature of real estate is compromised if the growth in the sector is mainly driven by investment in empty plots of land without linkages to other productive sectors of the economy. This sector study focuses primarily on this latter aspect of real estate activities in Pakistan. It highlights how informality, tax structure, and lack of regulation contribute to perverse growth in the sector at the expense of the overall economy.

1.3 Guiding Questions

The study aims to utilize a political economy approach, centered around the interaction of key actors, institutions, and structural conditions, to understand the persistence of informal economic activity in the selected sectors, and to provide policy actionable outputs that can help enhance documentation and rationalize regulatory and taxation incidence throughout the economy. ***For this study, we chose an analysis of the Wholesale and Retail Trade (WRT) and the real-estate sectors as they are, by most estimates, the largest components of Pakistan's informal economy***; in a potential follow-up to this study, we may be able to cover other key sectors (such as services) as well. The study covers the following sector-specific questions:

16 Labour Force Survey 2019

Wholesale and Retail Trade

1. How does informality emerge and sustain itself in the WRT sector? Why do WRT firms choose to stay informal?
2. What costs does WRT informality impose on the overall economy?
3. What does the political economy landscape of informality in wholesale and retail trade look like? Who are the key actors and institutions and what does the incentive framework look like?
4. What can we learn from Pakistan's experience in carrying out documentation reform in WRT and the presence of political economy barriers?
5. To what degree has recent technological adoption (such as point of sale machines) helped in addressing or inadvertently enabling informality?
6. How have other countries (Indonesia and Ghana) dealt with informality in wholesale and retail trade? What are the lessons for Pakistan, i.e., what policy reforms are needed

Real Estate

1. What is the extent of tax evasion in real estate activities, and how is black money parked in the sector?
2. What is the cost of parking money in real estate (especially in empty urban plots) on investment and the overall economy?
3. How much can the government gain in tax revenues by correctly documenting property transactions?
4. How does the taxation of urban immovable property vis-à-vis corporate income affect the investment decisions in the country?
5. What international best practices and cross-country (India, China, Ethiopia) learnings can help document property transactions more effectively?
6. What is the tax potential from the urban immovable property for the local government?
7. What are the challenges in collecting tax revenues from the urban immovable property by the local governments, and how can those be addressed?

The answer to these questions enables us to provide reasonable estimates on the nature and scale of tax evasion through informality. This analysis is critical in understanding the present state of a large section of the informal economy and to move forward in developing a policy agenda that can resolve current imbalances in governance, regulatory, and taxation structures that inhibit high-productivity sectors.

2. Wholesale and Retail Trade (WRT)

2.1 Overview of the Pakistan's WRT sector

2.1.1 Estimates of Tax Evasion and Informality in WRT

By 2021, total private consumption as a percentage of aggregate demand in Pakistan's economy reached 85.2%.[17] A significant part of this consumption takes place through wholesale and retail trade (henceforth, WRT), which contributes 32% within the services sector and 18% to overall GDP.[18] A key defining feature of WRT is that it consists largely of small and medium-sized enterprises operating in both the formal and informal economy.[19] Based on Economic Census data, 98% of all WRT businesses have 5 employees or less, while 90% have a declared annual turnover of less than PKR 1 million.[20] Informality in this study primarily denotes all economic activity that is unregistered for sales and income tax purposes, or is, at best, partially compliant with existing tax regulations. Other aspects of informality include the persistence of informal credit practices, and non-compliance with business registration, labour, and health regulations. Recent estimates of the size of the informal economy in Pakistan place it 37.7% of the formal economy[21] or an additional PKR 14,033,280 million in Gross Domestic Product at constant basic prices.

In the following sections, this chapter provides a quantitative assessment of the extent of taxation-based informality in WRT drawing on national accounts, FBR data on sector-wise collection of direct and domestic sales tax, and secondary analysis of the tax directory for 2017-18.

2.1.1.1 Direct Tax Obligation and WRT Sector

By 2019, the last year for which granular direct tax data is available, Pakistan's Gross Domestic Product at constant basic prices amounted to Rs. 37,184,104 million. Of this, the share of WRT was 18.13%, amounting to PKR 6,331,734 million. The manufacturing sector, consisting of large-scale and small-scale manufacturing, and slaughtering, contributed 12.33% or PKR 4,305,977 million.[22]

The corresponding share in direct tax collection[23] of these two sectors highlights a significant discrepancy. The share of the manufacturing sector in direct taxes amounts to 34.5%, a full 22% greater than its share in GDP. On the other hand, wholesale and retail trade contributes a paltry 2.9% towards direct taxes, 15% less than its share in GDP. In rupee terms, a rough proportionate revenue obligation, excluding variations in tax

17 Economic Survey of Pakistan, 'Pakistan Economic Survey 2022', 2022, https://www.finance.gov.pk/survey/chapter_22/PES01-GROWTH.pdf.

18 Economic Survey of Pakistan.

19 WRT businesses can also be characterized as 'semi-formal' insofar that they may be partially compliant with regulations and/or they may be dealing with formally registered and compliant firms through the value chain.

20 Economic Census of Pakistan, Pakistan Bureau of Statistics, 2005

21 Hayat and Rashid, 'Exploring Legal and Political-Institutional Determinants of the Informal Economy of Pakistan'.

22 Economic Survey of Pakistan, 'Pakistan Economic Survey 2022'.

23 Direct taxes include tax demanded, voluntary payments, and tax withheld under the Income Tax Ordinance.

rates and cost structures, on the wholesale and retail sector would amount to **PKR 277 billion, or PKR 234 billion greater than its current contribution.**[24]

Table 1 presents select sector-wise net direct tax collection and percentage share in net direct tax in million Rs. for the FY 2018-19[25]:

TABLE 1: Direct Tax Collection by Sector (2018-19)

Sectors	DT Collection FY 2018-19 (in million Rs.)	Percentage Share in DT Collection	Percentage Share in GDP	Gap b/w DT share and GDP share
1. Construction	73,895.40	5.1	2.78	2.32
2. Electricity and gas Distribution	63,943.10	4.42	2.25	2.17
3. Manufacturing	499,298.70	34.5	12.3	22.5
4. Mining and Quarrying	575	0.03	2.12	-2.09
5. Services<?>	350,316.80	24.24	28.46	-4.16
6. Transport	31,927.30	2.2	11.43	-9.23
7. Wholesale and Retail Trade	42,850.70	2.96	18.2	-15.24
8. Others	392,700.0	26.55	22.46	4.09
TOTAL	1,455,507.47	100	100	NA

Disaggregating direct tax collection from WRT shown in Table 2 reveals that nearly 60% is collected from wholesale trade, while large and small retail contribute 18% and 22% respectively. This highlights variation in informality at various stages of the distributive value chain, which as shown in subsequent sections, also maps onto geographic variation.

TABLE 2: Direct Tax Collection across WRT (2018-19)

SECTORS	DT COLLECTION FY 2018-19 (IN MILLION RS.)
A) LARGE RETAIL TRADE	7,940.20
B) SMALL RETAIL TRADE	9,730.90
C) WHOLESALE TRADE	25,179.60
TOTAL	42,850.70

2.1.2 Segmentation, Heterogeneity and Informality in Wholesale and Retail Trade

Reform efforts to reduce levels of undocumented economic activity in WRT will need to be cognizant of the significant heterogeneity that exists within the sector as a whole. This is primarily due to the differential impact that will be borne by different segments of the sector, and to develop reform interventions that cater to the type of informality found in each sub-sector. Currently, neither national accounts that capture economic value, nor labour statistics that gauge occupational and sectoral employment, capture variation in terms of the location of enterprises in the distributive value chain and the type of business that is being run.

2.1.1.2 Number and Segmentation of Establishments

In the first instance, in the absence of an updated census of economic establishments, it is increasingly difficult

24 In the absence of sectoral cost structure data and firm-level surveys, we opt for proportionate tax incidence.

25 Calculated from data published in FBR Quarterly Review, *October-December 2019-20*

to provide an accurate figure for total number of enterprises working in wholesale and retail trade. Based on NEPRA data from 2022, the total number of commercial electricity connections across Pakistan were 3.984 million.[26] Using past data of WRT enterprises as a proportion of commercial electricity connections (around 60%), we estimate that the total number of wholesale and retail establishments in the country is 2.39 million.

In terms of disaggregating establishments by type and location in the value chain, we draw on the data reported in the Survey of Wholesale Trade and Hotels & Restaurants carried out in 2006-7. Out of 1,471,062 reported establishments at the time, 1,249,394 or 85% were engaged in retail trade[27], 161,939 or 11% in the sale, maintenance/repair of motor-vehicles, and 59,729 or 4% in wholesale trade.[28] It is plausible to assert that this ratio remains accurate for the present era as well, which means there are currently around 2 million retail trade establishments, roughly 262,000 establishments involved in the sale, maintenance/repair of motor-vehicles, and 96,000 wholesalers.

TABLE 7: Number of wholesale and retail establishments (2005-6)

ACTIVITIES/DESCRIPTION	NO. OF ESTABLISHMENTS
WHOLESALE AND RETAIL TRADE	1,471,062
SALE, MAINTENANCE/REPAIR OF MOTOR VEHICLE	161,939
WHOLESALE TRADE AND COMMISSION AGENTS	59,729
WHOLESALE ON FEE OR CONTRACT BASIS	10,330
AGRICULTURAL RAW MATERIAL, ANIMALS & FOODS	21,052
HOUSEHOLD GOODS	11,516
NON-AGRICULTURAL INTERMEDIATE PRODUCTS	14,755
MACHINERY, EQUIPMENTS AND SUPPLIES	1,096
OTHER WHOLESALE	980
RETAIL TRADE	1,249,394
NON-SPECIALIZED RETAIL TRADE IN STORE	102,722
RETAIL SALE OF FOOD, BEVERAGES, AND TOBACCO	675,452
OTHER NEW GOODS IN SPECIALIZED STORES	377,132
RETAIL SALE OF SECONDHAND GOODS IN STORES	15,490
RETAIL TRADE NOT IN STORES	5,068
REPAIR OF PERSONAL AND HOUSEHOLD GOODS	73,530

2.1.1.3 Employment Structure

The WRT sector is currently the fourth largest employer in the country, behind agriculture, community and social/personal services, and manufacturing. Its share in total employment is 14.4%, amounting to a total of 10 million individuals. Of these 10 million, more than 9.5 million are self-employed proprietors (such as small

26 Govt of Pakistan NEPRA, 'State of Industry Report 2022.Pdf', 2022, https://nepra.org.pk/publications/State%20of%20Industry%20Reports/State%20of%20Industry%20Report%202022.pdf.

27 A retailer is a person/firm, supplying goods to general public for the purpose of consumption

28 Wholesaler' includes a dealer and means any person who carries on, whether regularly or otherwise, the business of buying and selling goods by wholesale or of supplying or distributing goods, directly or indirectly, by wholesale for cash or deferred payment or for commission or other valuable consideration or stores such goods belonging to others as an agent for the purpose of sale; and includes a person supplying taxable goods to a person who deducts income tax at source under the Income Tax Ordinance, 2001.

shopkeepers), contributing family workers, or sales workers working as employees in wholesale and retail establishments. Only 3% of the sector's labour force falls under the managerial occupation category, which is mostly associated with very large WRT businesses.[29]

The sector is almost entirely dominated by informal employment relations. Labour force estimates show that 97.7% of all persons (i.e., 9.77 million individuals) working in the WRT sector are informally employed.

The diffused structure of the sector can also be assessed drawing on data from the 2005 census of economic establishments. Table 8 provides the percentage of establishments in each employment category, by major industry division. It is apparent that WRT is dominated by small enterprises (with high rates of marginal or self-employment), more so than any other industry division.

TABLE 8: Establishments in each employment category, by major industry division (2005)

MAJOR INDUSTRY DIVISION	EMPLOYMENT SIZE, IN NUMBER OF EMPLOYEES				
	1-5	6-10	11-50	50-250	251+
AGRICULTURE, FORESTRY, HUNTING AND FISHING	94.39	5.23	0.37	0.02	-
MINING AND QUARRYING	41.65	36.04	19.78	2.24	0.28
MANUFACTURING	86.74	10.94	2.13	0.17	0.03
ELECTRICITY, GAS AND WATER	89.52	4.03	5.65	0.81	-
CONSTRUCTION	87.73	10.14	2.06	0.07	-
WHOLESALE AND RETAIL, TRADE AND RESTAURANTS AND HOTELS	98.02	1.86	0.12	0	0
TRANSPORT, STORAGE AND COMMUNICATION	94.91	4.4	0.64	0.04	0.01
FINANCING, INSURANCE, REAL-ESTATE AND BUSINESS SERVICES	92.89	5.93	1.11	0.06	0.01
COMMUNITY, SOCIAL AND PERSONAL SERVICES	92.96	5.34	1.65	0.05	0

2.1.2.3 Heterogeneity in Informality

Drawing on a 2015 survey-based study commissioned by the State Bank of Pakistan on the supermarket and retail sector, the heterogeneity of informality in the sector can be assessed using various non-tax business metrics. For example, only 37% of all businesses have any credit-relations with the formal banking system, while the rest utilize self-finance or informal credit systems. 30% of all businesses reported that they did not obtain invoices from suppliers, while only 53% said they issued printed invoices to their customers.[30] Interviews with small businesses reveal that onerous requirements from the formal banking sector, fear of predation from tax authorities after documentation, and insistence of maintaining undocumented relations with other actors in the supply chain are key factors. Regardless of these factors, the overall cost to the economy in terms of foregone revenue as well as the inability of businesses to scale and obtain efficiency gains remains significant.

In recent years, changes in the consumption economy, the development of sales and income tax registration regimes, as well as the enforcement of tax regulations have created significant heterogeneity of enterprise type, scale, and levels of informality within the WRT sector. The segmentation discussed so far consists of the differences in wholesale versus retail activity. Wholesalers, dealers, and distributors are liable for full sales tax registration and thus constitute one segment. However, within the retail sector, new types of segmentation have emerged and expanded, which has produced heterogeneity in the levels of informality as well.

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29 These would include individuals working or running large wholesalers as well as branded retail enterprises

30 Badr Siddiqui, '"Supermarkets and Retail Shops"', 2015, 45.

One principal source of segmentation that is based in the sales tax regulatory structure is between enterprises classified as Tier 1 retail versus non-tier retail. The stipulations for tiered retail were introduced in 2014 and relate to compulsory registration with the prevailing sales tax regimen at the rates specified in the Sales Tax Act. 'Tier-1 retailer' is defined in section 2(43A) of the Act to be a person who falls in any of the following categories:

- a retailer operating as a unit of a national or international chain of stores.
- a retailer operating in an air-conditioned shopping mall, plaza or centre, excluding kiosks;
- a retailer whose cumulative electricity bill during the immediately preceding twelve consecutive months exceeds Rupees twelve hundred thousand;
- a wholesaler-cum-retailer, engaged in bulk import and supply of consumer goods on wholesale basis to the retailers as well as on retail basis to the general body of the consumers"; and
- a retailer, whose shop measures one thousand square feet in area or more.

Since 2021, FBR has also pushed for the integration of Tier-1 retailers to the Point of Sale (PoS) system to monitor sales in real time. The integration scheme offers several incentives as well as punitive steps in case of failure.[31] To date, the scheme has registered over 8000 retailers, though has not been particularly successful in generating additional revenue, bringing in only an additional PKR 3 billion, given an initial target of 25,000 retailers and PKR 15 billion in additional revenue.[32] FBR releases a list of integration-liable retailers on a regular basis based on market intelligence, and a failure to comply can lead to sealing of business as well as fines ranging from PKR 500,000 to 1 million.

Retailers falling outside of the tier-1 conditions are only liable to pay sales tax at the rate of 5% or 7.5% on their commercial electricity bills, depending on the amount of the bill. The use of electricity bills to collect sales tax ensures a base level of collection from retail outlets, but this mechanism also has the impact of neglecting documentation of a large number of retailers that do not fall under the tiered conditions. This means that **while existing regulations provide at least a theoretical possibility of documenting the sales and thus incomes of tier-1 retailers over time, no such possibility exists to capture the same for thousands of other retailers**.

This is further confirmed by the data of income tax collection from selected marketplaces shared by FBR in 2018. Table 9 lists the top twenty commercial locations by average tax collected per filer out of the FBR-selected sample of major marketplaces in large urban centers. 17 of these are shopping malls and upscale commercial localities, where branded/Tier-1 retail is likely to take place, while only three are bazaars/markets populated mostly by wholesale businesses.

31 Failure to integrate with the PoS system carries several punishments, including a bar on input tax adjustment of up to 60% for the entire tax period, as per an amendment to the Sales Tax Act in 2021.

32 'Big Retailers Demand End to Tier System', The Express Tribune, 17 May 2022, https://tribune.com.pk/story/2356928/big-retailers-demand-end-to-tier-system.

TABLE 9: Top Twenty commercial locations by average tax collected per filer (2017-18)

MARKET	CITY	NO. OF FILERS	AVERAGE TAX COLLECTED PER FILER (IN RS.)
THE FORUM	KARACHI	202	16,406,213
LEGACY TOWER	FAISALABAD	17	8,569,800
MARKET ESTATE AVENUE	KARACHI	774	7,998,755
KOH-I-NOOR MALL	FAISALABAD	9	7,592,604
BLUE AREA	ISLAMABAD	5,854	6,821,930
PARK TOWER	KARACHI	132	4,710,724
UNI CENTER	KARACHI	220	2,721,193
JUBILEE MARKET	KARACHI	30	2,608,279
H BLOCK DEFENCE	LAHORE	32	2,319,814
GADDAFI STADIUM	LAHORE	62	2,266,036
TIBET CENTER	KARACHI	85	1,775,597
RIPPLE PLAZA	FAISALABAD	3	1,744,184
PACE SHOPPING MALL	LAHORE	120	1,537,764
JODIA BAZAR	KARACHI	2,384	1,283,525
EMPRESS MARKET	KARACHI	154	1,276,454
EMERALD TOWER	KARACHI	9	1,210,299
DOLMEN MALL	KARACHI	41	1,192,831
OCEAN MALL	KARACHI	6	1,186,346
TIMBER MARKET	KARACHI	209	1,115,538
MALL ROAD	LAHORE	1,339	1,111,728

Given the variation in business types, regulatory structures, enforcement, and business practices identified above, Table 10 presents a typology of informality in the WRT sector, which captures heterogeneity within business type, i.e., compliant versus non-compliant wholesalers, as well as across business types.

TABLE 10: Typology of Informality in WRT sector

TYPE	%AGE SHARE OF ESTABLISHMENTS<?>	LEGAL STATUS	LEVEL OF INFORMALITY	DRIVER OF INFORMALITY
WHOLESALE	4.5	Liable for registration and documentation	Medium-to-High	Evasion of registration; Concealment practices
BRANDED/TIER-1 RETAIL	9	Liable for registration and documentation	Low-to-Medium	Evasion of registration; Concealment practices
MASS/NON-TIER RETAIL	86.5	No registration and documentation requirement	High	Regulatory oversight; Concealment practices

2.2 Tax Collection Challenges - Leakages and Concealment

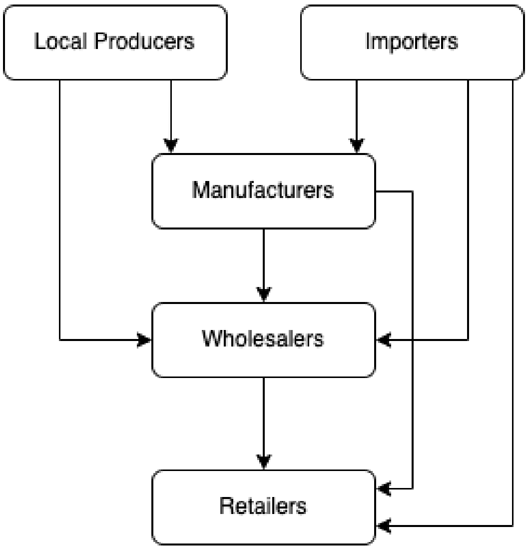
Concealment practices, such as conducting cash-based transactions, under-invoicing, maintaining separate books, and dealing in un-registered/smuggled/non-customs paid commodities, are the most common form of informality in wholesale and retail trade. The extent of these practices varies significantly across businesses and across business types, depending on their position in the distribution value chain.

Figure 1 presents a simple version of the economic supply chain that connects different spheres of commodity production and trade with the wholesale and retail sector. There are different aspects and degrees of tax-based informality at each stage and various mechanisms of concealment that produce the outcomes identified in the preceding sections.

FIGURE 1: Distributive Value Chain in Pakistan

This study focuses on concealment practices at three levels:

1. Import Stage
2. Business-to-Business Transactions
3. Stock and Turnover Concealment



2.2.1 Import Stage: Smuggling and Customs Evasion

While customs evasion and import stage informality is not a central focus of this study, its knock-on impact on the rest of the value chain through the distribution of such goods is worth highlighting. As a transit country for land locked neighbors, Pakistan faces a significant amount of informal cross border trade (ICBT). ICBT refers to undocumented business transactions that take place across porous borders. These include goods moving through unofficial (smuggling) and official trade routes (through mis-declaration of cargo). In particular, the smuggling problem in Pakistan is multimodal with goods coming in from multiple sources including the high sea and in containerized cargo with officials fully aware and involved in their transport.[33]

From the perspective of this study, the smuggled goods provide unfair competition to non-smuggled commodities and compete with domestically produced goods that have incurred production costs and are responsible for paying sales tax. Moreover, such goods block out the domestically produced goods for which an import tariff is placed for protection and elbow out duty paid imported goods which have borne the brunt of import tariffs.

As per FBR data[34], the 11 most smuggled goods were tyres, cigarettes, tea, auto parts, mobile phones, textiles, plastic granules, televisions, steel sheets, vehicles, and diesel. Smuggled goods in these categories are found to be catering to domestic market demand to a high degree. **In 2015, the smuggling to GDP ratio for the**

33 Smuggling, by definition, is the bringing in of goods/commodities into the domestic market without incurring Customs duties and other related taxes.

34 2015 FBR Report: "Ascertain the Market Demand of Goods Prone to Smuggling—Establishing the Volume of Smuggling" – prepared by MCC Preventive, Karachi.

eleven commodities investigated accounted for 3.88% of the country's total GDP, and 9.46% of the total tax collected by FBR, or USD 2.38 billion.[35] Table 11 summarizes the findings of this research.[36]

TABLE 11: Estimates of evasion due to smuggling in 11 key commodity categories

COMMODITY CATEGORY	TOTAL VALUE (IN $)	CD ($)	ST ($)	WHT ($)	TOTAL REVENUE LOSS ($)
TYRES	280,728,738	56,712,421	47,723,885	14,036,437	118,472,743
TELEVISION	17,438,475	5,231,542	2,964,541	871,924	9,068,007
TEA	242,198,238	24,219,824	41,173,700	12,109,912	77,503,436
CIGARETTES	51,673,897	15,502,169	8,784,563	2,583,695	26,870,427
MOBILE PHONES	4,394,218,566	89,942,250	747,017,156	219,710,928	1,056,670,335
PLASTIC GRANULES	822,915	41,146	139,896	41,146	222,187
STEEL SHEETS	351,785,740	35,178,574	59,803,576	17,589,287	112,571,437
POL HSD	2,731,403,430	273,140,343	464,338,583	136,570,172	874,049,098
VEHICLES	626,535,952	36,970,238	106,511,112	31,326,798	174,808,148
AUTOPARTS	320,000,000				185,980,000
FABRIC	6,111,966	1,247,950	1,039,034	305,598	2,592,582
TOTAL	9,022,917,917	538,186,457	1,479,496,046	435,145,896	2,638,808,399

The responsibility of combating smuggling is distributed amongst different agencies, thereby diluting it. Therefore, no agency takes this work as their primary function and the role is assigned to a lower level of priority and does not get the attention it deserves. At various fora, the principal recommendation to reduce revenue loss and the proliferation of smuggled goods in the domestic market has been for the Government to adopt a single agency focus to enforce Customs' laws. Customs should be equipped with the appropriate technological tools, principally cargo scanners, to ensure that enforcement is at its desirable level to support greater documentation and exercise greater market control.

2.2.2 Business-to-Business Transactions

The practices of concealment within B2B transactions are numerous, ranging from under-invoicing and utilizing all-cash transactions to fraudulent input tax adjustment and refund claims. As laid out in an important study by Dr Jawad Ali Shah, one common form of the latter is "Domestic Missing Trader" or DMT fraud.

The DMT fraud operates in a chain. In Pakistan's case, one firm issue invoices to the other and so on. Usually, the first supplier S1, issues sales invoices of the desired goods to a buyer without supplying them. The buyer in these cases is a well-established business operating in formal sector, generally a manufacturer. The invoice issued by S1 gives the buyer right to claim input tax credit although they actually purchased those goods from unregistered suppliers in the informal sector. In order to reduce their tax liability, the buyer now has legal claim of input tax against purchases, which never physically occurred. This can reduce the tax liability of the buyer significantly.

35 Pakistan's calculated smuggling to GDP ratio is extremely high compared to countries in the region. India's smuggling to GDP ratio (at least for goods, which have been studied) is 0.43% while Bangladesh's is 0.04%.

36 Since the implementation of the device implementation, registration, and blocking system (DIRBS) in 2018, the smuggling of mobile phones has decreased significantly. It is also expected that the decline of Afghan Transit Trade would have reduced smuggling in some of these commodity groups.

For example, a buyer who made purchases worth ten million Pak Rupees from the unregistered or informal sector can reduce their payable VAT by 1.5 million rupees (assuming a 15% tax rate). The self-enforcing mechanism of VAT demands that the seller S1 has a large amount of output tax which must be deposited in the treasury but to this end S1 is backed by a chain of suppliers say S2, S3, S4 S5 etc. who can provide the fake input tax credit to reduce the actual tax payment by S1 to zero or a negligible amount. One such network of suppliers who are criminally colluding with each other can deprive the exchequer to the tunes of millions of rupees each month. These fake suppliers exploit the difficulty of audit and enforcement faced by the tax administration to get away with this fraud.[37] In recent years, improvements in technological systems have reduced the viability of fraud through flying invoices, although a number of leakages in business-to-business transactions still exist.

A similar finding is recorded in a seminal study by Mazhar Waseem.[38] Exploiting a tax reform from Pakistan that cuts the tax rate on five major industries of the country substantially, estimates the size and nature of VAT evasion in the treated industries, finding that it ranges from 31–46% of the potential revenue. One important channel through which the evasion occurs is the overclaim of refunds, which constitute 11-23% of the potential revenue. Roughly two-fifths of the overclaimed refunds are based on spurious invoices issued by invoice mills.

Another common form of concealment is under-invoicing. The cost of hiding a transaction is not significant if the other party is an unregistered firm, or a firm willing to collude. In particular an unregistered buyer has no concern with sales value reported by their sellers because truthful reporting of seller has no marginal benefit for buyer. On the other hand, misreporting of true sales value provides a direct benefit to seller who can keep differential amount of tax due as profit. Therefore, the sellers have a strong incentive to deviate from truthful reporting and declare lower than actual value addition. They collect the price inclusive of tax but can keep a portion of this collected tax by declaring a price lower than the actual price.[39]

2.2.3 Stock and Turnover Concealment

The prevalence of cash-based transactions and weak enforcement capacity make stock and turnover concealment a particularly common form of informality. While this happens across the value chain, it is particularly pronounced at the retail stage, given that principles of self-enforcement for sales tax documentation breakdown at the last stage, as end-consumers do not generate any information trails.

The principles of concealment are similar to the ones discussed in business-to-business transactions, with maintenance of secondary books and *benaami* bank accounts, issuance of fake invoices, and the underreporting/ suppression of sales by making cash-based transactions all being common phenomenon at the retail stage. In a recent case, for example, a large shoe retailer was found evading sales tax of PKR 500 million by suppressing declaration of PoS-issued invoices to their customers.[40]

Limited human resource and weak and/or compromised enforcement capacity also means that physical assessment of stocks held by traders and sales made to consumers is a difficult task. As per an interview respondent from FBR, high-volume wholesalers operate small offices and establishments in inner city localities, while their stocks are frequently held off-site in undeclared locations. It is thus difficult to assess the true value of their assets and the volume of sales, much of which are carried out over the phone through informal networks of trust with long-time customers.

Ultimately, a key driver of this phenomenon is the high volume of cash circulating in Pakistan's economy.

37 Jawad Ali Shah, 'Dynamics of Missing Trader Fraud in VAT Regime: Evidence from Pakistan', 2020, 7.

38 Mazhar Waseem, 'Overclaimed Refunds, Undeclared Sales, and Invoice Mills: Nature and Extent of Noncompliance in a Value-Added Tax', SSRN Scholarly Paper (Rochester, NY, 2020), https://doi.org/10.2139/ssrn.3582327.

39 Jawad Ali Shah, 'ESSAYS ON EVASION AND ENFORCEMENT IN VALUE ADDED TAX (VAT)', *Theses and Dissertations--Public Policy and Administration*, 1 January 2021, https://doi.org/10.13023/etd.2021.284.

40 Mubarak Zeb Khan 'Rs500m Sales Tax Fraud by Shoe Retailer Unearthed', DAWN.COM, 12 January 2022, https://www.dawn.com/news/1668981.

The figure is reported to be around PKR 8 trillion. Over an eight-year period, currency in circulation has increased by 3.4x since 2014, and by almost 1.7x during the last four years. As a percentage of GDP, currency in circulation increased from 10% in 2016 to more than 18% in 2022. The currency in circulation grew at a much faster pace than the GDP, which signifies that increasing quantum of currency is floating in the system, and remains out of formal financial institutions, exacerbating the extent of economic informality.[41] Verifying a chain of transactions that takes place outside the banking system and does not make use of standard payment instruments remains an extremely difficult task.

2.3 Mapping the Political Economy Landscape

The incentive to remain fully or partially outside the tax net is fairly straightforward, given the direct impact that it has on accumulation of greater profits. Formalization and corporatization within bazaar-based activity is still in its infancy, as new businesses prefer to maximize autonomy and profit by operating as unregistered entities.[42] Barring unique pro-social or cultural shifts that encourage greater compliance among businesses, this is the baseline condition which every economy has to contend with. The reliance thus tends to be on technocratic approaches towards informality. Such approaches highlight changes in institutional arrangements, such as the legal and regulatory landscape of taxation laws; technological adoption, such as digitization of transactions, real-time monitoring of sales data, and machine-generated parametric or randomized audit of firms; or building the capacity of tax bodies through increased personnel and greater financial resources.

These approaches are important and have yielded some good results for fiscal administration in Pakistan. But the bigger point remains that despite the Government's stated commitment to broadening the income tax base and implementing an effective GST, it remains unable to document large parts of the economy. Section 1 and 2 of this study provided quantitative assessments of the extent of this informality in the wholesale and retail sector. It is reasonable to assert that the persistence of informality is a political, rather than a technical, outcome, produced by dynamic political economy interactions between state functionaries, political representatives, and businesses in the WRT sector. A central pillar of this dynamic is the collective action carried out by traders and businessmen associated with the WRT sector.

2.3.1 A Recent History of Attempted Reform

Since the 1990s, there have been a number of reform efforts to expand documentation of the economy, and specifically to capture the true extent of economic activity in the wholesale and retail sector. In June 1998, for example, the PMLN government at the center attempted to extend the General Sales Tax (GST) net onto the retail sector through a clause in the annual budget legislation. Using associational networks functioning at the marketplace, district, and provincial level, traders acted effectively through the legislature, operationalized backdoor channels, and carried out general strikes to weaken and ultimately overturn the government's resolve.[43]

Similarly, in 2000 and 2001, the military government of General Musharraf launched a documentation drive, through a Documentation of Economy ordinance, aimed at assessing the actual turnover value of the retail sector. Despite the regime's insulated, authoritarian character, it too was unsuccessful in the face of successive shutter-down strikes in Punjab and Sindh, including one that lasted for 11 successive days.[44] Interview respondents from the WRT sector claim that even the presence of armed forces officers accompanying tax inspectors did not dissuade traders from carrying out effective collective action and limiting the viability of the documentation drive.

41 'Cash Is Still King', Profit by Pakistan Today, 24 July 2022, https://profit.pakistantoday.com.pk/2022/07/24/cash-is-still-king/.

42 Colin Williams, Muhammad S. Shahid, and Alvaro Martínez, 'Determinants of the Level of Informality of Informal Micro-Enterprises: Some Evidence from the City of Lahore, Pakistan', World Development 84, no. C (2016): 312–25.

43 "GST rollout hits major snags." *The Nation* (Lahore, Pakistan) 21 Sept. 1998:11

44 "Strikes weaken documentation drive" *Dawn* (Lahore, Pakistan) 20 Oct. 2000: 14

In FY2010-11 there was once again significant mobilization against a reformed general sales tax/VAT extension to the retail stage. In 2014, traders successfully mobilized against consumption audits of self-assessed income tax returns, in 2015 against the imposition of 0.6% withholding tax on banking transactions, and in 2016 against the extension of the sales tax net to non-tiered retailers.

In 2019, tax authorities attempted a significant reform by making mandatory the submission of Computerized National Identity Card (CNIC) copies for all transactions above PKR 50,000 at the B2B and B2C level. The step was an attempt to mitigate against the systemic breakdown of the information trail at the stage of the final consumer. However, this again was suspended after significant collective action by traders across the country, coupled with backdoor lobbying against the then FBR chairperson. It was finally entirely rolled back in the 2022 budget.[45]

The most recent incident of collective action was against the imposition of a fixed tax on non-Tier 1 retailers in the 2022 budget, proposed to be collected through the electricity bills.[46] Here too, after public lobbying by associational representatives of the WRT sector, the move was taken back after a change in leadership at the finance ministry.

2.3.2 The Political Economy of WRT Collective Action

Writing about politics in Punjab during the 1990s, Andrew Wilder alluded to the dominance of *bazaar* actors in the following words:

"Traders are now on the rise. Every alley, every *bazaar* is now organized in the shape of some association or the other. These traders have 'shutter power'. If a 2000 worker factory is closed by workers in a rural area, it has no effect. But say the shopkeepers of Anarkali close their shutters for two hours, it will have a much bigger effect in the city.... workers have been leaving the Pakistan People's Party (PPP) for the Pakistan Muslim League (PML) because shopkeepers, businessmen and others of the same ilk are able to provide employment and access to the *sarkaar* (state)".[47]

Wilder's research taps into an important yet understudied theme in Pakistan's domestic politics: the organisational 'shutter' power and collective action of the retail-wholesale sector. This was first put forth by Stanley Kochanek in the 1980s in his work on business organizations in Pakistan, wherein he suggested that the upper-tiers (large manufacturers) of the business community had direct access to political decision-makers, so the lower-tiers (small manufacturers and WRT businessmen) tended to organize amongst themselves to match the former's policy and administrative influence. This was done not only through the established Chambers of Commerce, but also through other localized associations.[48]

Since these tangential observations were made many years ago, associational trends within the WRT sector have grown exponentially. Marketplaces, as mentioned by Wilder, are organized on an individual basis, with proprietors forming the constituent membership of a market association. In some instances, these associations are registered as non-profit 'societies' or 'trusts' under the Societies Act, and are thus, legally obliged to hold

45 Sohail Sarfraz, 'Supplies to Unregistered Persons: CNIC Condition Waived', Brecorder, 11 June 2022, https://www.brecorder.com/news/40179420.

46 For other than Tier – 1 retailers and specified service providers, a 'final tax' was levied on the basis of gross amount billed for commercial electricity connections at the following rates: Where the amount does not exceed Rs. 30,000: Rs 3,000; Where the amount exceeds Rs. 30,000 but does not exceed Rs. 50,000: PKR 5,000 Where the amount exceeds Rs. 50,000 but does not exceed Rs. 100,000: Rs. 10,000 Specified retailers and service providers through Income Tax General Order: Rs. 200,000

47 Andrew Wilder, *The Pakistani Voter, Electoral Politics and Voting Behaviour in the Punjab* (Oxford University Press, 1999).

48 Stanley A. Kochanek, *Interest Groups and Development: Business and Politics in Pakistan* (Oxford University Press, 1983).

internal elections and provide details of regular activities. However, most associations are informal, created by dominant individuals within each marketplace to institutionalize their influence over other business owners, and to expand their sphere of influence with government officials. Elections to elect office-bearers are irregular, and factionalism is rife within each marketplace, often perpetuated by divergent political or ethnic affiliations.

At higher tiers, individual marketplace associations and businesses network with apex organizations based at the district, provincial, and all-Pakistan level. Apart from the Chambers of Commerce, which are located in every major city and are regulated by the Trade Organizations Act, there are apex associations that represent retailers/wholesalers of particular goods – such as the Pakistan Auto Spare Parts Importers and Dealers Association (PASPIDA) – or generic bodies representing retail/wholesale businessmen regardless of goods sold – such as the All Pakistan Anjuman-i-Tajran (Association of Traders), the Qaumi Tajir Ittehad (National Traders Alliance), and the All Pakistan Association of Small Traders and Cottage Industries. Currently, there is no exhaustive list of apex associations working in retail and wholesale, but estimates gathered from the Ministry of Commerce place the total number of such organizations at close to 200. The number for *bazaar* associations – both formal and informal – runs well into the thousands.

The sector's ability to mobilize effectively and utilize their 'shutter-power' remains a significant feature of contentious politics in Pakistan. Between 2005 and 2010, WRT traders were the second-most mobilized occupational group, after government employees, accounting for approximately 15% of all protests and strikes.[49] Despite significant internal heterogeneity, activities of most WRT associations manage to traverse several different domains and help consolidate political and social capital for traders. Interview accounts reveal that association leaders provide access to supply-chain networks, wage-controlled labour, and in some instances, temporary financing to individual members. This is often coupled with the basic, yet important task of informal dispute resolution for commercial and personal disputes that arise between traders or with other actors.

Activities like collective action and provision of club goods help create internal solidarity and political cohesiveness within the traders' community. Similarly, constant engagement with political and bureaucratic actors for purposes of financing elections, exchanging rents, and safeguarding their economic interests bestows them with political influence that is used in a wide variety of circumstances, including for their own political ambitions.

From Pakistan's first general election in 1970 to its eleventh in 2018, the presence of small and medium-sized businessmen (especially from trading and commercial backgrounds) in the Punjab provincial legislature has grown exponentially. In 2013, businessmen were the second biggest occupational group, after agriculturalists/landlords, at 37% of the total assembly. Within urban constituencies, businessmen stood and won from nearly 72% of all seats in the province's burgeoning towns and cities. This trend is highly pronounced for the city of Lahore, where 81%, or 31 out of 38, national and provincial representatives elected in the 2013 general election work as fulltime traders or small-scale manufacturers.[50]

2.3.3 Bureaucratic Authority and Evasion

Even a cursory assessment of the statistics listed in the previous sections demonstrates that prosperous traders engage in large-scale avoidance or evasion of their tax liability. In recent interviews, most WRT businessmen openly acknowledged this reality at a sector-wide level, though are, understandably, resolutely silent on their

49 Ahsan I. Butt, 'Street Power: Friday Prayers, Islamist Protests, and Islamization in Pakistan', *Politics and Religion* 9, no. 1 (March 2016): 1–28, https://doi.org/10.1017/S1755048316000031.

50 Occupational data for the current term available on the Punjab assembly website http://www.pap.gov.pk. In local government elections held in 2015, 184 out of 268 candidates of the ruling Pakistan Muslim League-Nawaz (PMLN), and 167 out of 256 candidates of the main opposition party Pakistan Tehreek Insaf (PTI) were traders or other commercial entrepreneurs. Amongst the 273 candidates that won city council seats, 38 were presently serving as office-bearers of their local *Anjuman-i-Tajran*.

own complicity in it. In doing so, they produce a variety of narratives about taxation ranging from the failure of the state to keep up its end of the fiscal compact, fear of predation, financial burdens, and even Islamic injunctions around charity.[51] This tradeoff between charity or philanthropy and taxation is one that frequently comes up in research on fiscal practices in Pakistan. Many businessmen feel that they pay their due to society through indirect and private contributions, leaving no need for the state to ask for more.

A significant driver of informality is the practice of collusion between tax officials and businessmen that results in purposeful evasion.[52] This practice remains particularly salient in large commercial locations that are populated by wholesalers and distributors. Many of the subversive accounting practices mentioned earlier, such as *benaami* transactions, under-invoicing, and use of non-customs duty paid inventory, are widely prevalent and take place in considerable view of the Regional Tax Office (RTO). Tax and customs inspectors from the field office are frequent visitors to marketplaces and usually enjoy fairly cordial relations with prominent businessmen.

In the presence of political influence at the constituency level as well as through apex lobbying associations, and grassroots level collusion with field office staff, reform that seeks to enhance documentation of the sector is not a straightforward task. Moreover, the political economy of informality remains fairly entrenched across party lines, which makes generating sufficient political will for reform a difficult proposition.

2.4 Achieving Documentation Reform: Comparator Country Efforts

Countries that have successfully reduced informality in wholesale and retail trade have done so through a number of incentive and punitive-based interventions. These include heightening state capacity for market intelligence, enforcing business registration and forced-adoption of value-chain documenting technologies. Greater incentives such as easier access to formal-sector finance, reduced tax rates, and higher input-tax adjustments are also offered to improve compliance.

2.4.1 Indonesia

Indonesia implemented a one-stop-shop program (PTSP) in 2001—a large-scale program to reform its business licensing process. One-stop shops consolidate business licensing in one office at the district level, making the process of obtaining licenses less cumbersome for license applicants. At present, the program is steered by Indonesia's Investment Coordinating Board. Data from BKPM reveals the evolution of PTSP locations over time. In 2001, PTSP offices were located only in two districts. By 2006, this number went up to 23. However, after a ministerial decree promoting the expansion of PTSP across Indonesia was passed, one-stop shops began proliferating. By 2009, 256 out of 444 districts (57.7%) had one-stop shops. By 2013, only four districts were without them.[53]

PTSP prods firms that want to formalize or firms that are at the edge of formality into registering. Additionally, PTSP standardizes the process of registering. This is important because normally it is difficult for firms to obtain information about registration and certification processes. This creates a situation that corrupt officials can use to penalize firms that are trying to shift to the formal sector.[54] Therefore, the one stop shop program reduces costs associated with business licensing and exhorts firms to formalize, while also removing a key source of state predation.

51 Musharraf R. Cyan, Antonios M. Koumpias, and Jorge Martinez-Vazquez, 'The Determinants of Tax Morale in Pakistan', *Journal of Asian Economics* 47, no. C (2016): 23–34.

52 Muhammad Muazzam Mughal, 'Reasons of Tax Avoidance and Tax Evasion: Reflections from Pakistan', *Journal of Economics and Behavioral Studies* 4, no. 4 (15 April 2012): 217–22, https://doi.org/10.22610/jebs.v4i4.320.

53 Rothenberg, A. D., Gaduh, A., Burger, N. E., Chazali, C., Tjandraningsih, I., Radikun, R., Sutera, C., & Weilant, S. (2016). Rethinking Indonesia's informal sector. *World Development, 80*, 96–113.

54 Ibid.

Tax relief was another key policy for providing support to informal businesses and self-employed workers—especially those affected by the pandemic. Indonesia lowered its corporate income tax to 22% in 2020 and 2021 and reduced it further to 20% in 2022—mainly in manufacturing. Other tax measures include i) "reduced or exempted social security for affected MSMEs and industries", ii) "reduced or exempted value added tax for businesses", and iii) "various tax holidays and/or tax breaks for specific actors, especially small business owners or those that self-employed".[55]

2.4.2 Ghana

Ghana has a large informal economy and a low tax-to-GDP ratio. Ghana Revenue Authority (GRA) tried different ways to bring the informal sector into the tax net. One way was through the introduction of the 2004 stamp tax—arguably one of the most important informal sector tax reforms. However, apart from the stamp tax, the large non-farm informal economy also presented other opportunities for charging fees, licenses, and permits from informally self-employed workers—constituting 27% of local government revenues.[56]

In 2018, WIEGO researchers did a small survey of the informal street and market vendors and kayayei (market porters) in Accra. The survey asked questions that provided useful insights into the structure of local tax regimes. It found that most—almost 61%—informal workers pay some type of fee or tax to the local government authority (Accra Municipal Authority or the AMA). Two of them include the "daily tax" and "license fees". Few workers reported paying a tax directly on their income, and even fewer workers were exempt from different sources of taxation.[57]

While there are significant equity considerations involved with imposing taxes on the informal economy, the right approach and sequencing has helped in inducing more household-based enterprises to register and contribute to the economy. The role of greater monitoring and collaborative reform, partnering with informal economy associations, also remains central in Ghana.

2.5 Conclusion and Pathways for Reform

The entrenched political economy of informality identified in section 4 and the efforts of comparator countries in reducing evasion and expanding the fiscal base shows that reform is far from a straightforward proposition. The fact that many reform initiatives to document sales and implement tax regulations, especially at the retail level, have been launched and then aborted highlights the scale of the challenge. This section provides an overview of the institutional and technical changes required to limit informality, building on many of the initiatives that are already either under consideration or have been partially implemented. Table 12 provides a summary of the proposed initiatives along with a sequenced timeline for implementation.

TABLE 12: Key Suggested Reforms

YEAR	REFORM TYPE	STAKEHOLDERS	LEVEL OF LIKELY OPPOSITION

55 Das, A., & Bambang, S. (2022). *Informal Services in Asian Cities: Lessons for Urban Planning and Management.*

56 Rogan, M. (2019, September). *Tax Justice and the Informal Economy: A Review of the Debates.* Women in Informal Employment: Globalizing and Organizing. Retrieved from https://www.wiego.org/sites/default/files/publications/file/Rogan_Taxation_Debates_WIEGO_WorkingPaperNo41_2020.pdf.

57 Ibid.

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	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; simplification of registration for small traders.	FBR, CAP	High

2.5.1 Integration of Data

The central initiative proposed here is the real-time integration of data between several federal government entities, namely FBR, SBP, and NADRA. While the volume of cash-based transactions is high, the gradual closure of evasion-enabling instruments such as bearer prize bonds and law & order concerns means that high turnover businesses eventually have to make some use of banking channels. This data is being monitored consistently through the Financial Monitoring Unit (FMU) and banking networks, in particular with regards to large cash transactions that may generate Currency Transaction Reports (CTRs).[58]

The fact that real-time banking data is available provides a key opening with which to document patterns, drawing on existing machine-learning software such as those utilized by financial intelligence organizations elsewhere. This entails enhancement of capacity, much of which is currently focusing on anti-money laundering and terrorist financing initiatives due to extant pressures placed by the FATF regime. With Pakistan exiting the grey list, it is imperative that financial intelligence provides sufficient attention to undocumented economic activity that is causing fiscal erosion.

2.5.2 Centrality of Personal Identifier

Unlike many other countries at comparable levels of development, Pakistan has the distinct advantage of already possessing a centralized personal identifier database that is biometrically verified for upwards of 85% of the adult population. CNIC coverage is extensive and is already the connecting link between tax authority and banking data. It provides the only partial solution to addressing the break of information trail within unregistered B2B as well as B2C transactions as far as the sales tax regimen is concerned.
It is proposed here that the CNIC condition for transactions above a certain threshold be reinstated in order to generate valuable information on the volume and identity of transactions in the WRT sector. While acknowledging the political constraints of undertaking it, it is imperative to recognize that the institutional and technological base for this initiative is already in place, given the prevalence of the CNIC as a personal identifier.

The threshold and any suitable caveats may be arrived at after deliberation with associational representatives from the business community and sufficient grace period may be granted for wider adoption. But at this stage, given the existing tax regimen and its expedient reliance on indirect sources of information to assess WRT turnovers (such as electricity bills), this will be a significant step towards actual documentation.

2.5.3 Greater Market Intelligence for PoS Integration

The PoS initiative is an important one for documenting WRT sales and carries significant potential, if pursued aggressively not just in the three major cities, but across all regional tax offices. As the study has identified,

58 As per Gazette notification SRO 73 (I)/2015 dated 21-01-2015, the minimum amount for reporting a CTR to FMU is two million rupees.

the contribution of cities other than Karachi, Lahore, and Islamabad is incommensurate with their overall population growth and likely contribution to economic activity. Greater market intelligence needs to be deployed for integration and real-time documentation of turnovers

The punitive conditions for failure to integrate are important, specifically the abeyance of up to 60% of input tax adjustment, but a more conducive incentive structure may also be offered, including the offsetting of any initial costs that smaller retailers in particular may be wary of.

2.5.4 Other Initiatives

A host of other initiatives are important, including those pertaining to the removal of a tiered system of retail and gradually making sales tax registration mandatory for all businesses. This will have cost and profit margin implications for small businesses and an appropriate compensatory mechanism will have to be identified. Retailers will have to negotiate margins based on consideration of output tax liability and increase of input tax credit, which may be supported through appropriate government incentives.

As identified in the report, key sectors of the informal economy are reliant on smuggled goods to cater to market demand, causing significant fiscal loss as well as damaging the competitive landscape of the economy. Improved customs enforcement is thus another area which requires constant attention, especially in terms of technological adoption to enable accurate documentation and monitoring of goods entering the country.

2.5.5 Political Considerations and Sequencing of Reform

The issue of political will is central to any reform initiative. Entrenched opposition and collective action towards combating documentation efforts are unlikely to dissipate anytime soon. In this regard, the identification of appropriate sequencing strategies and openings provided by segmentation within the sector is key. In the view of this report, the cleavage between branded/Tier-1 retail and mass retail is an important one that is worth cultivating to develop a pro-reform lobby within the sector. Specifically, the Chain store Association of Pakistan (CAP) has emerged as a pro-reform voice for branded retail and is increasingly playing a leadership role, carrying out club good initiatives and representing the interests of documented sections of the sector. Greater engagement with such actors, rather than disruptive ones, is key to take the reform effort forward.

Lastly, any aggressive push needs to be re-considered given that it is taking place at a time when the country is going through a purposeful period of demand contraction. With businesses already experiencing slowdown, and consumers experiencing higher inflation and employment concerns, forcing greater compliance costs and punitive actions on one of the largest segments of the economy is ill-advises. A way out would be to phase in the interventions over a three-year stabilization period, with sales tax registration remaining the focus in year-1, an expanded and revised fixed income tax scheme, which would include medium and small-sized retailers, being introduced in year-2 and 3, and the provision of incentives (rather than penalties) for moving towards the CNIC identifier, digital payments, and greater transparency in documentation.

3. Real Estate Sector

3.1 Overview of Pakistan's Real Estate Sector

Real estate activities involve the use, purchase, sale, development, and building of real estate for residential, commercial, or industrial purposes. According to the World Bank estimates, real estate assets account for 60 to 70% of the country's wealth. Growth in the real-estate sector can arise due to a thriving economy that can further contribute to other allied industries such as cement, steel, bricks, building materials, etc., thereby leading to job creation and economic growth. However, this growth-led and growth-promoting feature of real estate is compromised if the growth in the sector is mainly driven by investment in empty plots of land without linkages to other productive sectors of the economy. This sector study focuses primarily on this latter aspect of real estate activities in Pakistan. It highlights how informality, tax structure, and lack of regulation contribute to perverse growth in the sector at the expense of the overall economy. This report exclusively focuses on urban real estate and does not directly address real estate-related issues in rural settings, such as agriculture income taxation. The report also does not look at the construction sector, which is closely connected to urban real estate.

Before we dive into the problems in the real estate sector of Pakistan, it is helpful to present the typology of taxation in the sector. Table 13 summarizes various provincial and federal taxes on real estate activities. The distinction is made between recurrent and non-recurrent taxes. The provincial recurrent tax is the yearly tax, called Urban Immovable Property Tax (UIPT), administered by the Excise and Taxation departments or the Cantonment Boards of the respective governments. Property tax is also applicable on open plots in urban centers, but they are taxed at a much lower rate. For example, in Punjab, the tax on the land area is 1/9th of the tax on the covered area. In practice, it has been difficult to enforce property tax on plots as the ownership records are not always easily available to the enforcement body. The federal government has introduced a tax on deemed income in the Finance Act 2022 as another kind of recurrent tax that will affect owners of capital assets.[59] In addition, tax on rental income from the property is collected by the federal government as another recurrent tax.

In contrast, non-recurrent taxes, such as stamp duty, capital value tax, capital gain tax, or advance income taxes, are levied at the time of the transaction of properties. The table shows the varying bases for these taxes. The recurrent property tax is levied on annual rental values (ARV) estimated by the relevant wings of the provincial government. In contrast, provincial stamp duty and capital value tax (CVT) are based on DC rates. Finally, the federal capital gain and advance income taxes use FBR's valuation of immovable properties as the tax base.

59 The deemed income tax is subject to some controversy regarding its constitutional jurisdiction between the provincial and federal governments (see Haq, I. (2022, December 2). Legal fiction, Section 7E & Constitution. Business Recorder. Retrieved from https://www.brecorder.com/news/40212067).

The advance income taxes or withholding taxes are levied on buyers and sellers at the time of the property transaction. The withholding tax on sellers is collected as advance capital gain tax and is adjustable and refundable in the annual tax returns. The withholding tax on buyers is levied to generate information on the potential income of the buyers and is also adjustable and refundable at the time of tax returns. In terms of tax collection on capital gains the majority of taxes are **collected through withholding taxes (12.15 billion) and only around one-fourth (3.44 billion) of the withheld tax is reported in the tax returns**.

TABLE 13: Taxation of Real Estate in Pakistan[60]

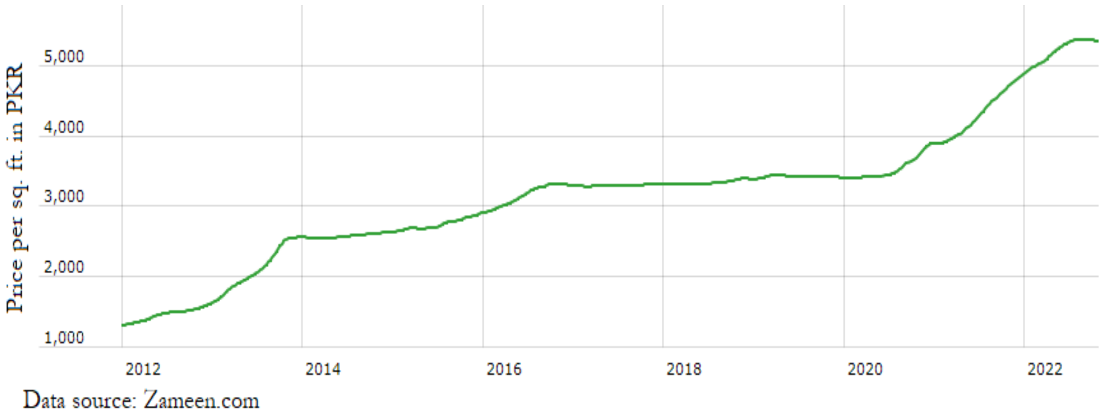
	RECURRENT TAXES			NON-RECURRENT TAXES				
	Property tax	Tax on Deemed Income	Income from Property	Stamp duty	Capital Value Tax	Capital Gains Tax	Advance Income Tax	Advance Income Tax
WHEN IS THE TAX LEVIED?	Yearly	Yearly	Yearly	Sale of property	Sale of Property	Sale of Property	Purchase of Property	Sale of Property
TAXPAYER	Owner, lessee, or occupier	Owner of capital assets	Owner	Buyer	Buyer	Seller	Buyers	Sellers
TAX BASE	Annual rental values of the land and built area of properties	FBR's valuation of immovable properties	Actual annual rental income or fair market value of rental income	DC rate assessments of property values	DC rate assessments of property values	FBR's valuation of immovable properties	FBR's valuation of immovable properties	FBR's valuation of immovable properties
TAX RATE	Rates vary by province. Punjab: 5% of ARV Sindh: 25% of ARV	20% of 5% of the Fair Market Value of the immovable property.	Progressive schedule from marginal rate of 0% to 25%	Rates vary by province. Punjab: 2% of D.C. value	Omitted by Finance Acts in Punjab and Sindh	Top rate of 15%, varying by the holding period and type of the property.	2% (5%) of the FBR's valuation for filers (non-filers)	2% (5%) of the FBR's valuation for filers (non-filers)
JURISDICTION/ COLLECTING AGENCY	Provincial Excise and Taxation or Cantonment Boards	Federal Federal Board of Revenue	Federal Federal Board of Revenue	Provincial Board of Revenue	Provincial Board of Revenue	Federal Federal Board of Revenue	Federal Federal Board of Revenue	Federal Federal Board of Revenue
LEGAL REFERENCE	Urban Immovable Property Tax Acts	Section 7E of the Income Tax Ordinance 2001	Section 15 of the Income Tax Ordinance 2001	Stamp Acts	Finance Act, 1989	Subsection 1A of Section 37 of the Income Tax Ordinance 2001	Section 236K of the Income Tax Ordinance 2001	Section 236C of the Income Tax Ordinance 2001
TAX COLLECTION IN F.Y. 2020-21 (IN PKR)	17.6 billion	NA	27.07 billion	NA	1.21 billion	NA	48.91 billion	12.15 billion

60 Sources: Income tax ordinance 2001, Provincial Urban Immovable Property Tax Acts, Provincial Budget Statements, FBR's Yearbook 2021, Provincial Stamp Acts

3.2 Rate of Return and Investment in the Real Estate

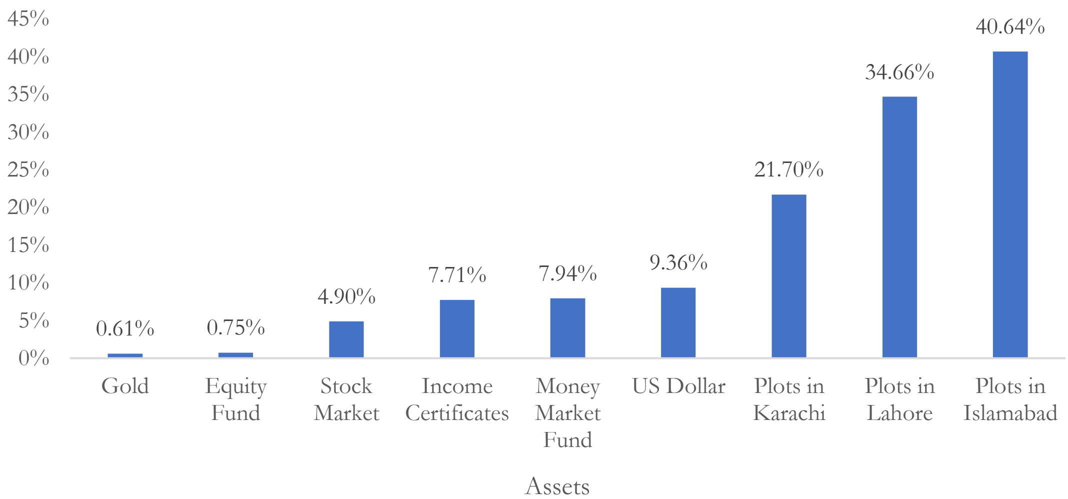
The real estate sector has attracted massive investment over the last decade, which has led to an excessive level of returns from the investment in the sector. Data from Zameen.com reveal that property prices have almost quadrupled in the last decade (Figure 2). While part of this price increase is fueled by genuine unmet demand for housing and remittance inflows, the speculative activity and the belief that property prices will keep increasing have contributed substantially to this growth.

FIGURE 2: Average Plot Prices in Pakistan



The reason for the active investment in real estate is straightforward. **Compared with return on other instruments, investment in real estate offers a lucrative return**. Figure 3 presents an annual rate of return on various investment options in Pakistan for the calendar year 2021 and highlights that the return on investment in plots is unmatched by any other instrument. This is further aggravated by the fact that the real-estate sector, unlike other formally regulated sectors, is characterized by lower taxes and many tax evasion or avoidance opportunities (explained below).

FIGURE 3: Comparison of Annual Returns from Various Assets in C.Y. 2021[61]



61 Source: Mutual Funds Association of Pakistan, Zameen.com, KSE-100 Index, forex.pk

3.3 Tax Collection Challenges and Potential in the Real Estate

Regarding tax revenue collection, Pakistan collects very little from the real estate sector. In the fiscal year 2020-21, Pakistan gathered PKR 107 billion from real estate-related activity (excluding stamp duties)[62] 1.9% of the total tax revenue. As explained below, the revenue collection from real estate activities is dismal to its potential. This section highlights some challenges preventing more significant resource mobilization from the sector.

3.3.1 Problems with Property Valuations

A significant source of revenue shortfall from transaction taxes is due to the underreporting of property values. Both the buyers and sellers face a strong incentive to underreport the value of the property to minimize their tax liability. To address this, the provincial governments (for stamp duty, transfer tax, and CVT) and the federal government (for CGT and WHT) publish a list of assessed property values by location and area. However, these rates are severely undervalued compared to market rates, leading to a substantial loss in tax revenues. Figures 4 and 5 present a comparison of the DC rate, FBR rate, and market rates for residential and commercial plots for a few of the most actively traded areas in the urban centers of Pakistan. While the FBR and DC rates are a fraction of market rates for both residential and commercial plots, they are much more severely undervalued for commercial plots. Based on these regions, on average, the FBR rate is half the market value, and the DC rate is one-fifth.

Focus group discussions with real estate agents indicate that the actual value of property transactions is hard to discern since they are not recorded in the sale/purchase deeds, and the reported value is almost always in reference to FBR or DC rates.[63] It is also revealed that many agents advise their clients to buy high-value plots, such as corner or park-facing plots, and report FBR or DC value to minimize their tax liability. Some agents also advise their clients to buy plots in the area where FBR values are not notified since, in such areas, tax is paid on the DC rate, which is substantially lower than the FBR rates.

Back-of-the-envelope calculations indicate that the mechanical loss in tax revenue due to under-declaration could be as high as 61 billion rupees for federal advance income taxes and five times the CVT and stamp duty collection for provincial taxes. This is based on the observation that FBR collected around PKR 61 billion from the buyers and sellers of properties in FY2020-21 as advance income tax. Combined with the observation that, on average, properties are underreported by half of their market value, this would imply a loss in revenue of 61 billion rupees from advance income tax solely due to underreporting. Similarly, since the DC rate is one-fifth of the market value, the CVT and stamp duties could be increased by five times if the valuations are based on market values.

62 The tax collection from the capital gains and stamp duty is not publicly reported.

63 Bank financed mortgage are exception to this where property values are much closer to the market values and based on assessment by surveyors.

FIGURE 4: Comparison of Market, FBR, and D.C. Rates for Residential Plots

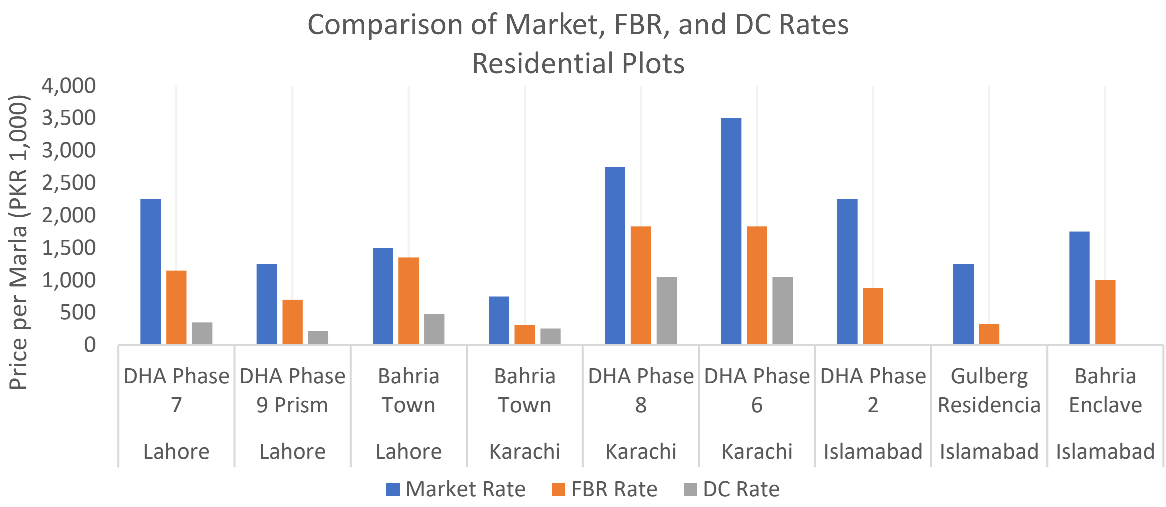
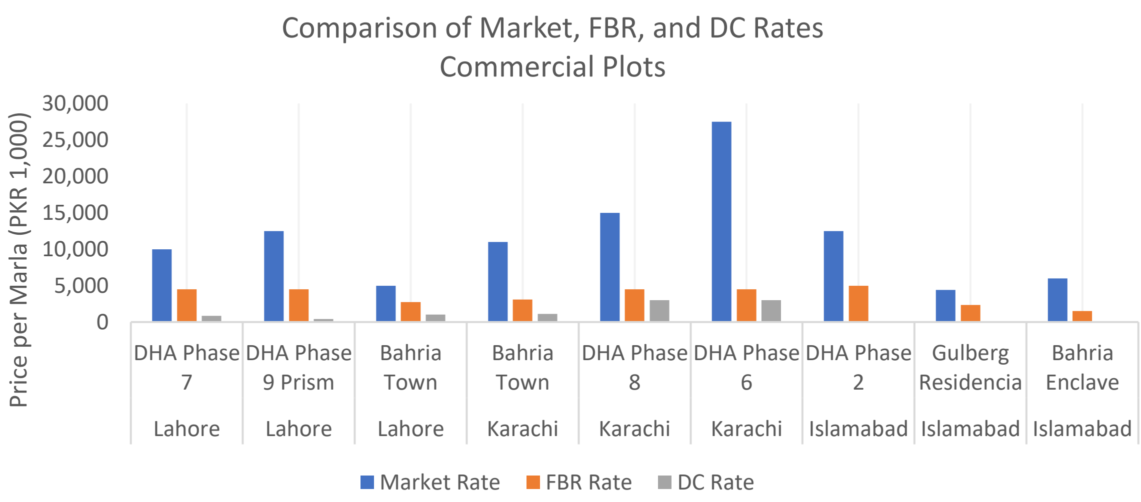


FIGURE 5: Comparison of Market, FBR, and D.C. Rates for Commercial Plots



3.3.2 Undocumented Transactions

The real estate sector is characterized by many transactions outside formal channels. It is tough to quantify the magnitude of evasion due to such undocumented and mostly cash-based transactions due to their very nature, so this section only presents some of the ways these transactions take place.

It is prevalent for the (open) plot file to exchange hands without an official transfer of ownership or payment of associated taxes. Discussions with real estate agents revealed that sometimes a file might be sold more than ten times before it is finally transferred to an end consumer. This arbitrage of files enables substantial gains for the intermediaries without contributing anything to the exchequer. The open files are an attractive avenue that allows complete avoidance of taxes on property transactions.

Another common practice some realtors employ is what is colloquially called "Bayane pe Bayana." This is when a real-estate agent arranges an agreement-to-sell (bayana) between a buyer and a seller, where the buyer is typically an investor who wants to make quick money. The agreement-to-sell involves payment of some fraction of the agreed price to the seller and a promise to pay the remaining amount after typically 30-90 days. During this period, the real-estate agent finds a new buyer willing to pay more than the agreed price. The agent then sells the property to the new buyer and shares the difference in the price agreed with the seller and the price received from the new seller between the investor and themself. It is revealed that this difference could be up to ten percent of the property price if the market is active and go completely undocumented and untaxed.

A few major players in the real estate sector, including builders and developers, have enjoyed substantial fruits from the growth in the sector at the expense of the general population. It is found that quite a few developers are engaged in the practice of overselling when they sell more files than the number of available plots. While some developers engage in outright fraud and run away with the money of investors, few others are involved in an interesting practice where, after selling the plot, these developers float rumors in the market to create panic, encourage widespread selling, and reduce the market price. The developers then buy back these files at a rate lower than the initially received rate. This practice allows the developers to amass substantial gains for the land that never existed at the expense of the general population.

3.3.3 Lack of Regulatory Framework

The outlined informality in the sector is enabled via real estate agents and developers that operate primarily outside any regulatory framework. The lack of an effective regulatory framework has led to mushrooming of unapproved development projects, false advertising to lure foreign and domestic investors, and unprofessional practices by the realtors and developers.

The real estate sector has provided opportunities to launder black money and conceal ill-gotten financial wealth. Lack of regulatory oversight and lower effective tax rates have allowed investors to use the real estate sector to park black money. This is mainly enabled due to many unregistered and unregulated real estate agents. In recent efforts to curb money laundering and counterterrorism, FBR is responsible for registering real estate agents (as designated non-financial businesses and professions (DNFBPs)) and ensuring the real estate activities are not used to launder black money. However, recent estimates suggest that out of the 500,000 property dealers and real estate agents, only 22,000 are registered as DNFBPs, and thousands of unregistered real estate investors and property dealers continue to trade unregistered open files, affidavits, and certificates.

3.3.4 Distorted Policy Framework

In addition to the outlined informality and the low property valuations, real estate activities have been subject to favorable tax treatments in Pakistan. There is an obvious disparity in how capital gains from real estate are taxed compared to income from other sources. The statutory tax on capital gains from real estate compares modestly to other income sources. This is striking if one compares the **top capital gain tax from real estate of 15% with a 29% tax on corporate income**. Also, capital gain tax is charged if the gains are realized within a certain number of years from the purchase of property, after which they are exempt from taxation. This creates a strong incentive to invest in real estate over other productive sectors of the economy.

The Government of Pakistan announced an amnesty scheme in the Finance Act 2020 (U/s 100D of Income Tax Ordinance) that guaranteed taxes at substantially lower rates and immunity from declaring the source of income, among other concessions. In addition to bringing black money into circulation, this amnesty was given in the aftermath of the pandemic to promote growth in the construction and allied industries. **According to FBR's figures, more than 2,527 projects with a declared cost of 629 billion have availed amnesty as of February 2022**. The discussions with FBR officials have revealed that the tax collection due to amnesty is far below the potential tax that would have been collected had these transactions been taxed at standard rates. It is expected that reported project costs are far less than the sales value of the projects, thereby offering lucrative returns to developers and builders without proportional contribution to the exchequer. This amnesty scheme has allowed an easy way for a lot of people to whiten the black money and pay minimal taxes on that money.

It has been especially tough to tax income from real estate in Pakistan. The extent of evasion and the government's incapacity led to the introduction of the Voluntary Declaration of Domestic Amnesty Assets Act, 2018, which allowed any person to declare and whiten their previously undisclosed income and assets by paying a tax of 5%. Table 15 shows that the beneficiary of the scheme reported more than 200 billion worth of property in response to the amnesty. These figures also highlight the magnitude of undocumented money sitting idle in the empty plots.

In addition to highlighting the lack of state capacity, violating horizontal equity, and reducing incentives to pay taxes in non-amnesty times, these amnesties are responsible for distorting investors' incentives in favor of real estate at the expense of more productive sectors of the economy.

TABLE 15: Assets Declaration under the 2018 Amnesty Scheme[64]

(Rupees in Thousand)

#	Domestic Income & Assets	Cases	Value of Asset	Rate	Tax Paid
1	Undisclosed income	10,769	127,296,143	5%	6,364,807
2	Open plots & land	15,812	157,295,145	5%	7,864,757
3	Superstructure	6,764	30,831,163	5%	1,541,558
4	Apartments & flats	5,422	32,316,486	5%	1,615,824
5	Imported motor vehicle	721	2,201,086	5%	110,054
6	Motor vehicles purchased from a manufacturer, assembler or dealer in Pakistan	2,508	5,572,271	5%	278,614
7	Used motor vehicles purchased locally	2,284	4,197,697	5%	209,885
8	Securities & shares traded on stock exchange	567	5,853,352	5%	292,668
9	Securities & shares not traded on stock exchange	307	4,487,926	5%	224,396
10	National saving schemes, postal certificates, bonds, & other instruments not traded on stock exchange	1,289	14,889,529	5%	744,476
11	Gold	1,298	6,611,582	5%	330,579
12	Other precious stones and metals	129	1,185,564	5%	59,278
13	Stock in trade	574	5,160,863	5%	258,043
14	Plant & machinery	543	3,987,840	5%	199,392
15	Accounts receivable	514	17,647,989	5%	882,399
16	Other assets	6,822	80,829,636	5%	4,041,482
17	Cash, prize bonds, bank accounts & FCAs	69,559	1,002,955,265	5%	50,147,763
18	FCA encashed in Rupee/investment in US$ bonds	1,020	2,490,551	2%	49,811
Total		**76,952**	**1,505,747,699**		**75,212,669**

Source: Pakistan Revenue Automation Ltd.

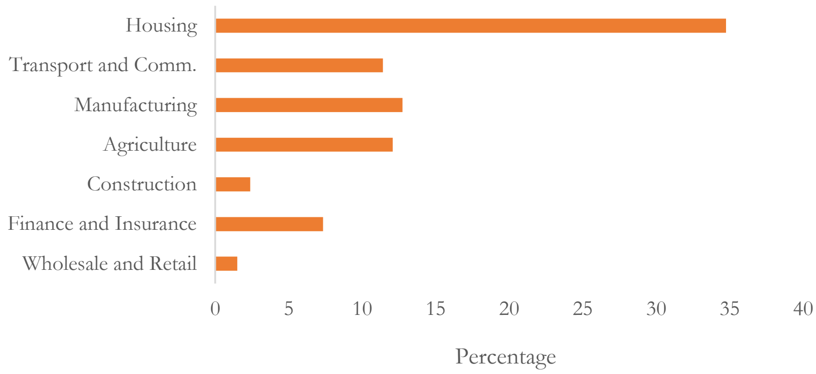
3.4 Real Estate Investment Hampers Economic Growth

If one can pin down problems of Pakistan's economy to one issue, it would be a low level of productivity compared to the rest of the world. The low productive capacity of the country is responsible for the lack of economic opportunities, dismal performance in exports, and resulting in recurrent problems of balance of payments. Unfortunately, the **real estate sector is partly responsible for the low economic productivity of the country as it has displaced capital away from the productive sectors of the economy into the unproductive empty plots of land**. This is problematic since most real estate investments do not contribute much to the economy. Especially investment in plots is counterproductive for the economy as the money sits in the plots without contributing to real economic activity while the scarce capital is crowded out from the productive sectors of the economy. This problem is so grave that **even the manufacturing sector finds it in its best interest to invest in unproductive real estate rather than enhance its capacity**. Examining a few

64 First published in Ahmed, M. A., & Malik, I. A. (2022). Pakistan: Economy Under Elites - Tax Amnesty Scheme, 2019. PIDE Working Papers

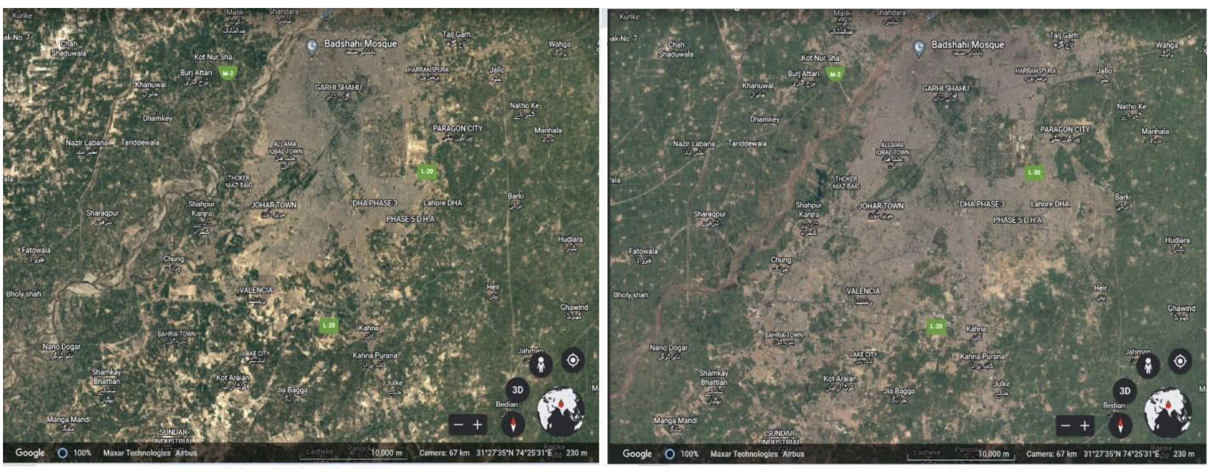
manufacturing firms' balance sheets reveals that these companies hold significant real-estate exposure and consider that an important source of income. This has been made worse by a wide-ranging amnesty scheme launched by the previous government that further pushed capital into the real estate sector. This is apparent in Figure 4, where it is shown that the housing sector has surpassed the manufacturing and agriculture sector in terms of attracting capital from the private sector as a share of sectoral GDP.

FIGURE 6: Sectoral Private Gross Fixed Capital Formation in 2020-21[65]



Overzealous investment in real estate in Pakistan is turning out to be counterproductive for the agriculture sector and the food security of the country. Acres of productive agricultural land is being converted into housing societies, severely impacting the country's agricultural output. So much so that Pakistan, with sixty percent of its population linked to the agriculture sector, has become a net food importing country, and food shortages are a norm. A report published by the Anadolu Agency (a Turkish news agency) indicates that the real estate developers offer farmers triple the market price, a temptation hard to ignore, and even use administrative and political power if any farmer refuses to sell land. Figure 5 shows how rapidly the green patches of fertile agricultural land have been converted into urban areas in 20 years in Lahore. While the expansion of cities is inevitable due to urbanization and population growth, the zoning laws in Pakistan have prevented cities' vertical expansion in favor of horizontal expansion. According to the secretary-general of the Kisan Board of Pakistan, a non-governmental agricultural advisory and research organization, around 20% to 30% of fertile land in Punjab province has been converted to industrial units and housing schemes.[66]

FIGURE 7: Map of Lahore in 2000 and 2020[67]



Map of Lahore in 2000 Map of Lahore in 2020

65 Data Source: Pakistan Bureau of Statistics

66 Pakistan's rising housing crunch devours fertile land, Profit by Pakistan Today. (2021, March 31) https://profit.pakistantoday.com.pk/2021/03/31/pakistans-rising-housing-crunch-devours-fertile-land/

67 Source: Google Earth

In addition to diverting money away from productive uses and the negative externalities on agricultural productivity, the speculation in the real estate market and the resulting boom have pushed house prices beyond the lifetime income of an average citizen. This has contributed to further housing shortfall and a lack of affordable houses for the majority.[68] While the boom in real estate has caused upward mobility of many families, this is mainly concentrated at the top or top middle of the income distribution.

Low effective tax on real estate leads to a direct burden on the formal sector. Since Pakistan suffers from extreme fiscal stress and needs to increase domestic revenues substantially, the lack of proportionate contribution from the real estate puts extra burden on the manufacturing and other regulated sectors, further reducing their competitiveness and export potential.

The exorbitant capital gains from real estate have allowed many people to raise their living standards substantially. However, the spending habits of the beneficiaries are focused on international travel and imported luxury items. These spending habits do not contribute to domestic employment-generating opportunities and instead further current account imbalances.

3.5 Potential and Challenges in Collection of Property Taxes

Recurrent taxes, such as the property tax, are considered more efficient than non-recurrent taxes and should be relied on more extensively because of their lower distortionary effects. Transaction taxes, such as stamp duty, transfer tax, or federal taxes, can reduce the turnover of property and distort the allocation of land and property away from its more efficient use leading to deadweight loss and lower economic growth.[69] In contrast, recurrent taxes on immovable property can incentivize landowners to use their land more productively. They encourage the reallocation of property and are broadly progressive. The tax burden can be designed to be borne predominantly by middle and high-income earners who tend to own properties. However, despite these advantages of recurrent property taxes, there is a dismal collection of urban immovable property tax in Pakistan, with property taxes contributing less than a percent to overall tax collection in the country. Table 16 compares the tax collection from UIPT in Pakistan with other countries. Pakistan is an outlier in terms of the revenue collection from this source, even when compared to countries with a similar level of development.

TABLE 16: Property Tax Collection (% GDP) for the fiscal year 2020-21[70]

High-Income Countries	
Australia	1.61
Belgium	2.37
Canada	4.05
France	3.96
United Kingdom	3.16
United States	3.12
Low- and Middle-Income Countries	
Bangladesh	0.2
Brazil	1.63
China	1.32
India	0.8
Indonesia	0.4
Mexico	0.31
Pakistan	0.003

68 According to the World Bank estimates, the housing gap in Punjab was estimated at 2.3 million units in 2017 and is expected to skyrocket to 11.3 million units by 2047. (Zaheer, N., Arshad, S., & Kwak, D. (2022). *Managing supply and demand: The key to getting 'housing' right in Pakistan*. End Poverty in South Asia, World Bank Blogs).

69 Best, M. C., & Kleven, H. J. (2018) in their work (Housing Market Responses to Transaction Taxes: Evidence from Notches and Stimulus in the U.K. *Review of Economic Studies*.) show transaction taxes are highly distortionary across a range of margins, causing large distortions to the price, volume and timing of property transactions in the UK.

70 Source: IMF, GFS Yearbooks; Provincial Budget Statements

Some of the challenges in collecting this provincial own-source revenue are as follows[71].

1. ARV acts as an imperfect proxy for the property's value due to the wide differential in the market rental value and ARV value. This difference gets exacerbated due to gaps in the updating of rental values. The latest assessment of rental values was done more than a decade ago.
2. UIPT has a radical differential in tax rates between owner-occupied and rented properties. With a ratio of 1:5, rented properties are taxed significantly higher than owner-occupied, creating an incentive for owners not to declare the rental status of the property.
3. There is a high exemption floor — for example, in Punjab, plots up to 151 sq. yards (including those occupying key central locations) are exempt from taxes irrespective of their value.
4. There is often a long-time lag between when new properties are added, and existing ones are re-evaluated. This is compounded by the fact that the tax can only be levied at notified rating areas which may not necessarily cover the entire urban built environment.
5. Significant enforcement constraints restrict tax officials' ability to seize property and levy a fine on tax evaders. Tax enforcement is often selective and politically motivated. Tax evaders can often push high administrative costs on the department by starting a lengthy judicial process.

3.6 Conclusion and Pathways for Reform

Given the informality and the challenges of the real estate sector, as outlined above, there is an urgent need for legislative and enforcement-related reforms. This section presents a few essential reforms and identifies political economy constraints in implementing these reforms. Table 17 provides a summary of the proposed initiatives for implementation. These reform efforts offer the substantial potential to increase tax collection from real estate activities. It is estimated that the **potential tax collection from real estate activities for the fiscal year 2020-21 could be up to PKR 620 billion, out of which only PKR 107 billion is collected** under various real-estate-related taxes.

TABLE 17: Key Suggested Reforms

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.

71 Wani, S., Shaikh, H., & Harman, O. (2020). Urban property taxes in Pakistan's Punjab. International Growth Center.

3.6.1 Reforming the Valuation System

The most critical area of reform involves introducing an effective valuation system for recurrent and non-recurrent taxes. As documented above (Figures 1 and 2), the FBR and DC rates are significantly lower than the properties' market value, leading to a large proportion of property values that remain undocumented. In addition, the current valuation methodology for recurrent property tax that relies on presumptive annual rental values is inaccurate and distortionary, that need to get away with.[72] There needs to be a systemic review by each provincial government to decide the valuation system. For example, an ongoing work in Punjab by Ali Cheema and others[73] indicates that **using a capital value-based system (DC or FBR rates) as the base for all recurring and non-recurring taxes would strengthen vertical and horizontal equity and allow for harmonization of all property-related taxes.**

Another typical valuation method often used in many countries (e.g., the United States[74]) is based on the cadastral of properties that record details on each property's location, ownership/occupancy, and value. However, Ahmad & Brosio[75] argue that the US-style property tax has not had much success in most emerging economies. Experience from Shanghai and Chongqing in China shows that the system is likely unsuccessful because of inherent difficulties in establishing ownership records. This, however, may not be an issue in Pakistan since the property can be taxed on occupancy if the owner is not easily established. While maintaining a cadaster is a resource-intensive endeavor, it offers substantial revenue potential in the long run. The government should seriously consider it as a long-term solution and for better documentation of real estate for legal purposes. CNIC should be leveraged to register each property in a cadaster.

Pakistan can also learn from cities like Addis Ababa and Freetown in Ethiopia, where cities reformed the tax design to capture closer to the real value of properties through using satellite imagery and mass property valuations. Because property values change quickly, it is vital to update valuations regularly. This can be done at the beginning of each fiscal year with the annual budget statement. The government can also institutionalize a self-declaration system and complement this with audits based on satellite imagery (to provide accurate delineations of properties and their size) and computer-assisted mass appraisal (CAMA) methods.[76] Like in many countries, CAMA methods may be used in combination with the maintenance of proper cadaster[77].

While reforming the valuation system is crucial, it is pertinent to mention that past attempts at updating property valuations have met stakeholders' resistance. For example, the realtors and other stakeholders vehemently protested the upward-revised FBR rates in December 2021, leading to suspension and, eventually, a significant downward revision in rates by March 2022.[78] The successful reformation of the valuation system will require consensus among the stakeholders. Since the realtor associations are bound to protest reforms that will put more taxes on their stakeholders, it may be necessary to implement a gradual transition toward a new valuation system rather than a sudden shift.

3.6.2 Increasing Transparency in Property Transactions

The Finance Act 2018 introduced important measures to counter the under-documentation in the real estate sector and to minimize instances of using the property market to avoid tax obligations. One of the measures allowed for the acquisition of properties at double the rate of the declared price if FBR proved the under-

72 Mumbai's tax collection increased by 170% after shifting to capital value-based tax.

73 This work is under progress and not publically available yet.

74 Poghosyan, T. (2016). *Can Property Taxes Reduce House Price Volatility? Evidence from U.S. Regions.* IMF Working Papers.

75 Ahmad, E., & Brosio, G. (2022). *Beneficial Property Taxation for Emerging Market Countries: Addressing Climate Change and Post-Pandemic Recovery*. Palgrave Macmillan.

76 A true self-assessment system requires an arm's length trust system, with a high probability of detection, relatively good information on local property tax transactions, and credible sanctions.

77 Ahmad, E., & Brosio, G. (2022). *Beneficial Property Taxation for Emerging Market Countries: Addressing Climate Change and Post-Pandemic Recovery*. Palgrave Macmillan.

78 Khan, M. Z. (2022, March 6). New property values bring FBR rates 'down to earth'. Dawn. Retrieved from https://www.dawn.com/news/1678545

declaration of more than fifty percent. However, this provision has not been implemented yet and awaits a notification to specify the effective date. Discussions with the FBR officials indicate that there are serious constraints preventing the effective enforcement of this provision, including

i. Lack of funds to acquire properties: One of the major challenges is the inability of FBR to pay for the acquired properties, which needs to be addressed before this provision can be enforced. There needs to be an effective disposal mechanism in place that can allow for the quick selling of acquired properties that can provide required liquidity in addition to being an important source of revenues.

ii. Problems with the price of acquisition: The law states that the under-declared property may be acquired at double the declared value of the property. The experience in India showed that such a high price, especially for properties that are not substantially undervalued, can lead to increased liability for the government and may end up increasing the ownership of undervalued but overpaid assets for the government. Considering this potential problem, there is a need to rationalize the rate at which the government may buy property from its owners. Linking the rate to the extent of undervaluation may be a plausible plan.

iii. Problem with lengthy litigations and inflation: The acquisition proceedings are likely to last years, and given the high inflation in the country, the law currently provides no provision for inflation adjustments. This may lead to severe concerns in the valuation of properties. For this provision to work effectively, there needs to be proper indexing of the values to account for the inflation in prices.

3.6.3 Rationalizing the Capital Gain Taxes

There is an apparent disparity in how capital gains from real estate are taxed compared to income from other sources. In addition to the outlined informality and evasion opportunities in real estate, the **statutory tax on capital gains from real estate compares modestly to other income sources**. This is striking if one compares the top capital gain tax from real estate of 15% with a 29% tax on corporate income. Also, capital gain tax is charged if the gains are realized within a certain number of years from the purchase of property, after which they are exempt from taxation (see Table 18). This creates substantial distortion and a violation of horizontal equity. The legal framework creates a strong distortionary incentive for investors to park money in real estate over business enterprises.

TABLE 18: Statutory Tax Rates on Capital Gains from Property[79]

		Open Plots	Constructed Property	Flats
(1)	(2)	(3)	(4)	(5)
1.	Where the holding period does not exceed one year	15%	15%	15%
2.	Where the holding period exceeds one year but does not exceed two years	12.5%	10%	7.5%
3.	Where the holding period exceeds two years but does not exceed three years	10%	7.5%	0
4.	Where the holding period exceeds three years but does not exceed four years	7.5%	5%	-
5.	Where the holding period exceeds four years but does not exceed five years	5%	0	-
6.	Where the holding period exceeds five years but does not exceed six years	2.5%	-	-
7.	Where the holding period exceeds six years	0%	-	-]

79 Source: Income Tax Ordinance 2001 (amended up to 30th June 2022)

Capital gains from property should be treated just like other forms of income, with no exemption for the holding period. The central argument for the lower capital gain taxes is to protect property owners against the effects of inflation. Although this is a valid point, the capital gains inflation problem is no worse than it is for other kinds of savings. Inflation leads to the excessive taxation of interest earnings as well. Thus, inflation protection is not a reason to have tax policies that favor capital gains over other types of capital income. Moreover, for both capital gains and other forms of capital, **the appropriate reaction to the inflation problem is not to lower the capital gains tax rate but to index the tax system**. The case of India is a good example as (short-term) capital gains on immovable property in India are taxed like normal income, and the (long-term) gains are indexed for inflation.

Another problem with lowering capital gain taxes with the number of years arises since individuals may delay selling their capital assets to reduce their tax burdens. This can lead to a lock-in effect, whereby individuals delay selling their capital assets to minimize the capital gains tax payments. Lock-in effects are distortionary because much of the success of capital markets rests on their fluidity, which allows investors to deploy their assets to the assets' most productive use. This distortion could lead to substantial deadweight loss and inefficiencies in the economy.

The government of Pakistan has already taken some encouraging steps to bring the gains from the sector to level the playing field with other income sources. The deem tax of 20% on immovable assets, introduced in the Finance Act 2022, is an encouraging step and may lead to more optimal land usage. Although the deemed tax raises important concerns about the jurisdiction boundaries of federal and provincial governments (since the tax on immovable property is a provincial matter, while income taxes are levied federally), the purpose of the deemed tax is to proxy for the income of the capital asset owners.

Treating capital gains as other forms of income offer substantial revenue potential for the government. As indicated above in Table 13, Pakistan collected PKR 12.15 billion as advance capital gain taxes in the fiscal year 2020-21, out of which 3.44 billion was reflected in the tax returns, which can be used as a crude measure to imply that roughly 0.28 fraction of capital gains are reported to FBR. Table 19 reports the reported capital gains and tax from properties during the same year. Using the figure of reported capital gains (815.36 billion), adjusting the gains for inflation, and assuming that only 28% of gains are reported to FBR, it can be deduced that the actual inflation-adjusted gains could be in the vicinity of PKR 1.5 trillion. Assuming an effective income tax rate of 15%, it is estimated that **Pakistan could have collected PKR 225 billion in taxes if the capital gains from the property were taxed like other incomes in the fiscal year 2020-21**.

TABLE 19: Reported Capital Gains and Taxes from Property in the Fiscal Year 2020-21

	(BILLION PKR)	
HOLDING PERIOD	Reported Gains	Reported Tax
LESS THAN 1 YEAR	25.11	1.18
BETWEEN 1 AND 2 YEARS	23.10	0.84
BETWEEN 2 AND 3 YEARS	33.33	0.87
BETWEEN 3 AND 4 YEARS	45.09	0.54
GREATER THAN 4 YEARS	688.73	0
TOTAL	815.36	3.44

Once again, there are significant political economy constraints regarding capital gains taxation. The powerful groups, who benefit immensely from capital gains, find it in their interest to ensure lower taxes on these gains. This is why a proposition was quickly shunned in the Finance Act 2022 that proposed to remove the special treatment of capital gains and treat them just like other incomes. Increasing the capital gains substantially from their current 15 percent to significantly higher income tax rates would lead to resistance. It would be appropriate to introduce a gradual and fully deterministic increase in tax rates such that the capital gains are eventually taxed equally as other income in the next few years. It is also critical to bring the relevant stakeholders to the discussion table and ensure that any resistance is adequately and timely addressed.

3.6.4 Establishing Regulatory Authorities

There is a pressing need to institute real estate regulatory authorities in each province. The federal government's attempt to establish the Real Estate Regulatory Authority (RERA) is a welcome step in this direction which will help address many of the challenges of real estate in the country. According to an article in Profit by Pakistan Today, "if it (RERA bill) is implemented, then at least 70 to 80% of issues in the Real Estate Sector will be settled."[80] However, it should be pointed out that the scope of RERA is limited to the federal level and lacks representation from provinces.

Provinces can take motivation from Real Estate Regulatory Authority (RERA) in Islamabad and ensure each real estate agent and developer in the province must be licensed and regulated by the authority to perform real estate activities. An overview of international best practices shows that a competent regulatory authority governs most countries with a mature and profitable real estate sector. For instance, the real estate sector of Dubai has been able to attract millions of dollars' worth of investment due to its highly regulated real estate sector. The establishment of real estate authority will also help to bring activities of informal real estate agents into the tax net and ensure they are adequately taxed.

3.6.5 Reviewing the zoning laws

There is a need to restrict the horizontal expansion of cities at the expense of productive agricultural land. In this regard, zoning laws need to be reviewed and strictly enforced to allow the vertical development of cities. In addition, land grabbing, particularly that of government-owned land, must be strictly curbed. The zoning laws are missing in most cases, and where they exist, they are flouted with impunity by influential people. There is a dire need to revamp the zoning laws such that money is diverted away from plots into productive investments. Of course, the challenge of enforcing zoning laws is plagued with political economy concerns, which is why not much progress has been made in this direction so far. There is a need to bring all stakeholders, including the establishment, bureaucracy, judiciary, business community, and others, to a table and agree on a consensus for revamping these laws for the benefit of Pakistan.

The development authorities, such as CDA, LDA, SBCA and KDA, need to play a more active role in ensuring that the laws are strictly enforced. According to an article in Dawn, "of the 200 housing societies in Islamabad, only 22 are legal, and 140 have never approached the CDA for necessary approval"[81]. This allows developers and builders to flout any regulations openly, the cost of which is ultimately borne by the people.

3.6.6 Reforming Property Taxes

Multiple reform efforts can be targeted toward improving the collection of urban immovable property taxes. There is significant potential to raise revenues from UIPT. Norregaard suggests targeting a revenue-raising potential of about 0.5–1% of GDP over the next 5–10 years for many developing countries while aiming for between 2 and 3% of GDP in the longer run. This would imply substantial tax potential from this source. Table 13 indicates that the provincial governments' tax collection under UIPT was PKR 17.6 billion in the fiscal year 2020-21, which was merely 0.003 percent of GDP (Table 16). **Increasing the collection to 0.5 percent of GDP would imply increasing the tax collection manifolds to around PKR 275 billion from property taxes**.

80 Paracha, S, (2022, May 31). Provincial govt should determine property valuation: Real estate sector. Profit by Pakistan Today. Retrieved from https://profit.pakistantoday.com.pk/2022/05/31/provincial-govt-should-determine-property-valuation-real-estate-sector/

81 Haque, N. u., & Hasan, L. (2022, September 26). Housing societies — a Pakistani animal. Dawn. Retrieved from https://www.dawn.com/news/1711924

Following are some measures to help exploit the true potential of property taxes in Pakistan.

3.6.6.1 Removing Differential in Tax Rates on Owner-Occupied and Rented Properties

Another vital area of reform relates to recurrent property taxes. In the provincial tax law of UIPT, the owner-occupied property is taxed favorably compared to rented property. For example, in the UIPT Act of Punjab, the ratio of the tax rates between the owner-occupied and rented properties is 1:5. This creates a strong incentive to declare rented properties as self-occupied by the owners. It is estimated that bringing owner-occupied housing into the tax net would triple the provincial property tax revenues[82].

Once again, the political economy constraints of implementing such reform are substantial. Because this tax is on the stock of assets rather than income flows, it can also place limitations on asset-rich but cash-poor people. This explains to a large extent why property taxes are unexploited despite their widely acknowledged potential. Careful design can mitigate concerns around taxpayer liquidity: such as tax deferral schemes that allow taxpayers to defer payments until they sell the property, someone inherits it, or outright exemptions for pensioners.[83] Changing the default frequency of tax payments from yearly to monthly can also offer ease to taxpayers and may reduce the salience of this tax.

3.6.6.2 Minimizing Contact Between Taxpayer and Tax Official

In keeping with trends in modern tax administration, the colonial tax administration model should be replaced by a functional structure of the administration to minimize contact with taxpayers and limit rent-seeking opportunities. Administration of property taxes, facilitated by high-tech satellite imagery and direct payments through banks or smartphones, supported by low-tech verification, should help consolidate the system and prevent corruption.

3.6.6.3 Strengthening Benefit Linkage of Recurrent Property Taxes

Unless the property tax is related to social services or benefits, it generates political resistance. In this regard, earmarking a portion of property tax revenue to be spent on neighborhoods from which the corresponding revenue is collected can strengthen the tax-service delivery link. The political economy of linking taxes to local benefits is essential in aligning incentives and ensuring greater local accountability. Lagos's Governor Fashola successfully implemented property taxes to deliver public services and was re-elected in 2011. Public investment led to increased property values and shared financial benefits resulting in further public investment. Once citizens see the benefits of this virtuous circle, they buy in. In this way, property taxes act as a beneficial tax system where property taxes can be linked to corresponding benefits provided to taxpayers.

3.6.6.4 Devolving the Rate-Setting Power to the Local Level

To improve the compliance and collection of recurrent taxes, the rate-setting power must be devolved to the local level. This is not implemented in practice; for example, in the current framework in Punjab, the power to set property tax rates is shared between the provincial assembly and local governments. The provincial assembly sets a fixed benchmark rate as part of the UIPT law. Although local government law allows local councils to alter the rate, local governments are reluctant to exercise their power. Since the local government does not effectively set tax rates, the property tax is the same as a transfer from higher levels of government. This significantly weakens the fiscal and accountability benefits associated with own-source local taxation. The property tax is even further removed from local governments when they lack information on how much should be, or was, collected and their share of the collections. Local rate setting leads to improved decision-

82 Bahl, R. (2009). *Property Tax Reform in Developing and Transition Countries.* Fiscal Reform and Economic Governance Project. USAID.

83 Wani, S., Shaikh, H., & Harman, O. (2020). *Urban property taxes in Pakistan's Punjab.* International Growth Center

making vis-à-vis devolved spending responsibilities. 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. Local councils must set rates within these brackets as part of their budgetary process.

3.6.7 Coordination Mechanisms for Reform

Successful implementation of the above reforms requires establishing a coordinating body with representations from each level of the government. This body should be responsible for streamlining the rules and regulations regarding the taxation of real estate activities. It can include the establishment of a data warehouse that allows the exchange of information between different levels of government and provides support for enforcing each tax. For example, this body can specify audit functions that are managed centrally. Additionally, the property tax valuations and transaction data at the provincial and local levels can be used to cross-check income tax statements at the federal level.

Given the closely related nature of recurrent and non-recurrent taxes by the provincial and federal jurisdictions, it is only natural that there should be effective coordination between various levels of the government. The synergies between the property tax and a national income tax can be better harnessed with a central enforcement function that includes a data warehouse and exchange of information across tax heads, as well as critical audit functions that are hard to manage at the local level. Similarly, modern technology, including satellite imagery, may make more sense if managed nationally. This can be achieved by establishing a coordinating body at the national level with representations from each level of the government. This body should be responsible for streamlining the rules and regulations regarding real estate transactions and taxes.

In addition to harmonizing the tax base across multiple taxes (as explained above), one of the significant areas of enforcement-related reforms concerns effective coordination between various government levels to enforce each tax. The enforcement function can include effective management of collections-related data to allow sharing across multiple levels of the government. This can facilitate an exchange of information between income taxes and recurrent property taxes. Specifically, the property tax valuations and transaction data at the provincial and local levels can be used to cross-check income tax statements by individuals. Building a picture of property ownership, use, and transactions is critical in expanding the personal income tax base. Better data management will facilitate information exchange between various tax administrations, which can then be used to conduct centralized audits for recurrent and non-recurrent taxes.

3.6.8 Political Considerations

The real estate sector has been a victim of 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[84]. The powerful lobbies and interest groups include land developers, real estate tycoons, senior bureaucrats, army generals, and judges. These groups have accumulated massive wealth due to abnormal growth in the real estate sector. A pragmatic real estate reform agenda would require political ownership from these stakeholders. These elites need to realize that the gains from moving away from real estate may be substantial in the long run. If the money is routed away from real estate to productive sectors, the profits will likely accrue to the elites and their generations. Everyone benefits from the transition away from real estate, but elites enjoy a disproportionate benefit. There is a need to have a collective conversation on these issues to make the sum bigger than the part[85].

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84 Mehmood, S. (2021, September 21). Zoning laws and the crisis of urban expansion). The Friday Times, https://www.thefridaytimes.com/2018/04/20/zoning-laws-and-the-crisis-of-urban-expansion/

85 Mian, A. (2022, September 22). Pakistan's core Economic Challenges. (S. G. Shaikh, Interviewer)

4. Concluding Remarks

This report has highlighted various ways informality operates in WRT and real estate sectors and identified reform efforts to move towards the documented and regulated economy. The main challenges can be summarized as poor political will and the limited capacity to tax. The latter is also partly due to the former, otherwise with so many donor-funded projects, there should have been substantial increase in the capacity. The challenge of transitioning to the formal economy is immense and requires a concerted effort from policymakers, bureaucrats, industry, and academics. Academics can play an important role in finding innovative and effective ways to implement the outlined reforms. For example, International Growth Center (IGC) has enabled collaboration between academics (that includes one of the authors of this report) and the Punjab Revenue Authority (PRA) to find creative ways of increasing formality in the services sector. Among other areas, the work looks at the role of competition as a force for preventing formalization and tests ways of increasing formality in the presence of competitive effects of tax compliance. Such engagements offer great potential to find long-term contextual solutions to some of the problems in the informal sectors.

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