Special Section 1: Real Estate – Implementing the Announced Reforms

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 for avoiding tax obligations. These included (i) imposition of ban on non-filers on purchasing property above Rs 5 million; (ii) legal proceedings against any property transactions and exchanges that are deemed to be understated for the purpose of either concealment of the source of income and/or tax avoidance; and (iii) vesting power with the government to purchase the property in question in case the understatement is proven.

There is an immense potential in these measures for improving revenue mobilization, all the while adjusting the incentive structure to provide a level playing field for other investment avenues. This section explains the dynamics of under-documentation of the real estate sector, and highlights the crucial need of timely implementation of the recently announced reforms.

1. Real estate development is crucial for Pakistan

The real estate sector – constituting housing, construction, retailing, hoteling, and renting of spaces for official or trading purposes[1] – has gradually evolved into an important source of economic growth in Pakistan. The combined direct contribution of construction and housing sectors (the latter of which is a part of the services sector in the national accounts) to the country's GDP has been consistently higher than 9 percent over the past decade; whereas, a steady expansion in wholesale & retail trade activities in the country has kept the buoyancy in commercial real estate intact. Spillover effects are also strong as evidenced by the sustained increase in activities of a large number of vertically integrated sectors (such as cement, steel, wood, cables, ceramics, etc.) with flourishing real estate sector.

While evaluating the macroeconomic relevance of the real estate development, the social dimension of the sector cannot be ignored. Pakistan's housing deficit is estimated to be around 9 million units;[2] this means that more than a third of the 32 million households in Pakistan are not provided with adequate housing. Market frictions such as non-availability of a common record of land and entitlement, and stringent regulations for site development, are responsible for the limited progress.

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[1] This definition is based on the categorization of loans to income-producing real estate under the BASEL-III framework. The three categories encompassing the activities of the sector are: (i) residential real estate; (ii) commercial real estate; and (iii) land acquisition, development and construction (ADC) exposures.

[2] Source: 11th Five Years Plan (2013-18), Ministry of Planning and Commission, Pakistan.

The demand side has not been helpful either as financing limitations have priced out lower-to-middle-income segments. On the one hand, banks remained reluctant to expand their mortgage portfolio due to weak contract enforcement, uncertainty of title deeds and their general inclination toward risk-free financing; and on the other hand, available mortgages have remained unaffordable for the majority of population due to low-income levels and savings capacity. Thus, while the structural demand for housing and potential supplies remained large, the real estate market has been operating at a low equilibrium.

2. However, the sector became a haven for tax avoidance and wealth concealment

Most recent empirical estimates put the size of informal economy of Pakistan between 70-91 percent of the GDP.[3] In addition, a strong contribution of informal sector (over 70 percent) in providing jobs, a high cash to GDP ratio, and tax gap of around 10 percent of GDP[4], all signify presence of a large informal economy. A significant share of the unreported gains finds its way to the country's property market, which is characterized by low regulatory oversight and absence of concrete know-your-customer requirements. This, coupled with very low official property valuations, provides individuals a 'legal' way of under-documenting the transactions; those are benefited particularly who aim to minimize their tax liabilities and/or conceal their wealth as well as the sources of income.

Table S1.1: Comparison of DC, FBR and Market Rates in Lahore, Karachi and Islamabad as of September 2018

Average Valuation of 1 kanal Residential Property/House (thousand Rupees)

	Lahore			Karachi			Islamabad		
	DHA Phase V	**Cantt Area**	**WAPDA Town**	**DHA Phase VI**	**North Karachi**	**Gulshan-e- Iqbal**	**D-12**	**E-11**	**G-11**
DC rate	14,000	14,000	8,800	6,987	1,197	6,987	N/A	N/A	N/A
FBR rate	8,400	11,700	8,400	15,124	3,024	15,124	19,541	15,730	23,050
Market rate	60,254	55,876	41,975	102,180	62,111	59,437	50,437	75,936	78,495

Data source: FBR, Punjab IT Board, Zameen.com, SindhZameen.gos.pk (Sindh Government)

Specifically, District Collector's (DC) rates are used in Pakistan for the calculation of provincial tax liabilities such as capital value tax, property tax and stamp duties. These rates are significantly lower than the actual property valuation with gap estimated between 2 to 5 times depending upon the city. In 2016, FBR introduced valuation tables for the collection of capital gain tax and withholding tax; these valuations were higher than the DC rates, but far below the actual valuations. In 2018, Punjab government made upward revisions in the DC rates for most areas

[3] Khan and Khalil (2017) and Kemal (2013).

[4] World Bank estimates potential tax capacity of Pakistan at 23 percent of GDP, against the actual of 13 percent.

and brought these closer to the FBR valuations in order to enhance revenue mobilization; however the rates in the rest of the provinces remained unchanged at a level much lower than the FBR valuations. **Table S1.1** provides few examples from the country's major urban centers.

Thus, while the activity in property market remained upbeat, both the Federal and provincial governments have not been able to mobilize revenues from this source. Compared with other emerging market economies, where the contribution of property tax in overall revenue mobilization is generally lower compared to advanced economies, Pakistan's performance remains weak (**Table S1.2**).

Table S1.2: Property Taxes - A comparison

Advanced Economies	As percent of Revenue	As percent of GDP
Australia	4.7	1.6
France	8.9	4.3
Singapore	5.4	1.1
Switzerland	5.4	1.8
United Kingdom	8.6	3.3
United States	9.3	2.9
Emerging and Developing Economies		
Bangladesh (FY15)*	2.1	0.2
Brazil	3.5	1.5
China	0.9	0.3
India (2014)**	4.8	0.8
Indonesia	2.7	0.4
South Africa	3.7	1.4
Pakistan (FY17)* **	**0.4**	**0.0**

Data source: IMF GFS; *Bangladesh's Ministry of Finance; **OECD;[5] ***Provincial budget statements/PBS
Ratios for 2016, unless stated otherwise.

3. Property prices were bound to boom

The property market in major urban centers of the country has been under pressure due to genuine demand emanating from a heavy influx of population from rural areas, and consistently rising remittance inflows over the past decade. This demand was further fueled by property purchases with an objective of wealth concealment and tax avoidance. Moreover, attracted by the potential of earning significant capital gains, a sizable amount of speculative and short-term investments also found its way into the sector. Resultantly, price pressures in the property market have persisted.

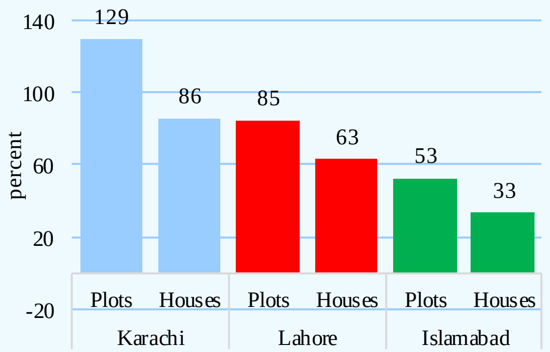
Since June 2011, from where any estimates of property prices are available, prices of plots in Pakistan have nearly tripled, whereas house prices have grown by 139 percent.[6] The relatively higher price surge for plots with respect to that of

[5] Joumard, I., A. Thomas and H. Morgavi (2017), "Making income and property taxes more growth-friendly and redistributive in India", OECD Economics Department Working Papers, No. 1389, OECD Publishing, Paris, https://doi.org/10.1787/5e542f11-en.

[6] The information on property prices throughout this document has been taken from Zameen.com, which is a customer-to-customer online marketplace for buying, selling, and renting residential property in the major cities of Pakistan. Launched in 2006, the platform expanded its operations gradually and in 2016, also started working as an online information intermediary by compiling

residential units indicates the consistently strong speculative interest in the real estate market of major urban centers (**Figure S1.1**).[7] Buoyancy was particularly noticeable during the past 5 years, when a noticeable improvement in the law and order situation of the country (following the decisive military operations) had played a key role in improving the overall business confidence.

Figure S1.1: Percentage Increase in Property Prices Between Jun 2013 and Jun 2018 in Major Cities of Pakistan



Data source: Zameen.com

4. Booming property prices had significant economic and social fallouts

Such huge capital gains, along with a steady increase in rentals and a subdued tax liability, made the real estate sector the most sought-after avenue for high net-worth individuals/firms. This was despite the investment appetite in other productive sectors remaining strong as the economy struggled within the low-growth-high-inflation equilibrium. More importantly, while the development in this sector is much welcome, anecdotal evidence suggest that a sizable amount of activity took place in sale and purchase of plots without a corresponding activity in the real estate development.

<u>Diversion of resources away from productive investments</u>

While the overall investment rate in major sectors of the economy remained weak over the past decade, the investment activity in housing services stood strong (**Figure S1.2a**). In fact, the overall gross fixed capital formation in housing services has even surpassed the same in the manufacturing sector, which has historically played a key role in several successful experiences with economic development across the world.

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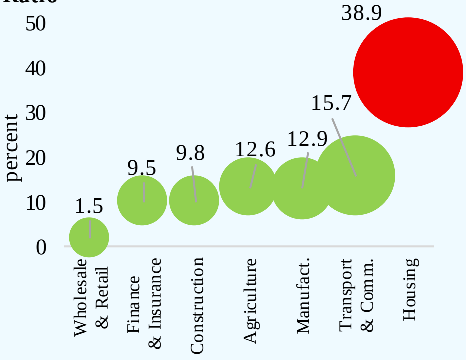
housing and plot price indices for various localities across Tier-1 and Tier-2 cities of the country. The tool was developed in collaboration with the Lahore University of Management Sciences (LUMS).

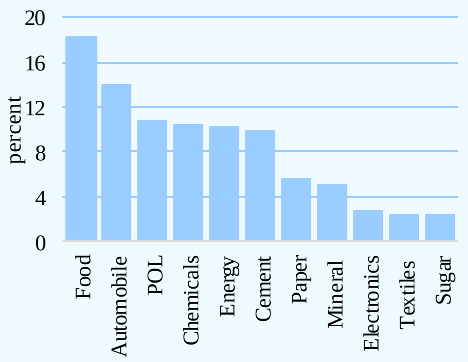
[7] Within these cities, investment activity in housing schemes that offered superior amenities (for instance, DHA and Bahria Town) were more upbeat, as plot prices in those areas nearly quadrupled during the last 5 years.

Figure S1.2a: Sector wise Investment to GDP Ratio*



*Calculated as sectoral gross fixed capital formation divided by sectoral GDP (both at current prices)
Data source: Pakistan Bureau of Statistics

Figure S1.2b: Average Return on Assets Earned by Listed Firms in Various Sectors (2011-16)



Data source: SBP's Financial Statement Analysis of Non-Financial Companies listed on PSX (2013-17)

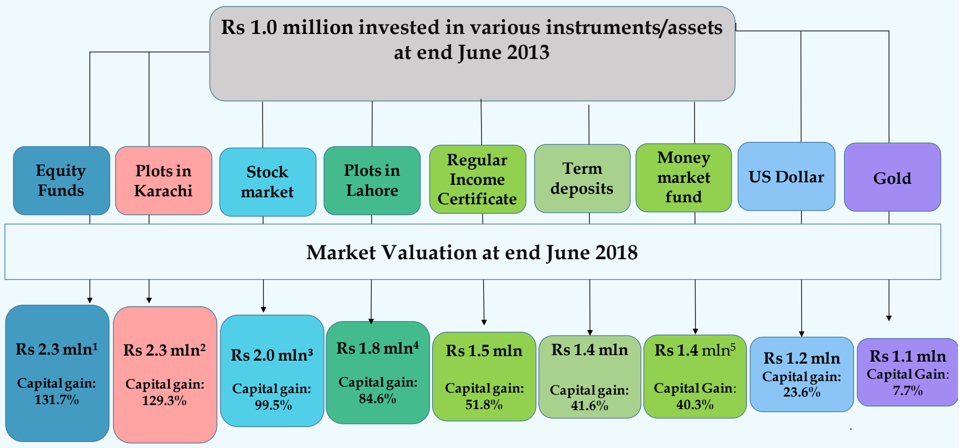
Anecdotal evidence suggests that some of the large industrial groups have preferred to invest their retained earnings in the real estate – both residential as well commercial (shopping malls and restaurants), instead of expanding their industrial base. This trend made sense also because of a steady rise in production costs (especially utilities) and overall weaknesses in the ease of doing business in the country during these years. Other than consumer industries, such as food (FMCGs) and automobiles, profitability in most industrial sector remained subdued compared to returns in property market (**Figure S1.2b**). Earnings of the export sector (mainly textiles) were particularly suppressed, as here the margins were constrained due to stiff competition with other countries; this is probably one of the reasons why big export houses have been diversifying in other inward-looking businesses.

Unwarranted competition with the formal savings channels

Formal modes of savings such as bank deposits and financial instruments cannot offer even a close competition as not only their returns/capital gains are much contained, but all the earnings are also taxable on fair value. Consider the following as an example: if someone had invested Rs 1 million in a plot in Karachi at end-2013, it would have attained a market valuation of around Rs 2.3 million in 2018 – a considerable capital gain of 129 percent in just 5 years (**Figure S1.3**). Savers enjoyed comparable returns only in equity funds; however, this avenue has not been much successful in attracting capital inflows due to the risk-averse behavior among savers and a general lack of awareness about the platform. In addition, capital gains under equity funds are subject to a 15 percent *unevadable* tax.

Earnings from other alternate avenues have remained quite subdued, such as 51.8 percent in case of regular income certificate; 41.6 percent in case of term deposits; and 7.7 percent in case of gold. Certainly, returns may vary depending upon the global and domestic economic environment, but the fact remains that a strong incentive structure has persisted in the country that favored property investments over others. The outcome of such gains was natural; the demand for formal savings instruments remained low, which effectively hindered the overall growth of financial institutions and availability of loanable funds for private businesses.

Figure S1.3: Comparative Performance of Various Assets Available for Investment Over the Last 5 Years



1 and 5: Based on Open-End Fund returns provided by the Mutual Funds' Association of Pakistan.This includes capital gains, interest payments and dividend payouts
2 and 4: Based on plot price index available at Zameen.com; does not include rental values and gains from short-term sale/purchase
3: Based on KSE-100 index value; does not include gains from short-term trading

<u>Pricing out of Genuine Buyers</u>

Another fall out of growing housing demand and booming prices was a gradual decline in the purchasing power of the genuine buyers. Making things worse, financing limitations and high cost of borrowing could not empower the lower-to-middle income segments of the society to afford housing. Nearly all of the urban housing shortage lies in the low-income segment of society. This situation basically represents failure of the formal financial sector in Pakistan in providing adequate and affordable housing finance products to a large segment of the population that could help catering their housing needs.

5. A number of reform measures have been introduced in recent years

Most of the earlier reform measures announced by the government were focused on increasing transparency and realize tax collection potential in the real estate sector (**Table S1.3**). In 2009 for instance, filing of tax returns was made compulsory for individuals owning a land area greater than 500 yards. Further, in 2012, a capital gains tax was introduced which was applicable on the sale of immovable property having a holding period of less than two years.

Table S1.3: Timeline of Major Government Reform Measures to Regulate the Real estate Sector

S. No	Year	Measure
1	2009	Mandatory filing of returns by persons owning immovable property with land area ≥ 500 square yards and/or having flat with covered area of 2000 square feet or more located in a rating area [Finance Act 2009 page 7]
2	2010	Through 18th amendment, provinces were empowered to collect Capital Value Tax (CVT) on immovable property (located in province). [FBR circular No C.No.ITP/B-2010-11/EC-e-Dox # 105236-R dated July 16, 2010]
3	2012	Introduction of a Capital Gain Tax (CGT) on sale of immovable properties, holding period of which is less than 2 years. [Finance Act 2012 page 437, Division VIII of the amended Income Tax Ordinance 2001]
4	2014	CGT charged at 10 percent for properties where the holding period was up to 1 year, and 5 percent where holding period is greater than or equal to 2 years. For holding period greater than 2 years, no CGT would be charged. [Finance Act 2014, page 135, Income Tax Ordinance 2001 amended up to June 2014, pp 328-329]
6	2014	Adjustable advance tax on sale of immovable properties at 0.5 percent for filers and 1 percent for non-filers of the gross amount of the consideration received. In case of purchase, the rate of tax was 1 percent for filers and 2 percent for non-filers. Properties with values below Rs 3 million exempted from the advance tax. [Finance Act 2014, pp 146 and Income Tax Ordinance 2001 amended up to June 2014, pp 346 and page 349]
7	2016	CGT on disposal of immovable property acquired on or after July 1, 2016 was kept at 10 percent (holding period up to 1 year); but this was raised to 7.5 percent (in case, 1 year > holding period < 2 year), and 5 percent (in case, 2 year > holding period < 3 year). For immovable property acquired before July 1, 2016, where holding period is ≤ 3 year, rate of CGT was 5 percent and if holding period > 3 years, rate of CGT was zero. [Income Tax Ordinance 2001 amended up to 31-8-2016, pp 364-365]
8	2016	Advance tax on purchase of immovable property (value > Rs 4 million) was increased to 2 and 4 percent for filer and non-filer, respectively. The rate of tax in case of sale was 1 percent of the gross amount of the consideration received for filers and 2 percent for non-filers. [Finance Act 2016 and Income Tax Ordinance 2001 updated up to 31-8-2016, pp 388 and 390-391]
9	2016	FBR valuation rates for 20 major cities were introduced effective July 31, 2016, for the purpose of calculation of federal taxes such as CGT and advance tax on sale and purchase of immovable property. [https://www.fbr.gov.pk/Contents/Valuation-of-Immovable-Properties/11042]
10	2018	An amnesty scheme for declaration of undeclared assets through Foreign Assets (Declaration and Repatriation) Act 2018 and Voluntary Declaration of Domestic Assets Act 2018 was introduced till June 2018.
11	2018	Non-filers were barred from purchasing property above Rs 5 million [Finance Act 2018, section 227C pp 82 and Income Tax ordinance 2001 amended up to 30 October 2018, pp 342]

Data source: Federal Board of Revenue

However, in 2016, a major move was taken when the FBR valuation rates were introduced for the first time for the collection of advance tax and capital gain tax. As mentioned before, these valuations in most cases were significantly lower than the actual prices. Provincial tax collection, nonetheless, remained subdued due to the prevalence of very low DC rates. In fact, the introduction of FBR rates created significant amount of ambiguity in the market, as buyers and sellers now had to take into account both the federal and the provincial rates.

In April 2018, the government announced (as part of budgetary measures for FY19) the imposition of ban on property purchases (above 5 million) by the non-filers. Furthermore, it was also suggested to abolish the FBR rates, whereas an advice was made to provincial governments to abolish the DC rates. In their place, the Budget introduced only a declared property value for the purpose of tax collection; however, to ensure that the value declared by buyers and sellers is the fair market value, the Finance Bill 2018-19 empowered the government with the first right to purchase.

Specifically, the government can purchase land and property at 100 percent above the declared value, in case the under-declaration is proven. The process involves the instatement of Directorate General of Immovable Property, who will be granted the authority to send a property for an evaluation in case it has reason to believe that the declared value is below the fair market value.[8] Moreover, instead of paying multiple taxes to different authorities, buyers and sellers of the property will face reduced tax incidence on property registrations. The simplification of tax collection by introducing a one-stage charge is of particular importance, as it holds the potential to increase government revenues by reducing the cost and time of paying taxes for the general public and nudging them towards filing returns.

6 An early implementation of the announced reforms is crucial

The dual objective of transparency and revenue collection necessitates the implementation of targeted and timely measures in the real estate sector. It is encouraging to note that the government has established the Directorate General Immovable Properties, which will act as FBR's specialized agency on all matters relating to the real estate. These include: geo mapping of immovable properties; survey and market analysis of real estate market segments; tracking online marketing of immovable properties; tracking operations of foreign real estate concerns; liaison with provincial Excise & Taxation and Land Revenue authorities for coordinated operations; identification of high end properties on sale and rent; Discreet Video Surveys of new & upcoming real estate projects

[8] According to FBR's notification F.No.1(01)/18-DG(BTB)/2018-19 dated 29th November, 2018, the formal filed structure of Directorate General IMP-IR has been initiated. Currently, DG BTB and Commissioners BTB Islamabad, Lahore and Karachi shall be assigned the additional charges of these newly established offices.

However, to make the property valuation process more transparent and effective, it is important for the provincial governments to abolish DC rates and discontinue the collection of stamp duties and other provincial levies. So far, none of the province has abolished DC rates. Since revenue mobilization from immovable property is a provincial subject post 18th amendment, there is little that the federal government alone can do to address the prevailing distortions. It is important to take all the provinces on board before reforms can be implemented.

Meanwhile, uncertainty prevails amongst stakeholders in the property market regarding valuations, tax incidence as well as the future course of property prices. Anecdotal evidence suggests a subdued activity recently as transactions have reportedly been put on hold – especially until the interested individuals do not register as filers. Similarly, some prospective sellers might just be extending the property holding period to reduce the burden of capital gain tax. Since credible data on transaction volumes is not available, a sense of market activity can only be taken from information available on prices; and this suggest subdued activity. Between April and September 2018, plot prices in Karachi have dropped by around 15 percent, whereas the same in Lahore have nearly stagnated. In the near term, therefore, tax collection might remain subdued due to a lower transaction volume, but in the medium to long term, these reforms would improve both the revenue collection as well as the overall incentive structure.

On the social front, addressing the housing supply situation is of paramount importance. In this regard, the government announced a new "Naya Pakistan Housing Program" on October 10, 2018, aiming to establish 5 million dwelling units across the country to cater to the needs of the lower-income class. State Bank of Pakistan has also increased its policy focus on the provision of low-cost housing finance in the country. In this context, it is important to put in place a non-judicial foreclosure framework in the country, in order to make it convenient for banks to exercise their right to collateral. However, the urgency to address property market issues needs to be felt across the entire chain of stakeholders in the property market, including federal and provincial governments, real estate developers, builders, banking industry, and suppliers of construction materials, if the industry's dynamics are to be improved.

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