Insights for Change

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The Dark Side of Real Estate: Uncovering its Malevolent Influence on National Economic Progression

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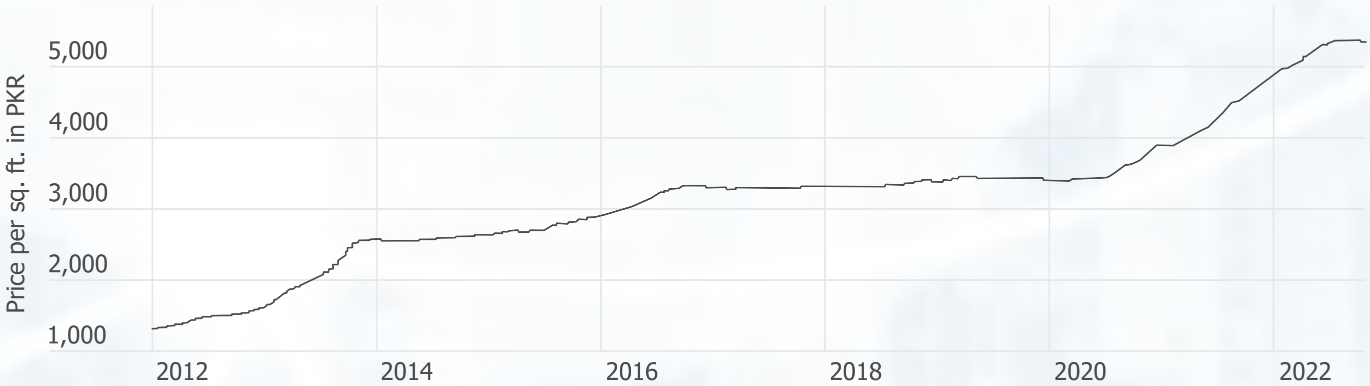
"Nations fail today because their extractive economic institutions do not create the incentives needed for people to save, invest, and innovate." (Acemoglu and Robinson, Why Nations Fail)

1. Introduction

If one can pin down the challenges of Pakistan's economy to one issue, it would be a low level of productivity compared to the rest of the world. The country's low productivity is responsible for the stagnation of manufacturing, dismal exports, and recurrent balance of payments problems. Unfortunately, the real estate activities, particularly investment and trading of plots, are partly responsible for the low economic productivity of the country as it has displaced capital away from the innovative and job-creating sectors of the economy into the empty plots of land. Investment in plots is counterproductive for the economy as the money is diverted towards the speculation of plots and away from the economy's productive and job-creating sectors. This problem is so grave that even the manufacturing sector finds it in its best interest to invest in real estate rather than enhance its capacity or invest in innovative practices. This piece brings to the forefront many issues linked with real estate investment in Pakistan and is based on a report commissioned by Consortium for Development Policy Research (CDPR) for Pakistan Business Council (PBC).

The real estate sector has attracted massive investment over the last few decades, which has led to excessive returns from the investment in the sector. Data from Zameen.com reveal that property prices have almost quadrupled in the previous decade (Figure 1). While part of this price increase is fueled by genuine unmet demand for housing driven by remittance inflows, the speculative activity and the belief that property prices will keep increasing have also contributed substantially to this growth.

Figure 1: Average Plot Prices in Pakistan



Data source: Zameen.com

The reason for the active investment in real estate is straightforward. Compared to other instruments, investment in real estate offers a highly lucrative return. Figure 2 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.

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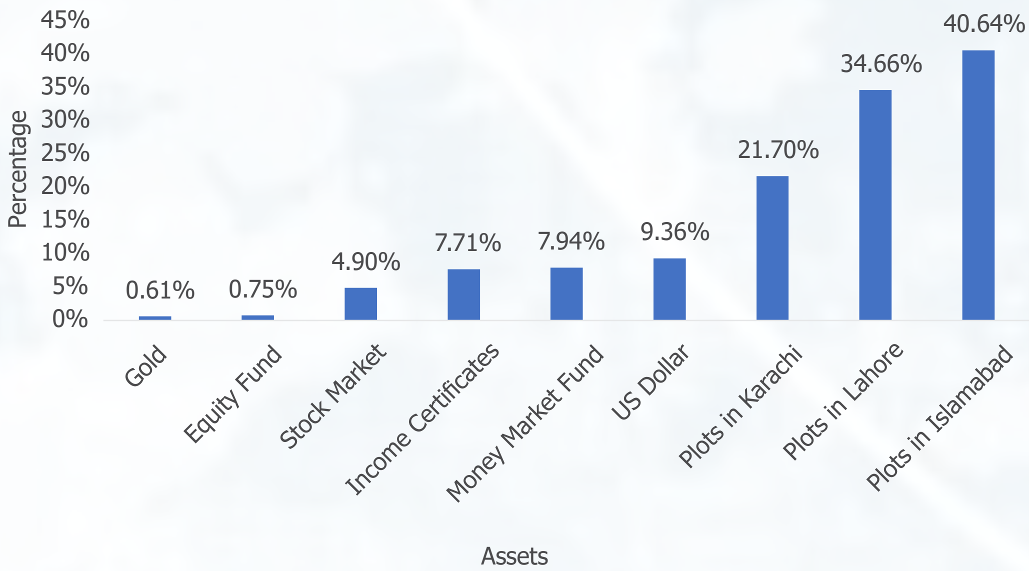


Source: Mutual Funds Association of Pakistan, Zameen.com, KSE-100 Index, forex.pk

2. Missed Tax Potential

In addition to taking a toll on economic growth, the real estate sector contributes very little to overall revenue collection in the country. 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 was collected under various real-estate-related taxes.

A significant source of revenue shortfall from potential taxes from real estate transactions is the underreporting of property values. The buyers and sellers face a strong incentive to underreport the property's value to minimize their tax liability. To address this, the provincial governments (for stamp duty, transfer tax, and CVT) and the federal government (for capital gain taxes (CGT) and withholding taxes (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 3 and 4 present a comparison of the D.C. 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 D.C. rates are a fraction of market rates for residential and commercial plots, they are much more severely undervalued for commercial properties. Based on these regions, on average, the FBR rate is half the market value, and the D.C. rate is one-fifth.

Figure 3: Comparison of Market, FBR, and D.C. Rates for Residential Plots

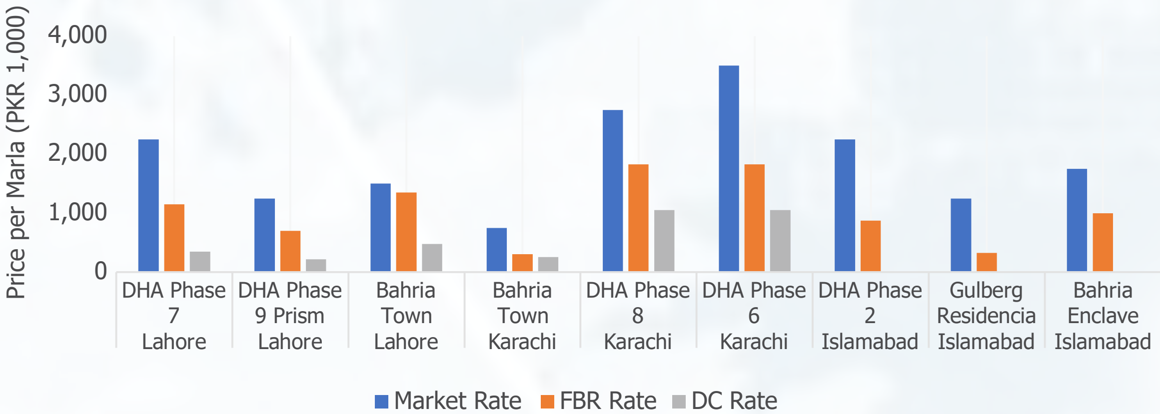
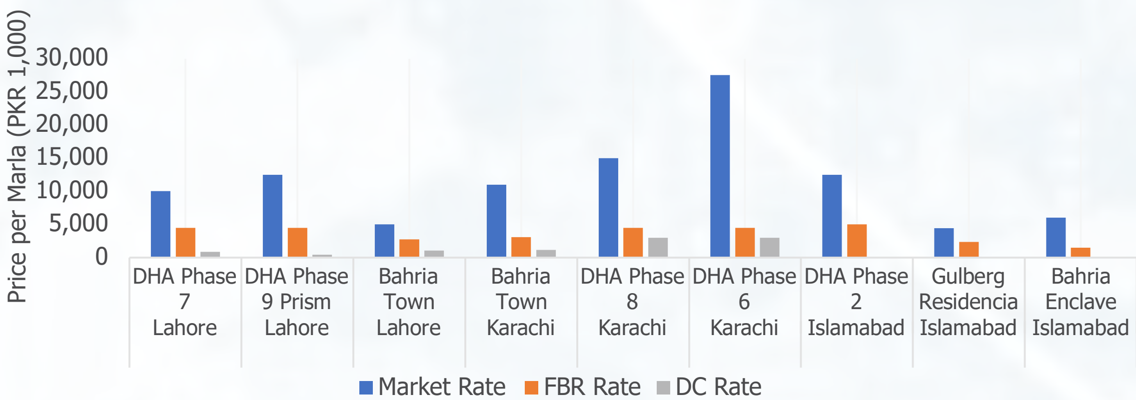


Figure 4: Comparison of Market, FBR, and D.C. Rates for Commercial Plots



Along with the under-reporting of property values in the documented economy, 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. Some of the ways these transactions take place are as follows:

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 transferred to an end consumer. This arbitrage of files enables substantial gains for the intermediaries without contributing anything to the exchequer.

2. Many realtors practice 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. This difference could be up to ten percent of the property price if the market is active and go completely undocumented and untaxed.

3. 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. Quite a few developers are engaged in overselling when they sell more files than the number of available plots. While some developers engage in outright fraud and run away with investors' money, 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 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. Lack of Regulatory Framework

The 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. In recent efforts to curb money laundering and counterterrorism, FBR is responsible for registering real estate agents (designated non-financial businesses and professions (DNFBPs)) and ensuring that real estate activities are not used to launder black money. However, recent estimates suggest that of the 500,000 property dealers and real estate agents, only 22,000 are registered as DNFBPs. Thousands of unregistered real estate investors and property dealers continue to trade unregistered open files, affidavits, and certificates.

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. Combine that with frequent amnesty schemes by successive governments, and we have a policy environment that showcases the state's incapacity, violates horizontal equity, and reduces incentives to pay taxes in non-amnesty times as well as distorts incentives in favor of real estate at the expense of more productive sectors of the economy.

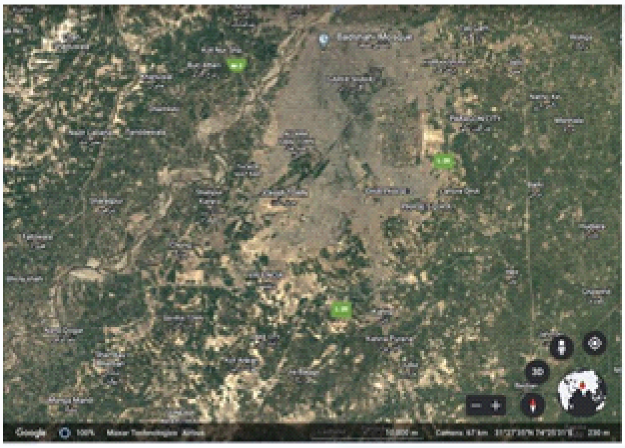
5. The Repercussions on the Economy

As argued above, the investment in empty plots of land is responsible for crowding out scarce capital from the productive sectors of the economy. In addition, other challenges arise due to the aggressive nature of investment in the real estate sector.

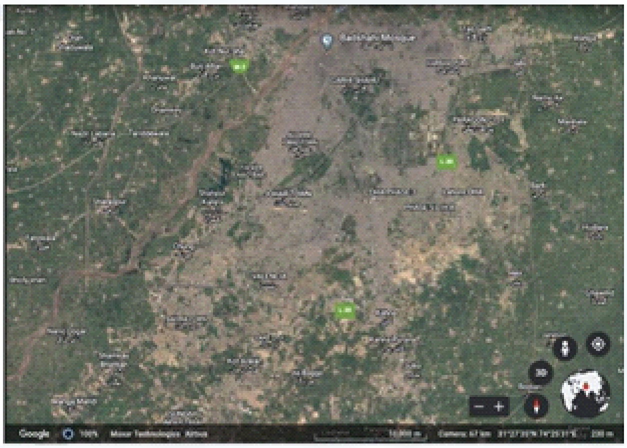
5.1 Impact on the Agriculture Sector

Overzealous investment in real estate in Pakistan is turning out to be counter-productive 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 already under-productive agriculture sector. 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.

Figure 5: Map of Lahore in 2000 and 2020



Map of Lahore in 2000



Map of Lahore in 2020

Source: Google Earth

5.2 Affordable housing has become a distant dream

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 life-time income of an average citizen. This has contributed to further housing shortfall and a lack of affordable houses for the majority. 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.

5.3 The burden on the formal sector

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 real estate puts an extra burden on the manufacturing and other regulated sectors, further reducing their competitiveness and export potential.

6. Reforming the real estate sector

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.

6.1 Reforming the valuation system

The most critical area of reform involves introducing an effective valuation system that harmonizes taxation of use (urban immovable property tax) and transaction taxes. As exhibited above, the FBR and D.C. rates are significantly lower than the properties' market value, leading to many under-documented properties. In addition, the current valuation methodology for urban immovable property tax relies on presumptive annual rental values that are inaccurate and distortionary that need to get away with. An ongoing work in Punjab by Ali Cheema of LUMS and others indicates that using a capital value-based system (D.C. 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.

A typical valuation method often used in many countries (e.g., the United States) is based on the cadastral of properties that record details on each property's location, ownership/ occupancy, and value. 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 actual 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. Like in many countries, CAMA methods may be combined with maintaining proper cadaster.

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 (particularly armed forces) vehemently protested against the upward-revised FBR rates in December 2021, leading to suspension and a significant downward revision in rates by March 2022.

6.2 Rationalizing the capital gain taxes

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 regular income, and the (long-term) gains are indexed for inflation.

Treating capital gains as other forms of income offers substantial revenue potential for the government. 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.

Once again, there are significant political 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.

6.3 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." 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.

6.4 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 often missing; 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, so not much progress has been made in this direction. 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, and KDA, must be more active in strictly enforcing the laws. 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". This allows developers and builders to flout any regulations openly, the cost of which is ultimately borne by the people.

6.5 Reforming urban immovable property taxes

Real estate taxation should be considered in conjunction with taxes on property use (urban immovable property taxes). There is significant potential to raise revenues from UIPT. It is suggested that Pakistan should aim for between 2 and 3% of GDP in property taxes. In sharp contrast, Pakistan collected merely 0.003 percent of GDP as property taxes in the fiscal year 2020-21. This piece is not intended to outline the plan for reforming property taxes; however, I list some essential reforms that academic researchers have identified to improve property taxes in Pakistan.

i. Removing differential in tax rates on owner-occupied and rented properties.
ii. Rationalizing exemptions
iii. Minimizing contact between taxpayer and tax official
iv. Strengthening benefit linkage of property taxes
v. Devolving the rate-setting power to the local level

6.6 Coordination mechanisms for reform

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 and critical audit functions that are hard to manage locally. 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.

7. Political considerations

The real estate sector has been a beneficiary of political favors and politicking by powerful interest groups, resulting in favorable 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, judges, and army generals. 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. As a Princeton economist, Atif Mian, argues, 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 job-creating innovative sectors, the profits will likely accrue to the elites and their generations. Everyone benefits from the transition away from real estate, and elites would enjoy a dis-proportionate benefit. There is a need for a collective conversation on these issues to make the sum bigger than the part. Otherwise, in keeping with the quotation at the beginning of this essay, the nation of Pakistan may soon fail.

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