Consortium for Development Policy Research

Policy Brief PB1301 | State | December 2013

Reforming Urban Property Tax in Punjab

www.cdpr.org.pk. +924235778180 admin@cdpr.org.pk

International Growth Centre

About the project

Funded by: International Growth Center

Key Counterpart: Advisor on Tax Reform to the Minister of Finance, Government of Pakistan; Secretary, Excise and Taxation, Government of Punjab

Impact: The principal author of the brief, Dr. Ijaz Nabi, was appointed member of the Punjab Chief Minister's task force that was set up to design the property tax reform. He provided hands on technical assistance to the task force throughout this period. This write up, in part, reflects the workings of the task force and the evolution of the property tax reform.

This policy brief is based on a report "Reforming the Urban Property Tax in Pakistan's Punjab" by Dr. Ijaz Nabi (IGC and CDPR) and Hina Shaikh (IGC) and has been written by the authors.

In brief

- Property tax collection in the Punjab is roughly a fifth of the level of comparable countries both in terms of the proportion of total local revenues and as share of GDP.
- Efficiently designed and properly administered, it can help improve the overall national tax to GDP ratio, currently at a low 10.5%, and enable the government to deliver much-needed local services.
- Zoning, and a well-functioning property valuation and titling system, which forms the basis of the property tax, will facilitate the creation of new borrowing instruments in the capital market.

Reforming Urban Property Tax in Punjab

Ijaz Nabi & Hina Sheikh for International Growth Centre

Roads, street-lights, policing, sanitation are some of the services for which governments levy the property tax. The Property Tax collected by Punjab is roughly a fifth of the collection by provinces in other comparable countries, both as proportion of total local revenues and as share of GDP. At present, the tax revenue collected is far less than the cost of urban services provided but Punjab can increase its collection to almost 25 billion after reforms. This would be ten times more, amounting to 13 percent of Punjab's development budget and 26 percent of its health and education budget for the year 2010.

When you look at the low tax collection in the country – 10 percent of the GDP - you can begin to see the property tax collection in Punjab in perspective. Overall, Pakistan fares poorly in comparison with other South-Asian countries (Sri Lanka: 16.5 percent and India: 14 percent) and the average for developing countries (15 percent). In addition, provinces account for a small fraction of the national tax revenue (4.3 percent of total national tax revenue or 0.5 percent of GDP). This profile has changed little in the past decade despite an increasing share of provinces in total national expenditure.

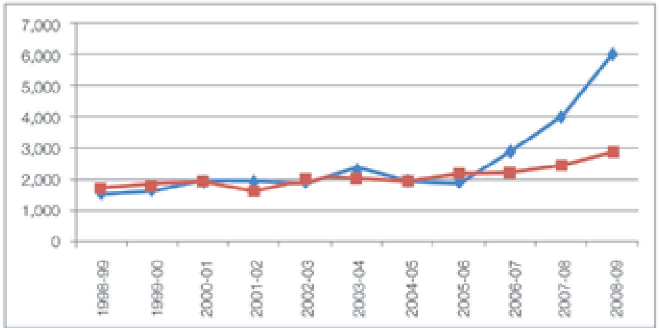
Provinces in Pakistan do not collect their taxes efficiently, but this has to change after the 18th Amendment, which assigns more responsibility to the provinces for the delivery of social services like education and health. This means that expenditure will have to be increased and a greater provincial revenue-collection effort will have to be made. And the voters know it.

Punjab's urban property tax: problems

The Punjab Urban Immovable Property Tax (UIPT) is levied under the Property Tax Act of 1958. Although, following the Local Government Ordinance (LGO) 2001, UIPT has become a local government tax, in reality, it functions as a provincial tax subject to revenue sharing with City District Governments (CGDs) and Tehsil Municipal Corporations (TMAs). These district and tehsil institutions are notoriously inept in collecting the tax.

Even though property taxation has a long tradition in the Punjab, the UIPT provides only a small amount of revenue - as a share of the provincial GDP, UIPT is an abysmally low one tenth of 1%. The gap between targets and collections, reflecting problems of tax administration, has become worryingly large.

Property Tax Target vs Collection



The main problems with Punjab's UIPT are:

Valuation: Despite the surge in market rents in the province between 2001 and 2008, the property tax base has not grown as valuation tables are not updated frequently enough to reflect actual market value. According to some estimates, owner-sellers may by undervaluing their properties by 45 percent to avoid being fairly taxed.

Collections & Incentives: World Bank (2006) has argued that strengthening tax administration and the billing and collection system can double if not quadruple revenue from the property tax. An IGC research project, in close cooperation with Department of Excise and Taxation, is currently underway that experiments with different incentive packages to motivate tax inspectors to bring in more revenue to the government.

Exemptions: Punjab's property tax structure is riddled with exemptions and preferential treatment of properties that have eroded the tax base. The most extreme case of this is the preferential treatment of owner-occupied property that inflicts a loss of revenue equal to nearly a quarter of the current receipts.

Poor Coverage: Failure to notify new rating areas – those not in the tax net - and extensions in existing rating areas have resulted in approximately 300,000 out of 750,000 properties remaining untaxed in Lahore alone. A modest estimate (two years old) is that approximately 73 more rating areas exist in the Punjab that need to be brought into the tax net.

Tax Rates: The two main issues related to tax rates are:

- Property tax rates of 20 to 25 percent are considered too high, creating incentive for evasion.
- The differential in tax rate between owner-occupied and rented out properties in Punjab (1:10) is much higher than in Karachi (1:2) and in Islamabad Capital Territory (1:1). This means that in Punjab owner occupied properties pay a mere 10% of the tax levied on the same property if rented out. The differential in rates is argued to be the most important source of corruption in the Excise and Tax Department, resulting in a substantial leakage of revenue.

Suggested Options and Reforms

The Government of Punjab has set a target of increasing revenue from urban property tax from the current 0.56 percent to at least 2.5 percent of the provincial budget over the next ten years under a phased approach. A task force on tax reform was set up in 2008, which deliberated on all major sources of erosion of the property tax base and decided to focus, in the first phase, on reforming the system of valuations and the rate structure.

Although the task force's recommendations tackled other issues such as extending the coverage to include new rating areas, complete reform of current system of exemptions, strengthening tax administration and improving collections, core recommendations addressed issues of valuation and tax rates.

Valuation: The task force recommended that the interval between successive surveys/re-assessments be reduced from 5 years to 3 years and the Punjab UIPT Act, 1958 be amended accordingly via an ordinance. It was also recommended that annual indexation of tax demand with inflation should be conducted for each successive year till 2015.

Tax Rates: The task force recommended reducing the tax rate to 10 percent immediately while reducing the differential – between rented and self-occupied properties - to zero in a phased manner, achieving 1:1 parity by 2018. By applying the new valuations, reducing tax rate to 10 percent and the differential down to 1:5, the revenue demand jumps from the current Rs.2.8 billion to over Rs. 5.0 billion. But if the differential were completely eliminated it would result in revenue demand increasing nearly four times at over Rs. 8.0 billion.

To assess the political viability of its recommended reform, the task force estimated the impact they would have on the tax payers. As in any reform process, some categories of tax payers gain whereas others have an increase in their tax burden.

The likely increase in property tax is highly affordable. For example a person owning a 10 marla plot in the most expensive area of Lahore would pay an additional monthly tax equivalent to the cost of three McDonalds burgers.

Concluding remarks

- Despite the low impact on household budgets, there is resistance to the proposed reforms by important political players. Reform, however, is inescapable.
- Recent developments (the 7th NFC Award and passage of the 18th amendment to the constitution) have changed the landscape of fiscal arrangements in Pakistan.
- The federation's decision to increase fiscal transfers to the provinces reflects the realization that the provinces need to be held fully accountable for the services they deliver to the citizens and the overall investment climate they create for economic growth and employment.
- It is also clear, however, that the current resource envelope is insufficient to provide the needed services.
- Provinces will thus have to tap into under-explored sources of provincial revenue including, importantly, the urban property tax.