REFORMING PROPERTY TAX IN KHYBER PAKHTUNKHWA

INTRODUCING AN EFFICIENT, EFFECTIVE AND EQUITABLE TAX POLICY

SEED (Sustainable Energy and Economic Development)

Improved Economic and Urban Planning in KP

Adam Smith International   SEED   cdpr   IGC International Growth Centre

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Message from Chief Minister, Government of Khyber Pakhtunkhwa

Taxes are a vital source of revenue for the government to enable them to provide essential services and finance development projects for their citizens. The Excise, Taxation and Narcotics Control Department has a pivotal role in own source revenue collection for Khyber Pakhtunkhwa, by driving revenues and inculcating a sense of responsibility amongst the citizens towards the country.

This year during FY 2020–21, we at Khyber Pakhtunkhwa are aiming to revitalize the functions of this department by establishing organizational KPIs, enhancing data analytics and utilizing experts in the fields to overcome tax gaps in our various tax streams. I would like to compliment the Excise and Taxation

Mahmood Khan

department for the old reforms agenda they have proposed and the steps in this regard that have already been taken. Property tax forms a core component of the overall functions of the department and can drive major revenues for its receipts as well. Property tax is not merely a technical instrument, but it is a substantial revenue factor with strong financial, institutional, and political connotations. Even though property taxation has a long tradition in the province, the UIPT provides for only a small amount of revenue as a share of the provincial GDP.

Hence, we at Khyber Pakhtunkhwa will put in our maximum efforts to optimize these tax and revenue generating streams for the betterment of the province and the country. This note throws light on some of the important steps that the department can take and adapt to bridge the gap between its collection and potential.
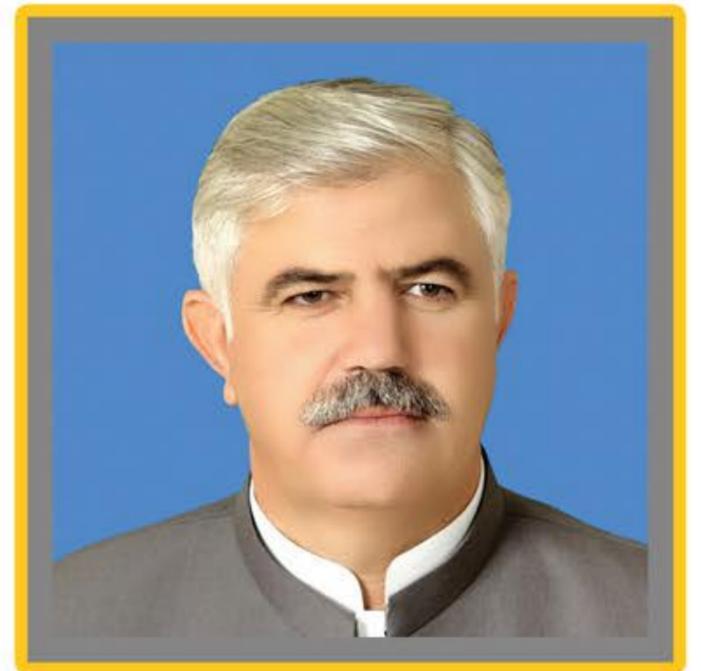
Message from Special Assistant to the Chief Minister for Excise, Taxation and Narcotics Control Department, Government of Khyber Pakhtunkhwa

Property sector has grown manifold following rapid urbanization in Khyber Pakhtunkhwa over the last two decades. This growth has created huge demand on public goods and services leading to large deficits in the provision of critical municipal services in cities that government needs to deliver. Urban property taxes are a key fiscal instrument that can ensure the effective provision of municipal services and critical for urban development as 85 percent of revenue collected from urban property tax is transferred to municipal and development authorities across the province. This instrument can help close fiscal deficits by ensuring sustainable financing through an expansion of own-source revenues. In Khyber approximately two percent of own-source revenue over the previous three fiscal years, with substantial revenue potential remaining untapped.

Ghazi Ghazan Jamal

An important factor constraining the public investment response to address deficits in service delivery is the province's weak capacity to raise municipal finances efficiently.
Devolution of service delivery should be accompanied with the expansion of tax base, making property tax a pivotal revenue source and policy lever. Recent policy response by Government of Khyber Pakhtunkhwa has centered around linking property tax collection with service delivery for the citizens to realize the benefits of taxation in the form of public service provision benefit, as well as consolidating the fragmented cities governance.

Evidence based policy decision making linking the provision of public services with receipt of property taxes can improve tax morale, increase accountability of local governments, enhance tax collection, make the development process more transparent, inclusive and strengthen local service delivery.

The major objective for reforming property tax in Khyber Pakhtunkhwa is to unlock additional revenue sources to make urban areas as engines of growth and development. To do so, it is pertinent to bridge the gap between research and policymaking and this policy note is a step towards integrating research findings into policy decisions.

Message from Secretary, Excise, Taxation and Narcotics Control Department, Government of Khyber Pakhtunkhwa

Increasing own source revenue is one of the key challenges the government faces today. Government of Khyber Pakhtunkhwa has initiated a reform process to modernize urban immovable property tax (UIPT) collection and strengthen enforcement capacity by enhancing citizen's trust in the tax administration.

The process of reforms necessitates assessment of the existing property valuation methods, digitization of data of urban immovable properties and simplification of procedures and modes of tax payments for tax payers of Khyber Pakhtunkhwa. While many initiatives have already been undertaken by the Provincial government to address these challenges, more efforts will be required to further strengthen citizen's trust in the Provincial tax administration. In particular, the current valuation regime in Khyber Pakhtunkhwa has a number of challenges. Khyber Pakhtunkhwa needs investments to upgrade information capacities and valuation systems that integrate various databases and digitize property tax valuations and billing, yet simplifying the process for paying property taxes for citizens. Administrative and systemic reforms needed in this direction include well-designed performance-based HR reforms for tax collectors, simplifying registration and payment processes, lowering compliance costs, and closing the information gaps through digitization, standardization and automation.

Islam Zaib

This policy note provides a discussion about challenges and key recommendations for the Government of Khyber Pakhtunkhwa to introduce an overarching and holistic reform agenda around property taxes.

Message from Team Leader, Sustainable Energy and Economic Development (SEED) Programme

Sustainable Energy and Economic Development (SEED) Programme, funded by UK's Foreign, Commonwealth & Development Office (FCDO), is aimed at generating higher levels of public and private investments. In the post–COVID scenario, there is even a more pressing need for greater public investment, but the fiscal space is now highly restricted. This means that if public investment has to increase, SEED will have to work with the government to increase the available fiscal space. This in turn is dependent upon helping government in optimizing its revenues but the revenue mobilization effort should not lose sight of the private sector development and improved urban planning goalposts. The provincial government presently relies heavily on federal transfers, while KP's own source revenues remain limited. In this context, the urban immovable property tax (UIPT), which at presents yields very little revenue for the province, is seen as a promising source of revenue with huge untapped potential. Besides a revenue source, UIPT is also a very effective policy tool to drive urban policy. SEED recognises scope for improvement on both the policy and administrative side of UIPT, while acknowledging the need to strengthen the social compact by creating a stronger link between service delivery and citizen's willingness to pay such taxes.

Hasaan Khawar

SEED has collaborated with the Consortium for Development Policy Research (CDPR) and the International Growth Center (IGC) to produce this policy note on UIPT. This note acts as policy guide not only for SEED but also for the provincial government to carve out a framework for future reform to improve the performance of urban property taxes in KP.

Through this note, and in consultation with the Government of Khyber Pakhtunkhwa, SEED has identified a number of priority areas for reforming property tax in the province including digitisation and integration of property tax data, updating property valuation, and improving tax collection through raising both tax morale and government accountability.

I hope that SEED will be able to help the Government of Khyber Pakhtunkhwa in reforming the UIPT regime, leading to increased public investment and a conducive urban policy, ultimately contributing in achieving the growth and prosperity agenda for the province.

Executive Summary

Reforming Property Tax in Khyber Pakhtunkhwa

Khyber Pakhtunkhwa (KP) is a population of 35 million people and contributes an estimated 10 percent of Pakistan's GDP. The province's urban areas have grown at a rate of close to 3 percent per annum during the past two decades. This has resulted in the emergence of significant urban agglomerations in the province's central and Hazara regions. Today more than one in five citizens in the districts of Peshawar, Swat, Kohat, Nowshera, DI Khan and Abbottabad reside in urban areas. In addition, significant populations connected to these urban agglomerations reside outside the administrative boundaries of urban areas along highways creating an urban system that includes peri–urban localities. As a result, the population density of districts in the central region have increased significantly and now exceed 1,000 persons per square kilometre. This ongoing urban transformation is giving rise to the downsides of densification — the emergence of slums, congestion, stressed municipal infrastructure that require public investment and policy responses if urban areas are to fulfil their potential as engines of growth and development.

There is considerable evidence which shows that KP's municipal infrastructure is already under stress (ADB 2020, Mansuri et. al. 2018) with urban citizens experiencing significant deficits in the provision of clean drinking water, sanitation and waste removal. An important factor constraining the public investment response to address these deficits is the province's weak capacity to raise municipal finances efficiently. Globally, urban land and property taxes are the most important sources of municipal revenue. However, KP's urban property tax system is underperforming in regional terms. The

contribution of Urban immovable property taxes (UIPT) to provincial own source revenues is five times lower in KP (0.5 percent) than in neighbouring Punjab (2.5 percent) (Estimates of Receipts 2019; Finance Department White Paper 2019).

The Government of Khyber Pakhtunkhwa (GoKP) is designing a reform program to strengthen the province's UIPT system in order to lay the foundation of sustainably financed public investment that can realize the potential of urban areas as engines of growth and development. An important objective of the reform is to catalyse a virtuous cycle, where public investments lead to an increase in the value of urban land and properties, which creates the financing for further public investment through a well–designed tax multiplier.

This note provides a conceptual framework for the reform program in KP. It draws on evidence of property tax reforms in Punjab and other developing countries at similar levels of capacity and facing similar challenges. It argues that the reform effort should not be designed to increase revenue per se, instead it should focus on creating a robust property tax system that:

1. Ensures tax buoyancy, while minimizing the economic distortions associated with taxation.
2. Is progressive and equitable.
3. Strengthens the accountability relationship between governments servicing cities and urban agglomerations, and their citizens.
4. Strengthens voluntary compliance by enhancing citizens' trust in the tax system and in government service delivery.
5. Optimizes existing state capacity and provides a framework for enhancing state capacity to meet the other four objectives.

The proposed framework is built around the following three pillars (Figure 1):

1. **Pillar 1 – Policy reform:** This pillar includes the reform of the valuation system and the exemptions regime. The ability of the property tax system to catalyse the virtuous cycle depends on the introduction of a valuation system that creates tax buoyancy by capturing a part of the increase in property value (Haque, 2020) – which results from public investment – in the form of an increase in tax collections (Collier et al. 2018). In addition, the valuation system must be designed to ensure equity and efficiency. This pillar also includes the design of a system of exemptions that is fair and minimizes distortions.

2. **Pillar 2 – Strengthening enforcement capacity:** This pillar includes the modernization of information data and audit systems, taxpayer facilitation measures, simplification of the tax regime and reforming the incentives of tax collectors. These instruments are important because traditional theory suggests that evasion, collusion and corruption are a result of poor information, weak audit capacity and an ineffective system of penalties related to registration, estimation of the tax liability and tax collection (Slemrod, 2007). It also argues that a complex tax system adversely effects compliance by incentivizing taxpayers to exit from the system. Finally, it also hinges on incentives provided to tax collectors.

3. **Pillar 3 – Building citizens tax morale:** This pillar focuses on measures that can help build taxpayer morale. The literature suggests that this can be done by increasing perceptions of fairness and equity of the tax system (Luttmer and Singhal, 2014). It also suggests that the

strengthening of tax morale requires creating a demonstrable and transparent link, which is apparent to taxpayers, between tax payments and the benefits that result from these payments (Khwaja et. al., 2020). These interventions are important because the recent literature on reforms suggests that citizens compliance with the tax system is based on social norms and on levels of trust in the fairness, equity, reciprocity and accountability of the tax system (Prichard et. al., 2019). It suggests that effective reforms must build citizens' tax morale in addition to *strengthening enforcement capacity.*

Figure 1: Pillars of the Reform Framework
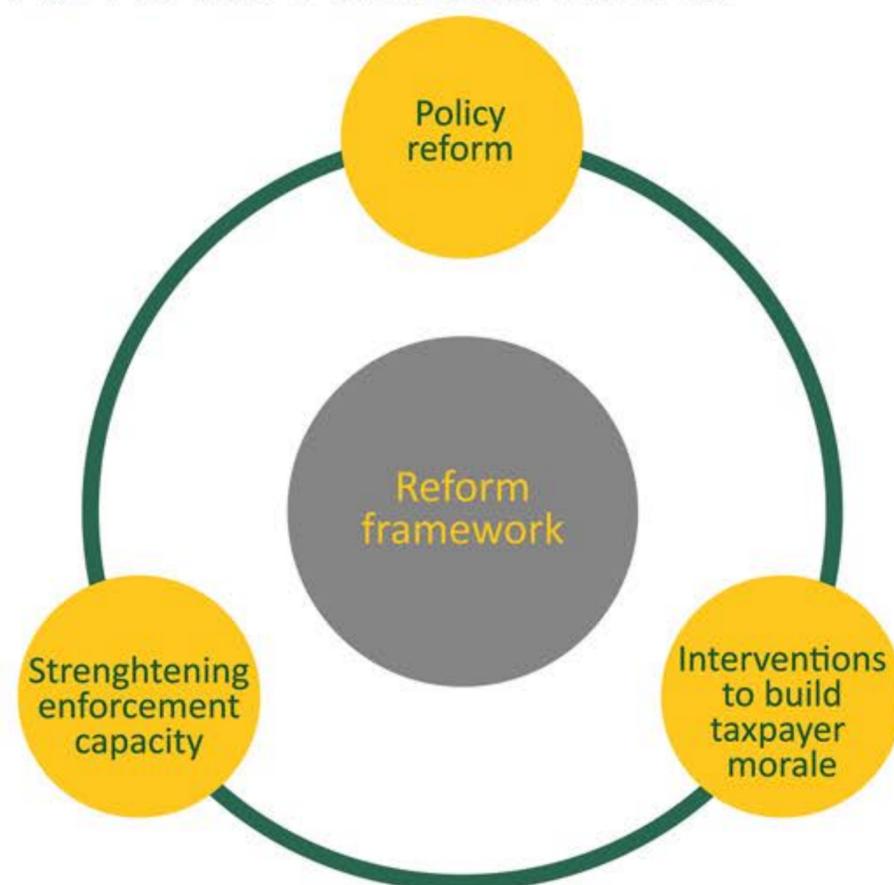
The report analyses the current challenges faced by KP in each of these three areas in light of the available evidence from related contexts and uses this analysis to recommend priorities for the reform strategy.

Valuation and Exemptions: challenges and priorities

The literature suggests that an effective valuation system should tax "land value".

Land is an important base to tax, because the gains from public investment are largely capitalized in "land values". Hence, enabling the virtuous cycle would require taxing the "land value" (Collier et al. 2018). Furthermore, the literature suggests that taxing land is more efficient than taxing improvements because taxing land does not distort decisions regarding land use. It is also fairer as the burden of taxes is related to the value of assets (Bird and Slack, 2002). Ideally, "land value" can be taxed using the market value of land (capital value assessment) or an estimated value of land rental (ARV method). However, both methods require large scale investments in upgrading the capacity of information and valuation systems, which are missing in the context of KP.

Hence, the framework recommends the introduction of a points–based system as an intermediate step with a long–term objective to move towards a capital value system. We also recommend taxing both land and improvements as it is difficult to obtain data that isolates the value of land from the value of improvements. The points–based system would require specifying taxable values per unit of land and covered areas in different zones of an urban area based on area–wise property values. In addition, it would require adjusting taxable value within zones based on observable characteristics of properties, e.g. access to roads and public transportation, quality of municipal services, density of neighbourhoods, and the quality of construction of property, which have the potential to affect the relative values of properties within each zone.

The current valuation regime being used in KP has several challenges associated with it. The valuation system in the province uses an area–based system that appears to use very broad zoning categories to assess tax liabilities. In the case of residential properties, it does not use any adjustment factors to adjust for differences in property values within zones. The current tax schedule creates a real risk of creating significant deviations between actual and assessed market values of properties. It also very likely results in making the tax liability regressive, which will be considered unfair by taxpayers, thereby eroding tax morale.

The KP valuation system uses an annual rental value (ARV) estimate to assess the tax liability that is gathered on the basis of verbal confirmation from the lessee and the surveyor's subjective judgment on the basis periodic market surveillance exercises. Abbas and Cheema (2020) provide evidence that similar, ARV–based method of property assessment in Punjab is creating a regressive tax burden. They also find suggestive evidence that the current ARV system in Punjab is underassessing tax liabilities, either because a low tax rate has been set under this system compared to regional comparators or because the system is systematically underassessing property values.

These challenges suggest that the introduction of a more sophisticated and better calibrated points–based system is an intermediate reform with the potential to make the tax less regressive and improve property tax collections. Although the administrative costs of a points–based system are low, the tax authority would still need to collect property–level data on land and covered area, geocode property location and merge this data with existing analogue information on characteristics of the property. The points–based method would require the collection of other data

related to the property and the neighbourhood. It would also require the delimitation of an optimal number of zones in an urban area to ensure lesser variation of values within each zone. Ideally, this reformed system should be built around the area-wise differences in property values and this would require modernizing and automating the district collector (DC) based land transaction registry through the introduction of e-stamping. The reform would also require introducing a regime of tax credits to reduce the adjustment costs for taxpayers who lose from the reform as this would make the reform politically acceptable.

The analysis of KP's exemption regime suggests that the current homestead exemptions are not tied to the "ability-to-pay" based on income and are too broad based and possibly resulting in unjustified tax expenditure. The report recommends instruments that should be considered as part of the reform strategy that can be used to introduce a targeted tax relief program that ties benefits to the "ability to pay." Finally, we find that the current policy regime in KP imposes differential liabilities on self-occupied and rented properties and on residential and commercial properties. These differentials are likely to distort investment decisions regarding property improvement and land use. It is important that the reform framework analyses the economic costs associated with these differentials and considers rationalizing these differentials.

Enforcement Capacity: Challenges and Priorities

The analog and decentralized nature of KPK's property tax information system is a serious constraint on its enforcement capacity. The automation, digitization and integration of the following databases is

essential for strengthening enforcement capacity:

1. A database of properties that captures data on the existence, area, other characteristics and location of all units of property, as well as data on access to public services and other amenities that may affect the capital or rental value of property.
2. Property transaction database matched to tax localities or zones that captures land sales and the values of these sales.
3. Property tax register that captures data on registration, assessment and billing, payments, violations and penalties and arrears.

The digitization of data will allow for digitalization of processes, such as paving the way for automation of the recurrent property tax billing and audits. By geocoding properties and the use of satellite imagery, vacant plots and new urban developments can be brought into the tax net. Automation can be used to simplify the process of generating standardized bills for taxpayers, and to facilitate them in paying taxes. Specifically, it can aid in clarifying the calculation of tax bills for taxpayers, lower taxpayer and tax collector contact, reduce non-essential workload of property tax staff, increase ease in paying taxes for taxpayers, and allow for property taxes to be incorporated into a one-window payment option for taxpayers.

Evidence from property tax reforms in Punjab shows the tremendous potential of well-designed performance-based HR systems for tax collectors to improve property assessments and enhance tax collection (Khan et al., 2015 & 2019). However, it is critical that the design of such a scheme be evidence-based, evaluated

continuously when implemented, and be credible, i.e. promised rewards are in fact provided if tax collection staff reaches established goals set under the scheme.

## Building Taxpayer Morale: Challenges and Priorities

Evidence from the Pakistani context shows that citizens have low levels of trust in government, which is weakening the fiscal compact between taxpayers and government. Potential causes of the weakening fiscal compact in Pakistan include perceptions of unfairness and inequity and the expectation of low reciprocal benefits from taxation and weak government accountability. Abbas and Cheema (2020) show that the existing valuation system is likely resulting in a regressive distribution of the property tax burden in Punjab's cities. Khwaja et. al. (2020) show that less than a third of their survey respondents in Lahore believe that 80–100 percent of their neighbours pay the required taxes. More worryingly, only 10 percent believe this of their countrypersons. This suggests that perceptions of equity are likely to be low in the Pakistani context and improving tax morale would require making the tax system fair and equitable.

Evidence also suggests that a vast majority of citizens in Pakistan believe that the reciprocity of the tax system is extremely low, and a majority are willing to reward reciprocity. Khwaja et. al. (2020) show that Pakistani citizens do not believe that they get reciprocal benefits from taxation. A majority of citizens (55 percent) in their Lahore survey believe that only 0–20 percent of taxes are actually used to fund services. And only 5 percent believe that the proportion of taxes used to fund services is 70 percent or higher.

Furthermore, Khwaja et.al. (2020) also find that more than half of their respondents (52 percent) strongly agree with the statement that people should only pay taxes if the government provides better services. Finally, they find that a very small minority (19 percent) of citizens believe that government is responsive to citizens. This evidence suggests that it is imperative to introduce measures that can strengthen tax reciprocity and accountability by improving tax governance outcomes.

The framework provides a menu of interventions that can be used as part of the reform framework to improve quasi–voluntary compliance and build tax morale by addressing perceptions of unfairness and inequity and weak reciprocity and accountability. This includes information disclosures about the distribution of the tax burden, simplification of valuation methods, taxpayer education programs and simplification mechanisms. It also includes instruments to strengthen reciprocity which include earmarking, information disclosure about the expenditure benefits from taxation and the introduction of third–party audits and participatory budgeting. In addition, we argue that strengthening the urban property rights regime is an essential complementary reform without which it will be difficult for citizens to realize the capitalization of the benefits of public investment in form of higher property values.

1. Context
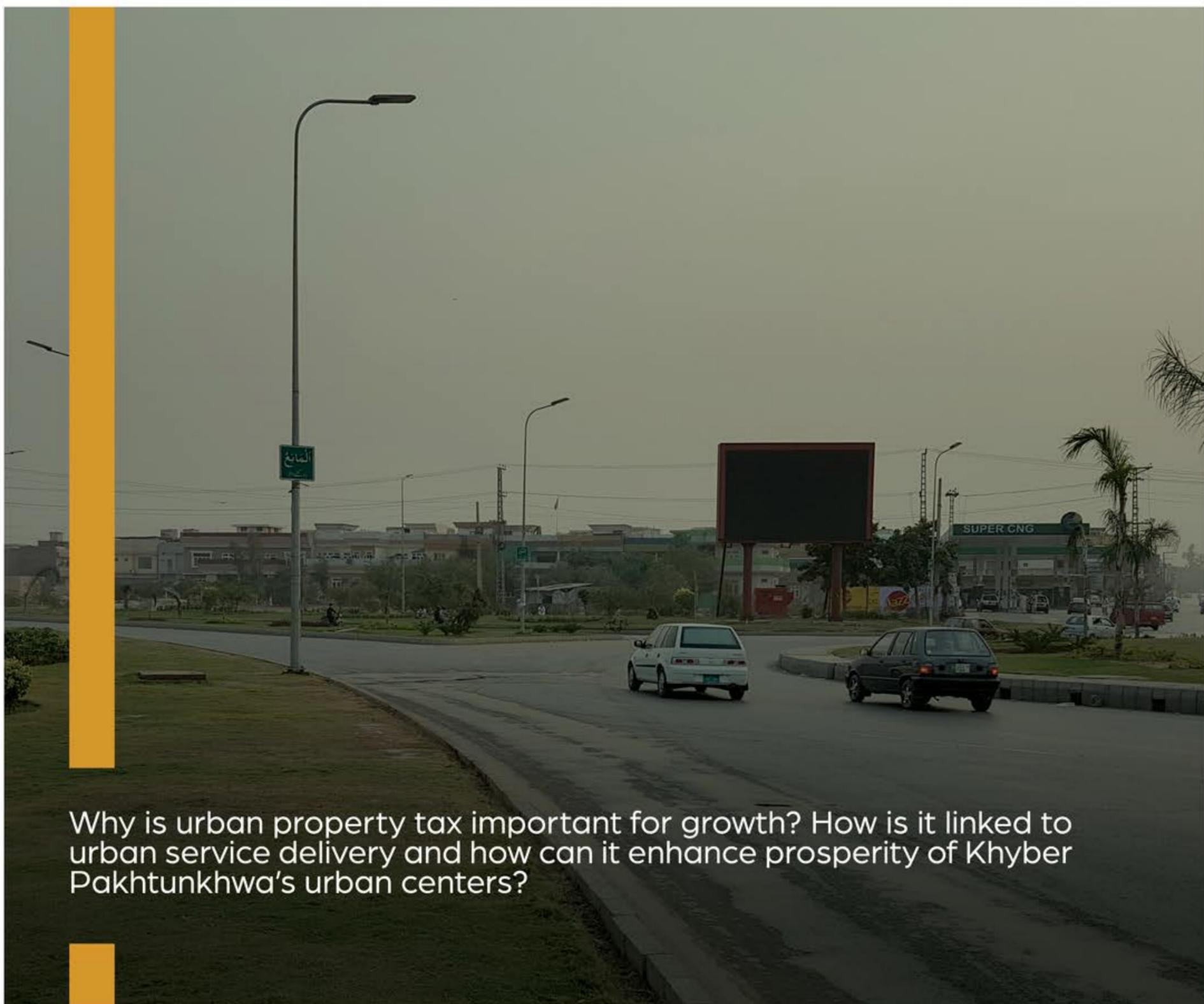
Why is urban property tax important for growth? How is it linked to urban service delivery and how can it enhance prosperity of Khyber Pakhtunkhwa's urban centers?

KP RECOVERY OF UIPT IN THE LAST 5 YEARS
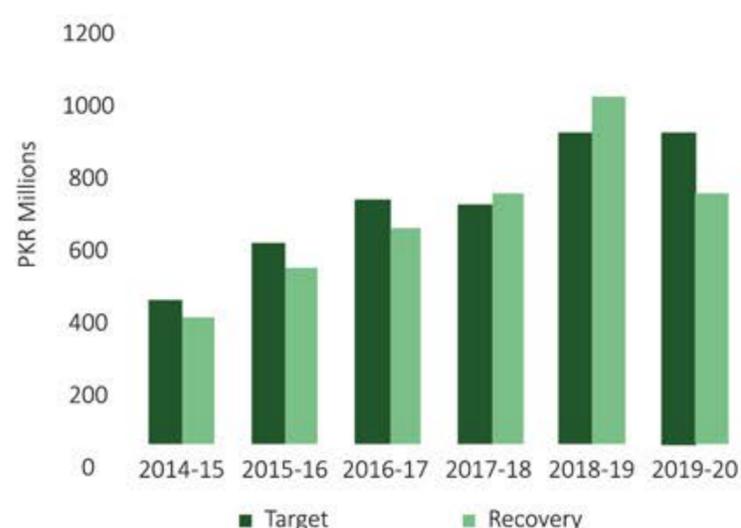
KP DIRECT TAXES, ANNUAL RECEIPTS
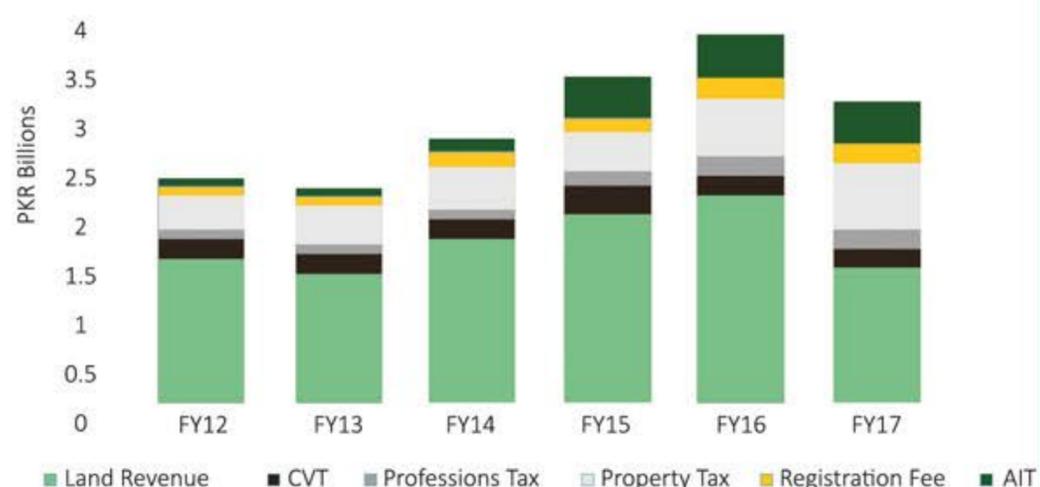
HIGHLIGHTS OF KP FINANCE BILL, 2020

- KP plans to increase the share of property tax revenue from 50% to 85% for the respective municipal committees
- Increase in rebate from 10% to 20% is admissible to those who have paid their tax in advance for the whole year
- Property tax will not be levied in the province until June 2021
- Outstanding tax payments can be paid in 12 installments with a 25-30% lump sum discount until June 30, 2021

At 35 million people, Khyber Pakhtunkhwa (KP) is the third most populous province of Pakistan, contributing an estimated 10 percent of the country's GDP. Home to a range of small- and medium-sized cities, KP's economy is driven by its forestry, mining, and agriculture industries. Peshawar, a city of approximately two million people, is the administrative and economic capital of the province.

Although, the least urbanized of the country's provinces, it has witnessed a high population growth rate in urban areas of close to three percent per annum between 1998 and 2017. It has also seen the emergence of urban agglomerations in its central region and Hazara regions. The urban cluster in the central region consists of the districts of Peshawar, Charsadda, Mardan, Nowshera and Swabi and comprises one-third of the province's total population and half of its urban population. The urban cluster in the Hazara region consists of the districts of Haripur, Abbottabad and Mansehra. It contains approximately ten percent of the province's total urban population. Significant populations connected to these agglomerations reside outside the administrative boundaries of the municipalities, and "ribbons" of development along the highways have evolved, largely to benefit from accessibility to these urban clusters. All the districts in the central region's urban cluster have population densities that exceed 1,000 persons per square kilometre, with Peshawar district having a population density of over 3,300 persons per square kilometre.

In addition, Figure 2 shows that six districts have urban shares that exceed twenty percent of their population. Slightly less than half of Peshawar district's population resides within urban limits; around one-third of Swat's population also resides within city limits; and more than one-fourth of Kohat's population is urban.

Figure 2: Urban Share in Selected Districts of KP

Share of Population in Urban Areas (%)
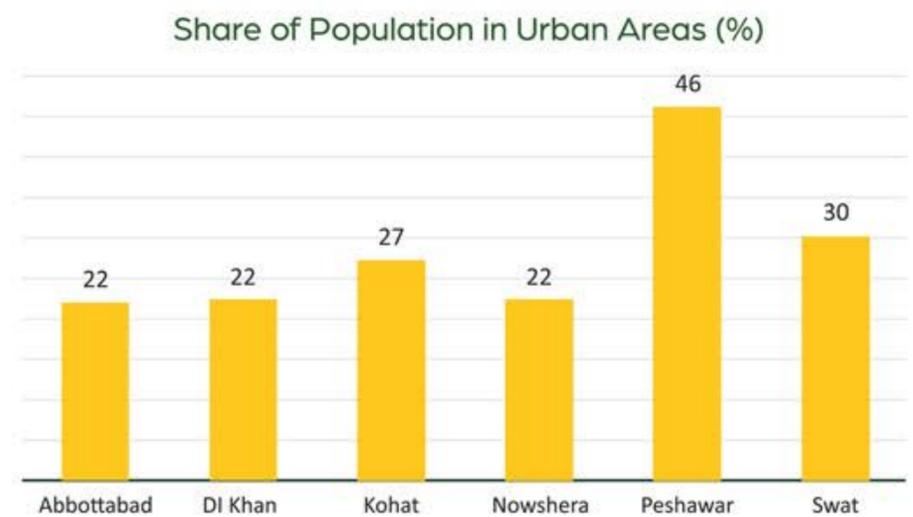
The province's high urban population growth rate and the development of urban agglomerations that account for a significant proportion of the population underscores the importance of cities and towns in the ongoing structural transformation in KP. This suggests the need for coordinated public policy that is designed to harness the potential of these urban agglomerations as engines of growth, and to tackle the potential downsides of densification: the emergence of widespread slums, low-quality housing, congestion and contagious disease and reliance on low wage jobs (Collier et. al. 2018).

The strain on KP's urban clusters is already showing: recent studies (ADB, 2020; Mansuri et al., 2018) find that piped water reaches less than half of the urban population of the province for limited durations during the day, with water loss due to leakages in the distribution system, and a high risk of contamination. Sewage waste generated by 85 percent of the urban population flows in open drains ending up, untreated, in agricultural areas

and in surface water drains, creating significant health risks and placing the young population of the province at a high risk of stunting and wasting.
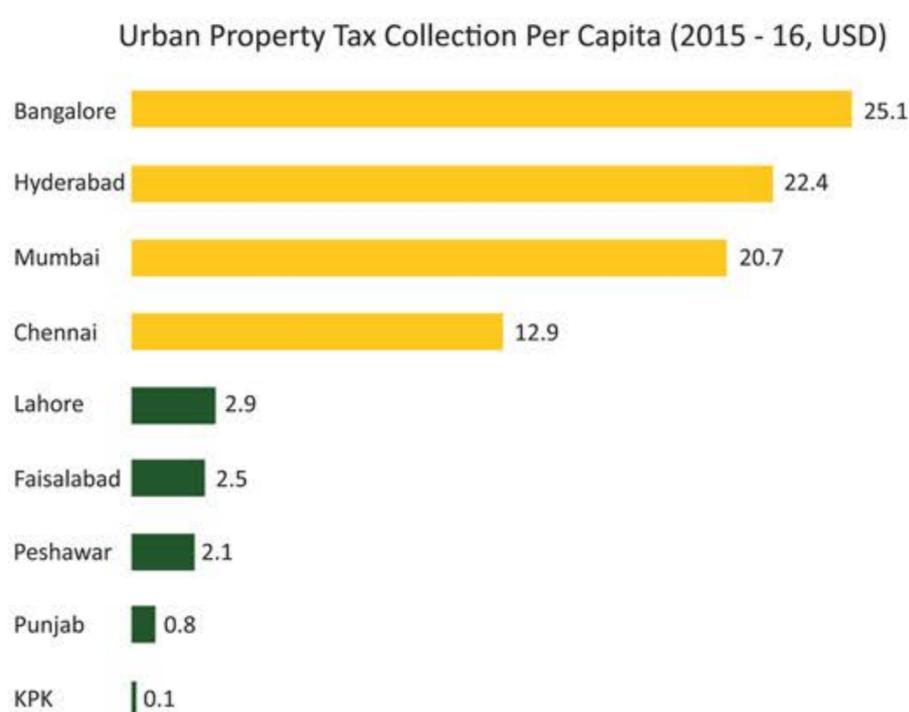
More than seventy percent of municipal solid waste is not collected, leading to ad hoc waste disposal, becoming a health hazard, and causing environmental degradation. The provision of other services such as streetlights and filling of potholes leaves much to be desired.

The problem for KP is that the necessary public investments that can catalyse the potential of cities and urban agglomerations to create prosperity are constrained by limited finances of governments tasked with carrying out urban policies. This problem is likely to worsen in the future as the province's rapidly growing urban population increases demands on public investment. This is also an important challenge constraining the institutionalization of a functional and empowered local government system in the province, which is an important commitment of the current government.

Globally, land and physical properties represent one of the most important sources of municipal revenue (UN–HABITAT, 2009). In the case of KP, Urban Immovable Property Taxes (UIPT) represent an important but yet, untapped source of municipal revenue that can be harnessed through the modernization and reform of its UIPT system. Although property tax collection has increased almost three-fold between FY 2010–2011 and FY 2019–2020, recurrent property taxes still form a small part of KP's revenue pool. Recurrent UIP taxes contributed 0.5 percent of all own–source revenue, and just 0.16 percent of all funds available to the provincial government in FY 2019–2020.[1]

has attempted to reform its property tax regime over the last decade with varying success, collects approximately 2.5 of its own–source revenues in UIP taxes. More importantly, the performance of property tax collections in KPK is behind regional comparators (Figure 2)[2].

Figure 3: KP UIPT Collection in comparison with Punjab and Indian Cities.

Urban Property Tax Collection Per Capita (2015 - 16, USD)

City	Value
Bangalore	25.1
Hyderabad	22.4
Mumbai	20.7
Chennai	12.9
Lahore	2.9
Faisalabad	2.5
Peshawar	2.1
Punjab	0.8
KPK	0.1

Recognizing these challenges, the Government of Khyber Pakhtunkhwa has begun work to develop a framework for UIPT modernization and reform. In our view, the overall goals of modernization and reform of UIPT in the province should lay the foundation of a tax system that:

1. Enhances the financial envelope for public investment and maintains its buoyancy, while minimizing the economic distortions associated with taxation.
2. Is progressive and equitable.
3. Strengthens the accountability relationship between governments servicing cities and urban agglomerations and their citizens.
4. Strengthens compliance by enhancing citizens' trust in the tax system and in government service delivery.
5. Optimizes existing state capacity and provides a framework for enhancing

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state capacity to meet the other four objectives.

The main objective of modernization and reform should not be to enhance revenue alone. For example, objective (1) would suggest that a good system would aim to enhance the envelope by applying a low tax rate across a broad base of properties and in a manner that minimizes any distortions to investment and land use decisions. Similarly, objective (3) and (4) imply that the reform should make transparent the linkage between tax payments and the benefits from these payments for citizens. Finally, objective (6) would suggest that the reform should not introduce a system whose capacity requirements far exceed existing capabilities. However, it should also not take existing capacity constraints as binding and must include a framework of gradually enhancing capacity.

Empirical evidence from Punjab shows that the current system of property taxes in the province – which shares many similarities with the system in KP – where the tax is collected by the provincial Excise and Taxation (E&T) Department on behalf of urban local governments, has made the link between taxes and benefits opaque for citizens. The existing evidence also indicates that this may be contributing to low tax morale. Furthermore, we also find that the existing system in Punjab, which re-values the tax base after considerable gaps, hasn't performed well on buoyancy; and evidence suggests that its annual rental value (ARV) property valuation system does poorly on horizontal equity of the tax system (Abbas and Cheema, 2020).

The purpose of the present note is to provide a framework for property tax modernization and reform that builds on current global thinking and evidence around property tax reforms. In particular, we draw on the International Growth Centre's (IGC) work on property tax reforms in Punjab and in other developing economies that faced similar challenges. The next section provides a conceptual framework for reform thinking. The remaining sections provide the current thinking on property tax reforms in three core areas of reforms

- Policy: What to tax? How to assess the tax base? How to think about exemptions?

- Enforcement capacity: Digitization; facilitation of taxpayers and simplification of the tax process; and human resource reforms.

- Tax morale and quasi-voluntary compliance: Fairness; reciprocity; accountability; and complementary investments to strengthen the urban property titling regime.

2. Conceptual Framework
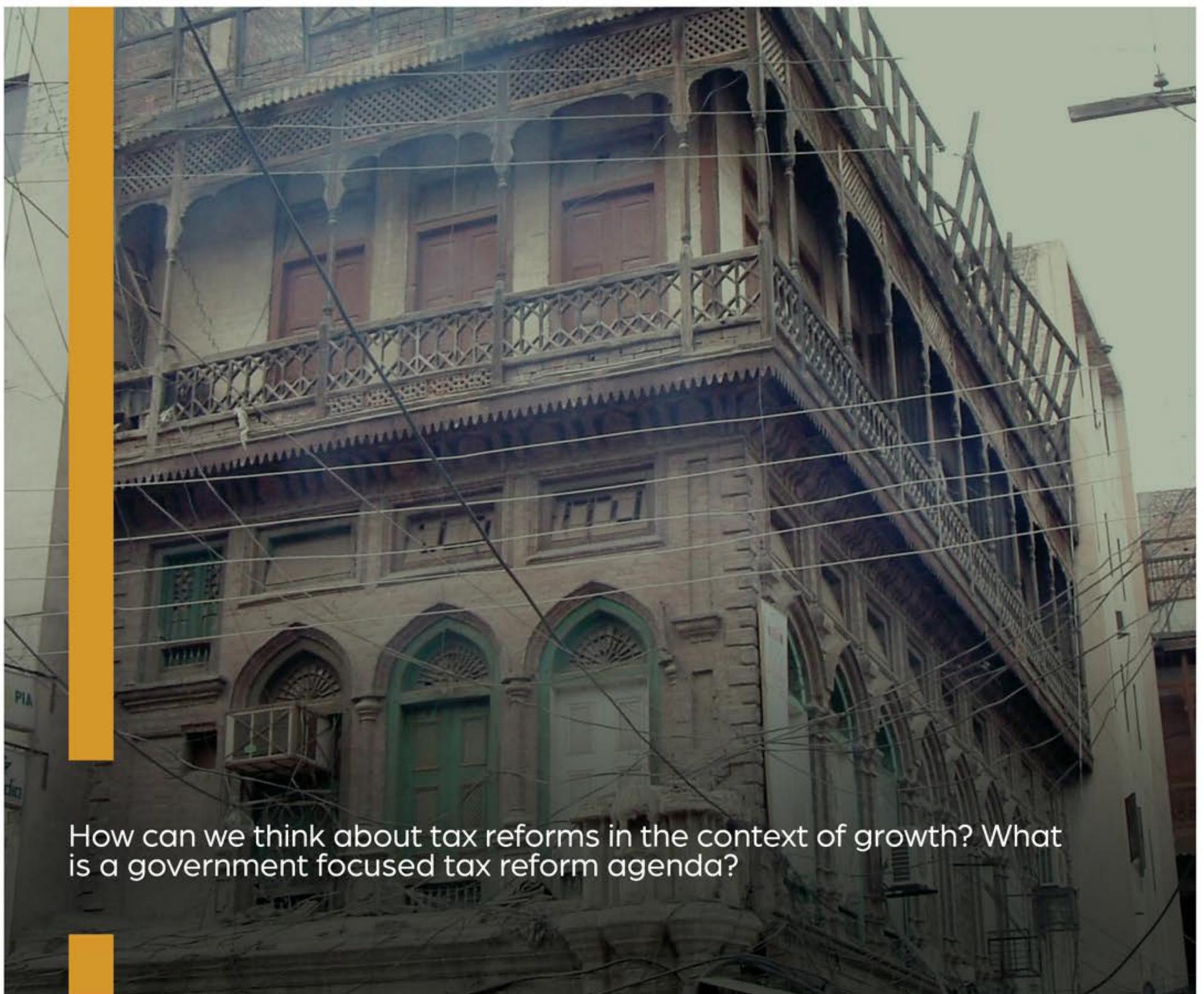
How can we think about tax reforms in the context of growth? What is a government focused tax reform agenda?

WHAT CONSTITUTES PROPERTY TAX?

What to tax?

- Capital Value
- Area-based Value
- Rental Value

What will constitute as the tax base?

Who to exempt?

Land/Property Tax Revenue = (registered **tax base** – **exemptions**) x taxable value determined **valuation** x legally defined **tax rate** x **tax collection**

How will the tax base be valued?

At what rate will it be taxed?

How will tax collection liability be enforced?

An important objective of property tax reforms is to catalyse a virtuous cycle, where appreciating urban land and property values finance public investments which make the city prosperous and, in turn, lead to an appreciation of land values, illustrated in figure 4 (Collier et al. 2018). Land and property taxes are an important element of this virtuous cycle because if designed well, they serve as a buoyant instrument, allowing governments to obtain returns on their investments into public services and infrastructure that raise land and property value (Haque, 2020).

However, to enable the virtuous cycle, property tax systems have to be designed to ensure that they do not distort land and property values, for example by reducing private investment into the cities' assets, and that taxes are used to fund public investment that increases the productivity of the city economy and the value of its assets. The former condition suggests that the tax system must be designed to meet the objective of minimizing economic distortions. The latter suggests that UIPT reforms must be embedded in an agenda of broader urban governance reforms that strengthen the expenditure accountability of cities. If these conditions are met, these taxes have the potential to provide governments with higher projected future income streams, which, in turn, enable them to raise financing for public investment through capital markets on the basis of higher projected revenues in the future. The literature from 19th century United States highlights the critical importance of the municipal bond market in the expansion of water and sanitation services (Cutler and Miller 2004, Bodenhorn 2017). Evidence shows that infectious disease mortality in the US declined during the first eight decades of the 20th century from 797 deaths per 100,000 in 1900 to 200 deaths per 100,000 in 1940 due to the public investments in clean drinking water and modern sanitization (Armstrong et. al. 1999).

Figure 4: The Virtuous Cycle of Public Investment

Traditional approaches to property tax reforms highlight the following elements of the system[3]:

Tax Revenue = (registered tax base — exemptions) x taxable value determined by valuation x legally defined tax rate x tax collection

The approach to reform is divided into measures that relate to: (A) policy reform and (B) administrative reform and modernization (Kelly, 2014; Bahl and Wallace, 2008; Slack and Bird, 2015).

Figure 5 shows that the main instruments that relate to policy reform include reform of the: (A.1) property valuation system and (A.2) the exemptions regime. This part of the framework includes a combination of technocratic policy reforms. The traditional approach suggests that leakages could

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[3]See Collier et al. (2018).

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approach suggests that leakages could arise directly on account of poor choice of valuation policy or liberal use of exemptions. However, they could also arise indirectly by reducing taxpayer compliance because the policy regime related to these instruments is considered unfair or inequitable.

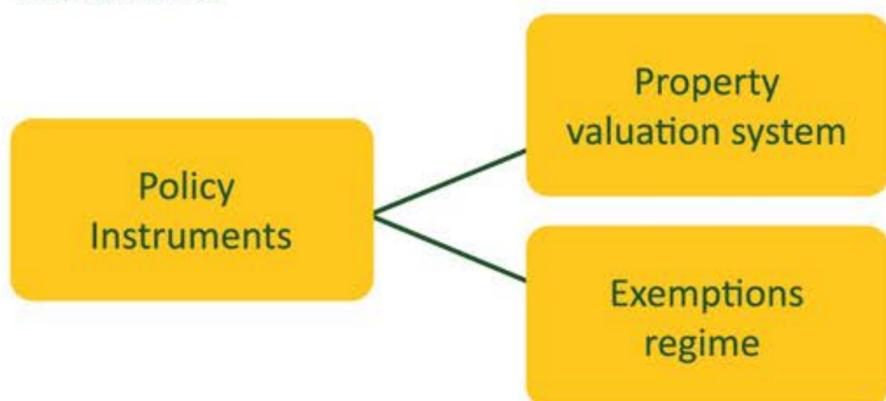Figure 5: Reform of Property Tax Policy Instruments

Figure 6 shows that administrative and modernization reforms focus on strengthening enforcement capacity, which is related to registration, tax payments and exemptions. It argues that once a given policy regime is established, gaps in revenue collection that result from evasion, collusion and corruption arise on account of enforcement failures related to: information gaps, low audit capacity, non–credible penalties, agency problems related to the incentives of tax collectors and the complexity of the tax policy and compliance regime. The theory is that weak information, audit and enforceable penalty systems would exacerbate leakages by lowering the cost of evasion during registration of taxable properties, calculation of the tax liability or its payment. Similarly, it is argued that a complex system that raises compliance costs for taxpayers would set incentives for them to vote with their feet, which will give rise to leakages. It is argued that systems, which are based on direct contact between tax collectors and taxpayers; for

or its payment, open up the possibility of collusion, corruption and evasion unless they are offset by well–designed incentives for tax collectors. These failures can also weaken compliance by creating perceptions of unfairness among compliant taxpayers.

Figure 6: Reforms to Strengthen Enforcement Capacity

It follows that the main instruments of enforcement capacity reforms include measures that strengthen information and data systems, improve audit capacity, and embed enforceable penalties that impose a sufficient cost to alter behavior. It is important to recognize that capacities need to be strengthened in relation to registration, calculation of tax liabilities and its payments. In addition, there is recognition that this improvement in tax systems needs to be complemented with measures that simplify the tax system, making the regime easier for taxpayers to use and navigate, and by improving incentives for tax collectors through human resource (HR) reforms.

While traditional approaches to tax reform have generally aimed to strengthen compliance through investments in enforcement and facilitation, they have paid limited attention to political economy factors, in particular, strengthening the

fiscal contract to foster quasi-voluntary compliance among taxpayers. Ample evidence now exists which suggests that political support is critical for reform[4], specifically the role of interventions designed to build taxpayers' trust in the tax system. The political economy literature makes a distinction between "enforced compliance", which is an outcome of the enforcement capacity of the state and "quasi-voluntary compliance", which is based on social norms and on levels of trust in the fairness, equity, reciprocity and accountability of the tax system[5]. For example, citizens might not feel compelled to pay taxes if they believe – accurately or otherwise – that tax revenues will not be used for the provision of public goods due to weak accountability on the spending side. The literature argues that overall compliance will be highest when both forms of compliance are embedded in the tax system. Therefore, this strand of the literature suggests that it is important that strategies that strengthen accountability of governments to spend in accordance with public preferences should be part of the reform matrix.

Prichard et. al. (2019, pg. 12) argue for a "governance-focused tax reform agenda" that places "greater weight on increasing the political salience of taxation (including through direct taxation), increasing horizontal equity in tax enforcement, expanding meaningful transparency around taxation and budget (including, possibly, earmarking), and directly supporting popular engagement through new institutional spaces and investments in civil society capacity." The new thinking is to combine policy reform with investments in enforcement, facilitation and trust that can strengthen the fiscal contract by enhancing both enforced and quasi-voluntary compliance (figure 7).

quasi-voluntary compliance (figure 7).

Figure 7: Governance-Focused Tax Reform Agenda
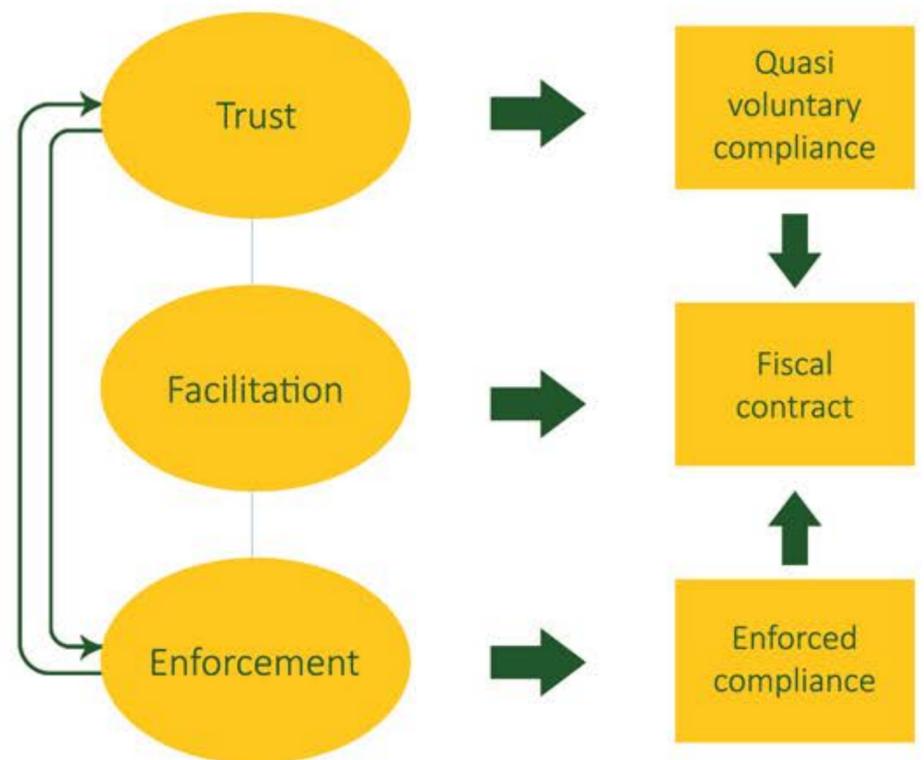
We use this framework and draw on available evidence in the sections below to identify challenges that are likely to affect the property tax system in KP as well as to suggest priority areas for property tax reform.

3. Property Tax Policy Reform
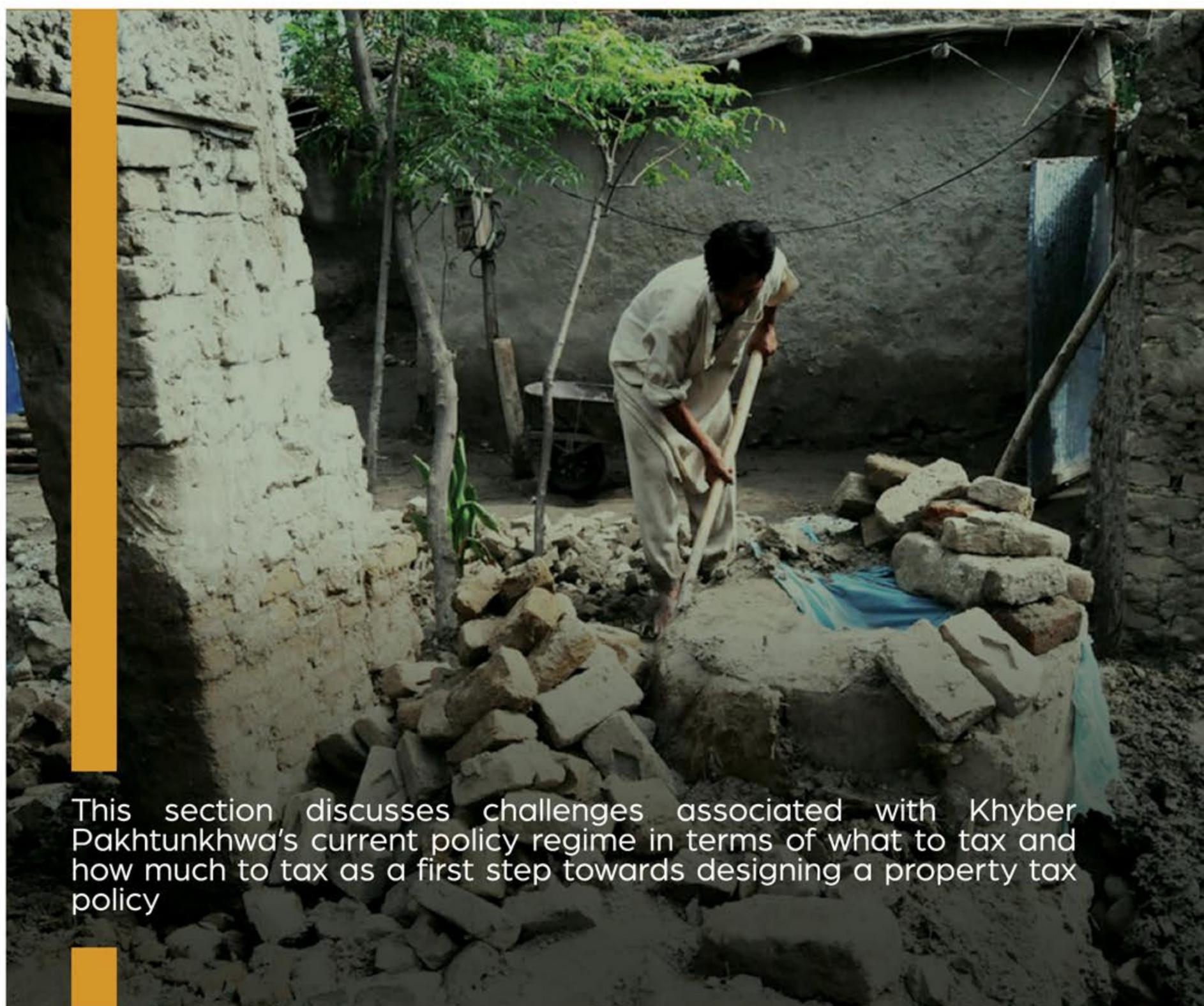
This section discusses challenges associated with Khyber Pakhtunkhwa's current policy regime in terms of what to tax and how much to tax as a first step towards designing a property tax policy

The two main instruments emphasized in the traditional approach include the reform of the valuation system and the exemptions regime. However, the first step in designing property tax policy is to decide what type of assets will be considered as part of the tax base. This section discusses each of these areas and assesses the types of challenges associated with Khyber Pakhtunkhwa's current policy regime in each of these areas.

What types of assets to tax?

Policymakers have a range of options about what types of assets to tax, which include:

1. Improvements to property (construction and buildings)
2. Land but not improvements on property
3. The composite value of land and improved property

The choice of which assets to tax needs to be assessed in relation to the objectives of property tax policy reform, in particular the need to enable the virtuous cycle given in figure 2, minimizing the economic distortions associated with the tax and ensuring fairness and equity. We assess how each of these options performs based on these objectives.

Taxing improvements to property alone: Theory suggests that taxing buildings and other investments in property improvements only captures a small portion of the value created by public investments because the value of improvements is, is mainly determined by the cost of construction and years of depreciation. Therefore, taxing immovable properties alone will be unable to enable the virtuous cycle, hence they are unlikely

government financing on capital markets, which requires the creation of a buoyant base for future projected revenues.

Furthermore, taxing improvements will discourage investments in improving properties. This tendency is exacerbated in the property tax regimes that place differential liabilities on different uses of property, e.g. commercial and residential property is taxed differently, as is rented versus self–occupied. These differentials are likely to create distortions in urban investment decisions regarding building, improvements, and land use.

Taxing land alone: Land taxation is considered more efficient than taxing improvements, in theory, for the following reasons. The argument is that taxing land alone does not discourage investment in improvements or distort decisions regarding land use. The fixed supply of land means that taxing this asset will not affect private investment in improving land and allocating it to its best use. It is also argued that taxing land will discourage windfall gains associated with land speculation and the manipulation of planning permissions and permits for private gain. It is argued that this will make land more affordable for productive uses.

Taxing the composite value of land and improvements: Taxing the composite value of both assets may be more feasible because it is difficult to obtain data that isolates the value of land and improvements from overall property value, as most transactions of property involve the transactions of land and improvements together.

Moreover, the occupiers of property consume a flow of services associated with it and ideally should bear the cost

associated with this flow. The advantage of taxing both land and improvements are that the tax regime is capturing part of the gain in land value because of public investment and is also recouping the value of the benefit associated with the flow of these services. This suggests that it is maybe most feasible to tax the composite value of land and improvements.

Reforming the property valuation system?

Methods of property valuation

One of the most difficult challenges in property tax policy reforms relates to the choice of the system of property valuation for tax purpose. A poorly designed valuation system will underassess the value of the taxable base and reduce the revenue potential associated with the reform. It may also use a base that has little buoyancy, which will reduce the projected future revenues associated with an increase in property values due to public investment, making it hard for government to raise finances from the capital market. Therefore, the design of an effective system of property valuation must be a critical component of reforms.

We focus on three main methods of valuation that are discussed in the reform literature:

1. Capital value assessment
2. Rental value assessment
3. Area- and points-based assessment

Capital value assessment: This method uses the market value of land and/or properties to assess the value of the property tax base. It can use the sales of similar pieces of land or properties as the basis of valuation. This is how land and

and UK (for residential purposes). This method ensures progressivity and fairness in taxes and is also attractive because it enables governments to recoup part of the gain associated with the virtuous circle of public investment which it can use to finance further public investment. This method is the most accurate way of capturing the true taxable value of land and properties.

However, this method requires large scale investments in upgrading the capacity of information and valuation systems and this is one of the biggest challenges associated with its adoption. It is also difficult to implement in contexts with sparse land and property transactions. This is because the effective implementation of this method requires: (i) significant data on land and property transactions, (ii) accurate sales valuations by well-trained valuation experts, (iii) maintenance of an up-to-date, accurate and accessible record of property and land transfers that record the contents and characteristics of plots that allow determination to be made across similar assets. Another challenge is that the estimations of individual properties are based on computer-aided mass appraisal (CAMA) models that require information over time, and the complexity associated with CAMA models makes the method less transparent for taxpayers. These challenges make it a difficult method to adopt for governments with weak administrative capacity. However, it is an important method to aspire to. This would mean setting up a pathway that includes building the capacity for capital value assessment in the future.

Rental value assessment: This method uses an estimated value of the typical rent required to occupy a particular property. This system of assessment is used in

Australia, the UK (for non–residential property), India and China. This method has several disadvantages compared to the capital value method. The key rationale underlying this method is that since property taxes are levied to defray the costs of benefits associated with services provided to occupiers of specific properties, it is better to apply a tax on rental rather than capital value. However, as this type of assessment is based on the value associated with the current and not the best use of the land and property, it will not enable the correction of distortions in land use. Furthermore, it can generate a fair distribution of the tax burden if the discounted stream of net rental payments approximates the market value of the property. Rental market frictions that break this approximation may make this tax regressive. In the South Asian context, rental value assessment is usually levied on improvements alone or is heavily weighted in favour of improvements, which compromises the ability of this tax to capture the public finance gains associated with the virtuous circle of public investment.

This method has similar, stringent requirements related to data and information systems as the capital value assessment method. It requires deep property rental markets and accurate data on rental transactions and on the contents and characteristics of properties. This method is more difficult to implement than the capital value method in the Pakistani context as data on rental transactions is harder to obtain because of the existing legal regime and because of the lack of any systematic government effort to record these transactions. Rental value, which forms the basis of the area–based method in the KP context, usually falls back on periodic surveys conducted by the

Excise, Taxation and Narcotics Control (ET&NC) Department to determine the rental value of properties. However, this makes the exercise less transparent and complex for taxpayers which, in turn, creates incentives for provincial governments to delay the survey exercise, reducing the buoyancy of the tax.

Area– and Points–based assessment: Area–based assessments are a much simpler method of valuation compared to capital or rental value methods. Under these methods, a fixed charge is levied per square meter or yard of land area and/or covered property area in the case of improvements. In addition to land area (or volume), location and land use are used as the basis of assessment. Often, adjustment factors based on locality in different zones of an urban area are used to bring assessed values closer to market values. Variations of this method are used in Central and Eastern Europe, Chile, Kenya, Tunisia, parts of China and increasingly in parts of India.

The method has several advantages. It is not as demanding in terms of administrative capacity as it does not require extensive data on land and property transactions. Hence, it uses limited estimation capacity, is transparent and is easy to communicate to the public.

However, assessing the value of land or property based on area or location is a coarse way to –capture their actual value. This is especially of concern if there is significant variation in property/land values within localities. This will lower the taxes collected and, more importantly, increase the risk of worsening the equity and fairness of the tax system. The literature suggests that the accuracy of this system can be improved by adopting a points–based

system that assesses taxable value on the basis of a combination of land/property area, zone–wise values and qualitative judgements based on observable characteristics of properties that have the potential to affect the relative values of properties within different localities. Potential property characteristics include access to roads, transportation, quality of municipal services, quality of construction of property and density of neighbourhood. The introduction of a points–based system would be a good intermediate step to introduce as part of a reform effort whose purpose is to move towards a capital value system.

While the administrative costs of an area or points–based system are low, they are not negligible. The tax authority would still need to collect property–level data on land and covered area, geocode property location and merge this data with existing analogue information on characteristics of the property. The points–based method would require the collection of other data related to the property and the neighbourhood. It would also require the delimitation of an optimal number of zones in an urban area to ensure lesser variation of values within each zone.

This method would also require data to be collected on the market value of properties in a given area. It ideally requires the adoption of a method of collecting land or property value that is being continuously updated. The important question to ask here is whether average rental or capital values should be used as the basis of assessment in the points–based system.

The Khyber Pakhtunkhwa Valuation System: Challenges and Priorities

Current System

This subsection describes the method of valuation used in KP's property tax system. It draws on the learnings from recent work conducted with the support of the International Growth Centre (IGC) on the distributional and revenue impacts associated with different methods of property valuation in Punjab (Abbas and Cheema, 2020). Currently, recurrent property taxes are collected under rules set in the North West Urban.

Immovable Property Tax (NWUIPT) Act of 1958. The property tax valuation system in KP uses a combination of area–based and annual rental value methods. Types of properties that are taxed include residential, commercial, and industrial, with ownership status determined by whether a property is self–occupied or rented. Certain kinds of property are exempted, with some of the major ones being self–occupied, residential properties which are less than 5 Marlas in size; government rented, or owned properties not being used to generate profit; and properties owned and occupied by widows.

A. Residential, Self–Occupied

While the NWUIPT Act (1958) requires property taxation to capture the productive value of both land and buildings via annual rental value, the method of assessment and taxation of residential, self–occupied properties does not specifically follow this requirement. Tax liability for such a property is determined by measuring the total land area of the property, with no weight attributed to construction on properties. In practice, it is not clear how the value of land is isolated from the value of construction on

a property. Further, on the surface, this seems to be closer to a pure land tax established through an area–based method rather than an ARV–based valuation method. However, an area–based method requires information on the size of the property, as well as the true market value of land underlying the property. The method for estimating the latter is missing in the NWUIPT Act, which provides broad slabs for different areas for properties of different sizes.

The following two tables from the NWUIPT Act define final tax liabilities based on the land size (see issue of isolating value from construction above) of properties in urban and suburban areas of the province. Besides taking into consideration the size of the property, tax liabilities are also adjusted based on the location of the self–occupied property: highest tax liabilities are associated with locality "A", and then decreasing in "B" and "C"; from urban to suburban; and from townships (an administrative subdivision) to areas which are not part of townships. Note that category "1" (first row) does not apply when a residential property is less than 5 Marlas in size, and self–occupied.

Table 1: Tax Liabilities by Band in Khyber–Pakhtunkhwa (urban areas)

		PART A				
Sr. No.	Category	Rate of tax for areas of Provincial headquarter as notified by the Government (per annum)			Rate of tax at Divisional headquarters (per annum)	
		A	B	C	Townships	Other than Townships
1	Upto 5 Marlas (other than self occupied)	Rs. 1000/–	Rs. 900/–	Rs. 750/–	Rs. 900/–	Rs. 750/–
2	Exceeding 5 Marlas but not exceeding 10 Marlas	Rs. 1700/–	Rs. 1600/–	Rs. 1500/–	Rs. 1600/–	Rs. 1500/–
3	Exceeding 10 Marlas but not exceeding 15 Marlas	Rs. 2200/–	Rs. 2100/–	Rs. 2000/–	Rs.2100/–	Rs. 2000/–
4	Exceeding 15 Marlas but not exceeding 20 Marlas	Rs. 3300/–	Rs. 3200/–	Rs. 3000/–	Rs.3200/–	Rs. 3000/–
5	Exceeding 20 Marlas but not exceeding 40 Marlas	Rs. 7400/–	Rs. 7200/–	Rs. 7000/–	Rs.7200/–	Rs. 7000/–
6	Exceeding 40 Marlas	Rs. 10600/–	Rs. 10300/–	Rs. 10000/–	Rs. 10300/–	Rs. 10000/–

[6]Tracking actual rents is not a trivial excercise. Owners and tenants have an incentive to understate rents to reduce property tax burden, and with weak audit capacity, there is a possibility that reported rents are lower than actual rents. In this context, "actual" rents are estimated with the use of survey conducted for UIP tax, with maximum assessments based on verbal confirmation by the owner, as well as on the subjective determination of market value made by assessing authority of the local level.

[7]Private commercial organizations (PCOs) require clarification in the NWUIPT Act and should be defined with an additional clause which is currently missing. In practice, retail outlets are not considered as PCOs, but the retail outlets of chain stores are considered as PCOs.

B. Residential, Rented

Rented residential properties generally follow the same schedule as shown in tables 1 and 2, but all tax liabilities are doubled, with the exception of rented properties which are under 5 Marlas in size, for which the tax liability schedule shown in category "1" (row 1) applies.

Table 2: Tax Liabilities by Band in Khyber–Pakhtunkhwa (suburban areas)

		PART B					
Sr. No.	Category	Rate of tax in suburban areas of Divisional Headquarters (per annum)		Rate of tax at District Headquarters (per annum)		Rate of tax at District other than District Headquarters (per annum)	
		Townships	Other than Townships	Townships	Other than Townships	Townships	Other than Townships
1	Upto 5 Marlas (other than self occupied)	Rs. 500/–	Rs. 325/–	Rs. 400/–	Rs. 300/–	Rs. 200/–	Rs. 150/–
2	Exceeding 5 Marlas but not exceeding 10 Marlas	Rs. 900/–	Rs. 750/–	Rs. 800/–	Rs. 7500/–	Rs. 600/–	Rs. 500/–
3	Exceeding 10 Marlas but not exceeding 15 Marlas	Rs. 1100/–	Rs. 1000/–	Rs. 1100/–	Rs.1000/–	Rs. 600/–	Rs. 500/–
4	Exceeding 15 Marlas but not exceeding 20 Marlas	Rs. 1700/–	Rs. 1500/–	Rs. 1700/–	Rs.1500/–	Rs. 900/–	Rs. 750/–
5	Exceeding 20 Marlas but not exceeding 40 Marlas	Rs. 3700/–	Rs. 3500/–	Rs. 2700/–	Rs.2500/–	Rs. 2000/–	Rs. 1750/–
6	Exceeding 40 Marlas	Rs. 6300/–	Rs. 6000/–	Rs. 5200/–	Rs. 5000/–	Rs. 4000/–	Rs. 3500/–

Further, rented properties falling under the following categories are not taxed based on the schedules provided in tables 1 and 2, and are instead taxed at 20 percent of the actual, annual rent[6] – the method being closer to the NWUIPT Act's spirit of an ARV–based tax:

• Government and Semi–Government (for profit), Non–Government Organizations
• Development Financial Institutions
• Private commercial organizations
• Guest houses and hostels
• Banks

There are gaps in the definition of private commercial organizations (PCOs)[7] and in the tax treatment of residential properties being used for commercial purposes, which must be clarified moving forward.

C. Commercial, Self–occupied

As per the NWUIPT Act, tax liability for commercial, self–occupied properties is to be based on estimated annual rental value

of properties. The method of operationalizing the NWUIPT Act for these properties follows an area–based method with locational adjustments, with tax liability being calculated as follows:

Tax Liability = (Land Area + Covered Area)[8] x Locality Factor

Table 3: Old Locality Factors for Commercial Properties

	Locality	
(a)	"A1" locality (located within 100 yards of either side of the main road of Peshawar	39
(b)	"A" locality	30
(c)	"B" locality	14
(d)	"C" locality	10
(e)	"D" locality	18

The KP Finance Act of 2020 has introduced greater variation in locality factors by linking them to the different floors of a given property. The new formula is therefore:

Tax Liability = (Land area x Ground Floor Factor) + (Covered Area in Basement x Basement Factor) + (Covered Area on Ground Floor x Ground Floor Factor) + (Covered Area on 1st Floor x First Floor Factor) + ...

Table 4: New Locality Factors for Commercial Properties

Locality / Category	Ground Floor	Basement	1st Floor	2nd Floor	3rd Floor	4th Floor	5th Floor	All other Floors beyond 5th Floor
A1	20	18	18	16	14	12	10	8
A	15	13	13	11	9	7	5	5
B	10	8	8	7	6	5	5	5
C	7	5	5	5	5	5	5	5
D	5	5	5	5	5	5	5	5

Note that land area is measured in square yards (1 Marla = 30 square yards), and covered area is measured in square feet (1

Marla = 272 square feet). Since the formula for the tax liability for this type of property adds land area and covered area without converting the two to a comparable unit of measurement, there is a much larger weight assigned to covered area as compared to land area in terms of determining the liability. This is to the order of weights given to land area versus covered area being in the ratio of 1:9. Consider the following example for a single–storied (ground floor only) property spread over 5 Marlas in category:

Land area = 30 x 5 = 150 square yards
Covered area = 272 x 5 = 1,360 square feet
Tax liability = (Land area x Ground floor factor) + (Covered area x Ground floor factor)
= 150 x 20+ 1360 x 20= 3000 + 27200 = PKR 30,200

Therefore, land area contributes approximately 10 percent of tax liability estimated for this property, while covered area contributes 90 percent. Such distortions in the tax system can create behavioral responses amongst taxpayers, affecting land–use decisions by disincentivizing property improvements, thereby generating inefficiencies in the economy.

Separately, it is not clear if these locality factors bring assessed value of such property to be closer to the market value. The underlying assumptions for the locality factors need to be clarified, with empirical testing done to ensure that final liabilities are close to liabilities that would result from a market–based valuation system.

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[8]Land area is measured in square yards. Covered area is measured in square feet.

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D. Commercial, Rented

Following the introduction of the KP Finance Act of 2020, commercial properties rented out to be used as shops which are not part of chain stores are taxed based on the locality factors provided above in table 4. Other rented, commercial properties will be taxed at the rate of 15 percent of actual annual rent. Previously under the NWUIPT Act, such properties were taxed at the rate of 18 percent of actual annual rent. Entities renting commercial properties and taxed with the use of this ARV–based approach include:

- Government and Semi–Government (for profit), Non–Government Organizations
- Development Financial Institutions
- Private commercial organizations (chain stores, wedding halls etc.)
- Guest houses and hostels
- Petrol/CNG stations
- Banks

E. Industrial

The tax treatment of industrial properties accounts for the specific use of different parts of the industrial property located in a given rating area. For example, factory area[9] is subject to a pure building/improvement tax, with covered area taxed at Rupees 2.50 per square feet. Parts of the industrial property which are put to residential use such as colonies, hostels, mess areas, and compound follow the schedule for residential properties. On the other hand, any commercial–use parts of an industrial property such as workshops, shops, godowns, banks, petrol pumps, factory offices and mobile towers are subject to the commercial property tax schedule.

In summary, provincial UIP tax in KP is calculated using different variations of area–based methods, with the excepted of certain properties rented by Government and Semi–Government (for profit), Non–Government Organizations, Development Financial Institutions, Private commercial organizations (chain stores, wedding halls etc), Guest houses and hostels, Petrol/CNG stations, and Banks. For these exceptions, properties are taxed based on actual annual rent.

Tax liabilities for residential properties (tables 1 and 2) and locality factors for commercial properties (tables 3 and 4) are on average, updated every three years, with these tables having been updated more frequently over the past few years. Information used for the underlying computation of these tables is collected through the "General & Special Surveys" conducted by ET&NC department staff members. The General Survey is conducted every three years by the field staff and the Special Survey is implemented whenever the assessing authority (Excise and Taxation Officer) receives an application for reassessment from a property owner.

Challenges

The current system of valuation used in KP raises the following concerns:

1. It uses an area–based system that appears to use or very broad zoning categories to assess tax liabilities. This puts it at risk of creating significant deviations between actual and assessed market values of properties. It also very likely results in making the tax liability regressive, which will be considered unfair by taxpayers. The introduction of a more sophisticated and better c a l i b r a t e d points–based system is an intermediate reform with the potential to make the tax less regressive and improve collections.

2. It uses an annual rental value estimate

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[9]Factory area is defined as a building or group of buildings where finished, semi-finished or raw goods are manufactured, processed, stock filed or assembled.

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to assess the tax liability that is gathered on the basis of verbal confirmation from the lessee and the surveyors' subjective judgment on the basis of market surveillance typically conducted after intervals of three years, which raises potential challenges discussed below. Punjab uses a periodic market surveillance survey exercise to determine area based ARVs, and based on the analysis of its data, Abbas and Cheema (2020) provide evidence that this method of ARV assessments in Punjab is creating a regressive tax burden. They use unit–level data on property characteristics and property tax assessment and locality–based data on district collector survey exercise to determine area based ARVs, and based on the analysis of its data, Abbas and Cheema (2020) provide evidence that this method of ARV assessments in Punjab is creating a regressive tax burden. They use unit–level data on property characteristics and property tax assessment and locality–based data on district collector (DC) rate–based land valuations for the cities of Lahore and Sargodha and find that there is weak correlation between a property's tax liability and its DC rate–based land value under the current ARV system. They find that the correlation is much weaker in the case of residential properties. They also find that a reform to the DC rate–based land valuation method, using a revenue–neutral tax rate, would make the tax burden progressive. Specially, they find that if Lahore's property is divided into five land value bands, properties in the bottom four (out of five) quintiles would see a relative fall in their tax liabilities under the DC–rate based system compared to the existing system. In the case of Sargodha, the distributional gain benefits the properties in the bottom two quintiles. In Lahore, the liability of properties in the bottom quintile decreases by 60 percent on average, and in Sargodha, it decreases by 26 percent on average for properties in the analysis sample.

3. Analysis by Abbas and Cheema (2020) also suggests that estimating ARVs on the basis of infrequent, periodic surveys is likely to reduce the buoyancy of tax collections. This appears to be the case in Punjab, which makes it harder to realize the fiscal benefits from the virtuous cycle of public investment.

We find that the final challenge of an ARV based valuation is the underassessment the tax liabilities. In the case of Punjab, they find suggestive evidence that the current ARV system may be underassessing tax liabilities, either because a low tax rate has been set under this system or because it is underassessing property values. They find that a revenue–neutral tax rate under the DC–rate system would be around 0.2 percent of land value in Lahore, which is much lower than the tax rates of 0.3–0.6 percent applied under early land value systems in cities such as Bangalore which are collecting a much higher property tax than Lahore. In relation to global examples, the effective tax rate on the market value of properties in the United States is 1.1 percent.

This suggests that it is important for the reform strategy in KP to assess the potential of moving to a DC rate–based land or property valuation system as part of the points–based assessment system. Of course, this reform shows great potential for Punjab because significant investment in an automated e–stamping system has enabled the DC value system to capture a higher proportion of the market value of land. This has enabled the possibility to make the existing area–based system much

more progressive.

Switching Over

However, it is important to note certain challenges related to switching from the currently used ARV–/area–based system in KP to a DC rate–based system, that policymakers need to be aware of, and that the reform strategy will need to tackle:

1. **Windfall loss for land and property owners:** In general, there is a legitimate concern that introducing land taxes takes value away from people who bought property thinking that land will not be taxed. Due to potential tax capitalization, one would expect the value of these newly taxed properties to decrease once land tax is instituted. An innovative solution to such is found in the use of tax credits. Current Property owners who bought the property before the introduction of the land tax may use the tax as credit against other tax obligations for a few years. One can also make this tax credit "portable" so even if the owner sells the property, the land tax paid on that property (by the new owner) can still be used by the original owner as tax credit up to a stated number of years.

2. **District Collector (DC) and the alternative Federal Bureau of Revenue (FBR) valuation tables may not be aligned with market valuations:** Anecdotal evidence suggests that DC/FBR valuations broadly understate market values. This is because buyers have a strong incentive to understate property value to reduce provincial stamp duty and capital value taxes (CVT), and sellers understate property value to reduce federal capital gains taxes (CGT). A potential solution would be to introduce an e–stamping regime and complement this by decreasing CVT and stamp duties to incentivize buyers and sellers to reduce

the divergence between true market value and registered value of properties, leading to better estimates of valuation and higher local property tax generation. Revenue losses due to the reduction in CVT and stamp duty can be compensated with measurable increases in the tax base due to taxpayers registering property prices at a higher rate. Any remaining shortfalls in revenue can be met with a commensurate increase in the recurrent property tax rate.

3. **Buoyancy of DC/FBR tables and property taxes:** If DC/FBR rates fail to account for secular growth in market values over time, then assessed values can become obsolete. Therefore, it is important that DC/FBR rates are automated and designed to capture data on land and property transactions, whichis integrated into the property tax database. While FBR rates fall within the jurisdiction of the federal government, the provincial government on its part can ensure that DC rates track the secular growth of real estate value. rates fall within the jurisdiction of the federal government, the provincial government on its part can ensure that DC rates track the secular growth of real estate value.

How to Reform the exemptions regime?

Policy exemptions not only distort locational choices of taxpayers and their economic behavior, but they also impose a disproportionate burden on some taxpayers. If property taxes are seen as a "benefit tax" (Ahmad et al., 2019), where the property tax is a user fee paid by residents for the use of municipal services, then exemptions on properties such as small houses, government offices, schools and religious institutions shift the burden of user fees that they should be paying to other,

non-exempt taxpayers. Further, if exemptions are being set by higher authorities as is the case in KP where exemptions are established by the provincial authority, then non-exempt taxpayers in localities with a higher number of exempted properties bear an even higher burden of taxes used to fund municipal services.

Current homestead exemptions such as those for residential properties smaller than 150 square yards (5 marla) which do not account for "ability-to-pay" based on income, are too broad-based, and result in possibly unjustified tax expenditure. If incomes and property size are not strongly correlated, this can blunt the intent to make these taxes more progressive. Further, such broad-based tax expenditures are a serious drain on resources.

A potential solution is a targeted tax relief program rather than broad-based exemptions that uses well designed tax credits, tax circuit breakers or tax deferral schemes as instruments. There are many models for tax relief with inherent trade-offs between complexity, feasibility, administrative costs and uptake. However, such targeted programs can make the tax system more progressive by tying property tax liabilities to "ability-to-pay" of taxpayers (Haque, 2020). As an example, one such solution is provided in the form of property tax circuit breakers, a common tool used in the United States. The actual instrument depends on its specific design, but the core idea is to cap a taxpayer's property tax once such a tax, as a percentage of income, crosses a given threshold. If say, the threshold is set at ten percent, then taxpayers paying ten percent or more of their annual income in property taxes will be refunded the tax

paid over and above this threshold.

Operationally, one way to do this is to introduce tax cuts for these individuals in tax bills, but since income can be volatile, this can lead to volatility in estimated receipt of property taxes, potentially hampering planning and delivery of local public services. Another avenue is to give tax credits which can be claimed when income tax returns are filed. Property owners pay the full property tax to the province upfront – aiding in reducing volatility in property tax receipt – but can claim credits against income tax in returns filed to the federal government. The federal government can refund these credits, and an adjustment can be made in resources being transferred to the provincial government (or the provincial government can offset this with an increase in underutilized funds returned to the federal government). This can lead to an increase in tax returns being filed, stability in local government revenue, and cost-saving in terms of eliminating broad-based homestead exemptions which can be regressive if property size and income are not strongly correlated.

Linking property tax payments with the ability-to-pay requires technical capability for taxpayer information to be integrated and cross-validated across the federal income tax and provincial UIP tax databases. For this purpose, it is necessary that the digitization exercise captures Computerized National Identification Numbers (CNIC) of all property owners/property taxpayers so that taxpayers can be identified across income and property tax databases. Making property tax exemptions contingent on income thresholds that are declared as part of the income tax declarations can be a powerful tool for

making exemptions progressive and increasing income tax compliance as a valuable byproduct.

Circuit breakers are better targeted and less costly than "across-the-board" tax relief mechanisms such as homestead exemptions and tax caps. However, unlike the last two which reduce the property tax bill, circuit breaker credits must be claimed by taxpayers, so there is an educational component to them, otherwise it is possible that taxpayers fail to claim them out of ignorance of the credit available to them. This requires strong outreach so that taxpayers understand and utilize the tax credit. Underutilization of the tax credit can lead to the targeted program being regressive, if there is correlation between income and utilization.

The other more straightforward option is for taxpayers to fill out property tax circuit breaker forms and provide supporting income documents to the local government. However, this can lead to increased cost of administering the program at the local level, so a cost-benefit analysis will have to be done on whether the cost of administering the program is higher than the reduction in tax expenditure via homestead exemptions.

One challenge pertaining to recurrent property taxes is that these taxes are a tax on the stock of assets, rather than income flows. As such, these taxes may be difficult to pay for certain groups that own high-value assets but do not earn commensurately high incomes, such as retired seniors, disabled individuals, or low-income earners (Collier et al., 2018). In order to address this issue, policymakers can employ tax deferral schemes, which limit the amount of tax current property owners pay, with the outstanding amount

taken as a transfer tax on the asset when it is sold or inherited.

A last point to note here is the widespread use of exemptions in KP. These range from – with certain caveats – exemptions on residential properties spanning less than 5 Marlas, to exemptions for properties being used by the federal government, in use for religious purposes, and those serving as public parks and playgrounds. As discussed above, such exemptions can act as a major tax expenditure item, requiring further review and revision based on the goals of the provincial government related to urban development and sustainability.

Further, the current policy regime in KPK imposes differential liabilities on self-occupied and rented properties, on residential and commercial properties, and on land and constructed area. These differentials are likely to distort investment decisions regarding property improvement and land use. It is important that the reform framework analyses the economic costs associated with these differentials and considers rationalizing these differential.

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VALUATION

⚙ CHALLENGE

- Current system of property value estimates using rental value of rented and self-occupied property and taxes only property structures and not land
- Taxing property alone distorts investment in buildings and investment

⚙ WHAT NEEDS TO BE DONE?

Improve market valuation and area-based valuation to maximize revenue

?? HOW?

- For FY 21, KPK has approved the survey, geocoding and digitization of urban properties in 4 cities
- Employ a pilot of the Punjab model of E-stamping to reduce under-declaration of land values
- Centralize data from satellite imagery, market valuations, and Deputy Commissioner (DC) and Federal Board of Revenue (FBR) rates to analyze potential of property tax collection and distribution
- Compare DC/FBR rates with current valuation system via mapping shape files of DC and FBR areas

4. Reforms to Strengthen Enforcement Capacity
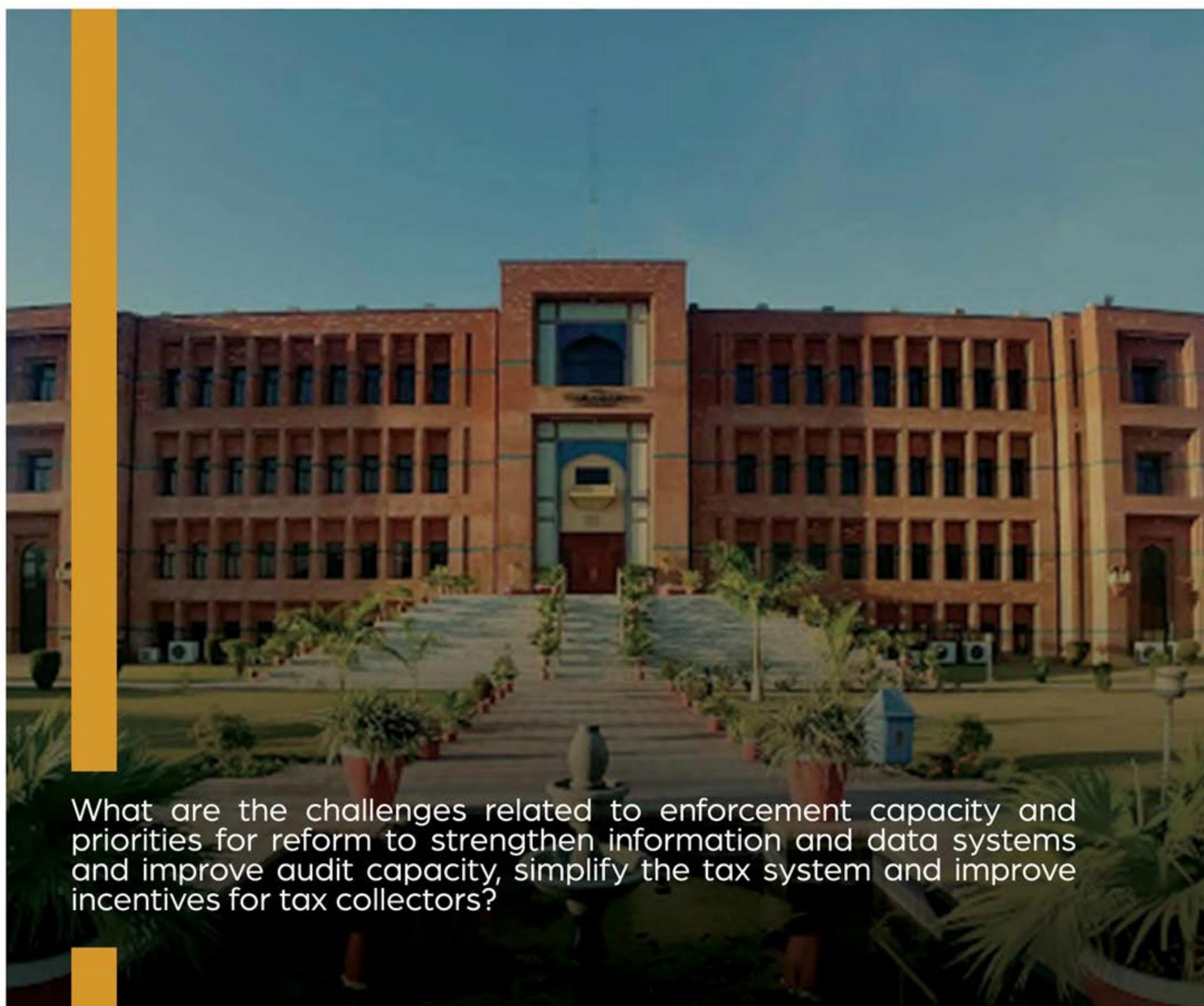
What are the challenges related to enforcement capacity and priorities for reform to strengthen information and data systems and improve audit capacity, simplify the tax system and improve incentives for tax collectors?

As discussed in section 2, the main instruments for strengthening enforcement capacity include measures that: (1) strengthen information and data systems and improve audit capacity, (2) simplify the tax system and make it easier for taxpayers to navigate the tax system, and (3) improve incentives for tax collectors and minimize contact between them and taxpayers. This section discusses the challenges related to enforcement capacity and priorities for reform in these areas.

Digitization and modernizing information systems

At a minimum, an effective tax information system needs to integrate the following automated databases:

1. A database of properties that captures data on the existence, area, other characteristics and location of all units of property, as well as data on access to public services and other amenities that may affect the capital or rental value of property.
2. Property transaction database matched to tax localities or zones that captures land sales and the values of these sales.
3. Property tax register that captures data on registration, assessment and billing, payments, violations and penalties and arrears.

The challenge for KP is the analog and decentralized nature of its property tax information system. Currently, property tax information is housed in local E&T offices across the province. The property register captures information on the size (land and covered area), location, occupancy status and residential/commercial status of residential/commercial status of individual properties, together with information on the owner of the property, estimated tax liability, payments, and arrears kept in various property tax registers. The analog and decentralized nature of this data places binding constraints on policymakers attempting to conduct policymaking and planning in this area. Further, it precludes the possibility of automating tax bill generation.

Digitization of these databases must be an important pillar of the reform strategy. Currently, the Government of Khyber Pakhtunkhwa is planning to use its development budget to fund the survey of individual properties currently covered by the West Pakistan Urban Immovable Property Tax Act (1958), to geocode them, and to digitize data preserved in local offices in the following cities: beginning with Peshawar and expanding to Mardan, Abbottabad, and Nowshera in a phased manner. This activity is planned for FY 2020–2021 and if designed well, it will go a long way in strengthening the enforcement capacity of the property tax system.

The digitization strategy should involve the automation and integration of the information registers across the Government of Khyber Pakhtunkhwa. It should focus on geocoding property–level data and developing capacity for use of satellite imagery and geographic information system (GIS) technology. It also means investing in e–stamping of property sale deeds and using automation to capture transaction–level information.

The digitization of data will also allow for digitalization of processes, such as paving the way for automation of recurrent property tax billing and audits. By geocoding of properties and the use of

satellite imagery, vacant plots and new urban developments can be brought into the tax net.

However, it is important that the digitization process which requires substantial investments is done right, and that:

- Data is collected on all parameters that are necessary for registration, valuation, automation of tax billing and integration of tax data.
- Data is collected on parameters that can be used in the future to simulate the impact of alternative property valuation systems, changes in the exemptions regime, and changes in the tax rates, among others.
- Both property–level and satellite data are collected accurately with the aid of continuous, real–time quality control of the survey to prevent sunk costs in terms of having to correct errors and/or revisit survey units later.

Digitizing data on not only valuation, billing, and collection but also registration, and consolidating this data in one system can improve administrative and auditing capabilities. The digitization exercise conducted in neighbouring Punjab province from 2014–2016 allowed for all property tax billing to be automated and standardized across tax offices, with the divisional and provincial headquarters acquiring the ability to analyse trends in the growth of the tax base and revenue with the use of a specially designed analytical dashboard. There are further examples[10] from other developing country contexts, where digitization has led to marked improvements in the property tax system. For example:

- GIS mapping has been integrated with the Local Government Revenue Collection Information System in has allowed local tax authorities to understand and assess potential tax revenue.
- In Lagos, Nigervia, an inventory of every property in Lagos State was undertaken which expanded the tax registry fourteen–fold between 2007 and 2010. This data was stored on an electronic database that includes pictures of properties and has been integrated with systems for valuation and tax collection to include data on value assessments and history of payment. This digitization of property tax records has enabled automated billing which has increase annual revenues from land and property tax from 1.72 billion naira in 2008 to 7.13 billion naira in 2013.
- In the Philippines, tax collection systems were integration and physical and fiscal cadastres digitized in 2006, improving local revenue generation.

A key benefit of digitization is the ability that it provides to tax authorities to conduct tax planning for the future. It also enables government to systematically and critically assess the potential, benefits and disadvantages of various facets of the existing tax system, including the valuation method used to establish the tax base; rules surrounding tax rate–setting; enforcement and collection capabilities; and tax expenditures such as exemptions provided to different economic agents.

Facilitation of Taxpayers and Simplification of Tax Processes

The digitization of property tax data and its integration can create a range of pathways for the digitalization, standardization, and automation of property tax processes. Digitized property tax data can be used to

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[10]Borrowed from Collier et al. "Land and property taxes for municipal finance", International Growth Centre, July 2018.

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simplify the process of generating standardized bills for taxpayers, and to facilitate them in paying taxes. Specifically, it can aid in clarifying the calculation of tax bills for taxpayers, reduce non-essential workload of property tax staff, increase ease in paying taxes for taxpayers, and allow for property taxes to be incorporated into a one-window payment option for taxpayers.

Digitization of property characteristics can be exploited to compute individual property tax liabilities for all urban properties in a matter of minutes. In case property tax valuation formulae or tax rates are changed, an automated system precludes the need for property tax staff to calculate new tax liabilities for each property manually. Even under a property tax regime where valuation parameters and tax rates do not change as often, automation allows for generation of property tax bills on pre-designed, standardized formats without the need for preparing these manually each year, leading to substantial time-cost savings.

A standardized format for tax bills can be designed in a strategic way to ensure that the key statistics such as tax liability and due date are presented saliently, together with details on how the tax liability was calculated, with different fields in such a section automatically pulling data on properties from the central database. Such standardization of the tax bill and inclusion of relevant details increases transparency of the tax calculation process and facilitates ease of interpretation of the tax bill for taxpayers. Automation also increases the distance between the tax collector and taxpayer, minimizing the need for such contact which can lead to increased bargaining power of tax collectors and collusive behaviour. This

simplification of the property tax process has potential for significant long-term dividends.

Digitization and automation of property tax data can also be leveraged to facilitate and simplify the process of tax payments. In fact, digitization of multiple tax regimes such as property taxation, motor vehicle registration, and e-stamping among others, allows for the creation of one window for paying taxes, registration charges and user fees, substantially reducing transaction costs and the complexity of paying these liabilities through different channels. An example of this approach is the ePay Punjab app developed by the Punjab Information Technology Board (PITB), which enables Public to Government (P2G) and Business to Government (B2G) payments. The ePay Punjab app generates a 17-digit code for a desired transaction related to property taxes or other fees. This code can be used via mobile banking, internet banking, or over the counter (OTC) banking to make payments to the government. There is large potential in KP to experiment with these technologies in the medium-term. However, the necessary condition for such innovations is robust digitization of data, robust quality control, and integration of this into cross-departmental databases.

Human Resource (HR) reforms

Tax collection staff is a critical component of the overall property tax infrastructure. Tax collectors serve as the primary interface between tax authority and citizens. Besides enforcing tax rules, tax collection staff currently also maintains tax data at the local level. The right set of incentives maximizes tax collector effort and breaks down political economy constraints such as collusion between taxpayers and tax collectors. A smartly

designed human resources program which incentivizes tax collectors to perform their duties to the best of their abilities generates substantial marginal increases in tax revenue. These incentives can take the shape of monetary, as well as non-monetary benefits for tax collectors who improve on past performance. Evidence from neighbouring Punjab province reveals that there are significant gains to be made by tying tax collector performance to rewards schemes.

Two separate large-scale experiments conducted between 2010 and 2014 in Punjab province tested the potential of monetary and non-monetary schemes to increase revenue generation via enhanced tax collection and improved property assessments. In the first of these experiments, Khan et al. (2015) provide monetary incentives to high-performing tax inspectors working in approximately one-third of property tax areas in the Punjab province. Year-on-year revenue growth in these areas – as compared to control units where such incentives were not introduced – increased by 46 percent, on average. In fact, in areas where the design of incentives was simple, year-on-year growth in treatment areas increased by 64 percent relative to control units, without detrimental effects on taxpayer satisfaction and property assessment accuracy.

A second related experiment (Khan et al., 2019) focused on providing non-monetary incentives to tax collectors, by allowing high-performing tax inspectors to effectively choose – conditional on their performance relative to other inspectors – tax areas where they wished to be posted. This performance-based posting design elicited year-on-year growth in tax revenue of between 30–41 percent. Benefits for

these experiments were larger in initial years, but lower in later years indicating that periodic incentives schemes can provide the biggest bang for the buck if implemented periodically.

However, it is critical that the design of such a scheme be evidence-based, evaluated continuously when implemented, and that the scheme is credible, i.e. promised rewards are in fact provided if tax collection staff reaches established goals set under the scheme. Such a scheme has been discussed amongst E&T department officials in KP, and engagement with government officials indicates that there is demand for it amongst tax collection staff. However, a comprehensive, performance-based incentives scheme has not been formally initiated up till now. The provincial government stands to gain from including such monetary and non-monetary incentives in the design of its human resource system, with periodic triggers for potentially increasing revenue and improving tax collector morale.

CHALLENGE

- Decentralized and analog nature of property tax data in local offices
- Current information on land sizes, location, occupancy status, use, owner(s), estimated tax liability, payments and arrears are kept in PT-1 and PT-8 registers
- This makes it difficult to retrieve important information for policy making and analysis

WHAT NEEDS TO BE DONE?

Prioritize the following (as done by KP government for FY21)

Digitization of property tax data

Integration and automation across key KPK departments

? HOW?

- Survey and geocode properties currently covered by the UIPT and digitize data preserved in local offices
- Automate recurrent property tax billing and audits
- Design surveys that capture essential features for automating future billing and simulating revenue, under different tax bases/rates
- Introduce continuous, real-time quality control of survey to prevent sunk costs, correct errors and revisit survey units

5. Reforms to Improve Tax Morale and Quasi–Voluntary Compliance

Measures that help improve voluntary compliance and build political support for reform are important component of the politic economy of tax reforms. What reforms will improve citizens' tax morale, create non–pecuniary motivations for tax compliance and strengthen citizen trust in the state?

The political economy literature on tax reforms underscores the importance of introducing measures that help improve voluntary compliance and build political support for reform. It strongly advocates for the need to introduce reform measures that are designed to build citizens' tax morale, create non-pecuniary motivations for tax compliance (Luttmer and Singhal, 2014), and strengthen citizen trust in the fiscal contract with the state. Prichard et. al. (2019) argue that building tax morale is particularly important for reforms in societies with a weak fiscal contract because policymakers are unlikely to implement reforms that are expected to be met with political resistance. There is also evidence that administrators are unwilling to implement enforcement measures if they perceive that citizen trust in the government is low (Prichard, 2016). Khwaja et. al. (2020) provide evidence from Pakistan which shows that citizens have low levels of trust in the government. Therefore, building tax morale and enhancing quasi-voluntary compliance are likely to be critical complements to building enforcement capacity through reforms in KP.

Prichard et. al. (2019) provide a framework that identifies factors underpinning low tax morale and the failure of quasi-voluntary compliance. Their framework also suggests reform measures that correspond to each factor. Broadly they argue that tax morale is likely to be low when citizens perceive "tax system outcomes" to be poor. The main tax system outcome is that citizens perceive the tax system to be fair and equitable. However, they also highlight citizens perception of poor "tax governance outcomes" as another factor underpinning low tax morale. Tax governance outcomes relate to citizens

hold governments accountable (accountability) for the lack of delivery. The literature proposes a range of measures, summarized below that relate to these four outcomes:

1. **Fairness:** The literature identifies three important causes for citizens' perceptions about the lack of fairness in the tax system. These include perceptions of complexity, arbitrary and/or abusive enforcement and arbitrary and/or highly punitive enforcement (Fjeldstad, O-H, 2015; Hassan and Prichard, 2016; Jibao et al., 2017; Campos et al., 1999; Brautigam et al., 2001; Olken and Singhal, 2011). Taxpayer education is often recommended as the preferred policy instrument to make the system accessible. However, to have a meaningful effect it must be complemented by well-designed tax simplification measures. The facilitation measures proposed in the last section have the potential to mitigate the problems arising out of perceptions of complexity. Similarly, rationalizing penalties and introducing accessible appeals mechanisms are measures which have the potential to improve perceptions of fairness.

2. **Equity:** The literature suggests that perceptions of inequity are related to unequal enforcement, laws that impose differential burdens on properties of similar value or result in a regressive tax burden (Prichard et. al. 2019). The literature on property taxes in Pakistan suggests that subjectivity in assessments and the failure to regularly update valuations are important causes for horizontally inequitable assessments (Piracha and Moore, 2015; Khan et al., 2016). Abbas and Cheema (2020) show that the existing valuation system is likely resulting in a regressive distribution of the property tax burden in Punjab's cities. Khwaja et. al.

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(2020) show that less than a third of their survey respondents in Lahore believe that 80–100 percent of their neighbours pay the required taxes. More worryingly, only 10 percent believe this of their countrymen This suggests that perceptions of equity are likely to be low in the Pakistani context. One set of interventions to address this challenge is to use regular information disclosures to make the distribution of burden across taxpayers transparent. The other potential intervention is to introduce a simplified valuation system and make its basis, and the resulting distribution of the tax burden, equitable and fully transparent to the taxpayers

3. **Reciprocity and accountability:** These outcomes lie at the heart of the fiscal contract, because we would expect taxpayers' willingness to pay for taxes to be directly related to the effective provision of services that they receive. There is growing evidence that higher levels of tax morale are related to the translation of tax payments into public services or the reciprocal benefits a taxpayer receives from taxation (Ortega et al., 2016; Ali et al., 2013; OECD ,2013; Navarro and Domeque, 2015). Khwaja et. al. (2020) show that Pakistani citizens do not believe that they get reciprocal benefits from taxation. A majority of citizens (55 percent) in their Lahore survey believe that only 0–20 percent of taxes are actually used to fund services. And only 5 percent believe that the proportion of taxes used to fund services is 70 percent or higher. Furthermore, Khwaja et.al. (2020) find that more than half of their respondents (52 percent) strongly agree with the statement that people should only pay taxes if government gives better services. This evidence suggests that a vast majority of citizens in Pakistan believe that the reciprocity of the tax system is extremely low, and a majority are willing to reward reciprocity. They also find that a very small minority (19 percent) of citizens believe that government is responsive to citizens. This evidence suggests that it is imperative to introduce measures that can strengthen tax reciprocity and accountability by improving tax governance outcomes.

The literature suggests that addressing the challenge of reciprocity will require introducing measures that highlight the connection between tax payment and the delivery of quality services related to the needs of taxpayers. Various measures have been suggested in the literature to improve perceptions of reciprocity (Prichard et al. 2019). These include the provision of information to citizens, which details the revenue raised and the projects that have resulted from this revenue and helps citizens monitor the utilization of their tax payments. The evidence on information as an effective instrument is mixed. While, results from Rwanda (Mascagni et al., 2017) find that information designed to enable taxpayers to monitor the tax–expenditure links was as effective in increasing compliance as enforcement measures, studies from the Americas find that simply providing information does not improve compliance (Blumenthal, Christian, and Slemrod, 2001; Castro and Scartascini, 2015). Another set of measures relates to earmarking revenues for specific public services demanded by taxpayers through government declarations or formal legal commitments (Khwaja et al., 2020; Prichard et al., 2019). However, the evidence suggests that earmarking is more effective when complemented by a well–designed oversight mechanism, which ensures that commitments are executed (Prichard 2015). In addition, strengthening the urban property rights regime is an essential complementary reform without which it will

be difficult for citizens to realize the capitalization of the benefits of public investment in form of higher property values. This reform should be complemented by transparent information disclosures about changes in property values.

An important question for Government of Khyber Pakhtunkhwa is whether measures to strengthen reciprocity should be restricted to upper tier local governments – tehsil and city governments – or whether these measures should also be extended to the level of the smaller neighbourhood councils where it may be easier and less costly to demonstrate the tax–expenditure link because of the close proximity between taxpayers and services.

We recommend the establishment of an automated budget and financial management system for town/city governments and neighbourhood councils of these cities that has the capability to obtain service delivery preferences and needs from citizens and integrate this information into the planning and budgeting process. The system must also have the capability to generate information on how taxes are spent and more specifically, what services these taxes are spent on. This information must be shared with citizens to increase their knowledge of how the taxes that they pay are being utilized for their benefit, potentially resulting in increased tax morale.

However, interventions that strengthen reciprocity may not be effective unless they are complemented by institutional mechanisms, designed to strengthen accountability, that give citizens voice and ensure that public providers do not deviate from their commitment to citizens. The literature suggests that audits designed to

curb corruption in spending and participatory budgeting and governance institutions can be effective mechanisms for strengthening accountability (Sjoberg et al., 2019; Timmon and Garfias, 2015; Touchton et al., 2019; and Torgler, 2005).

Local government accountability in Pakistan has historically been weak because of poor audit capacity at the levels of these governments. Research shows that disclosure of audit reports conducted by third parties can have a significant impact on curbing corruption in local governments (Bobonis, Fuertes, and Schwabe, 2016; Larreguy; Marshall, and Snyder, 2014; Ferraz and Finan; 2008). Evidence shows that building effective capacity to commission and use third–party independent audits as a tool of oversight and accountability can have a significant positive impact on the performance of local governments. There is a critical need for building this capacity at the provincial level.

The literature also suggests that introducing deliberative and participatory budgeting and budget monitoring forums at the neighbourhood level may be an effective way to strengthen accountability. The existence of these forums provides an institutional opportunity to lay the foundation of bottom–up planning and ensures that minorities, women, non–elites and the disabled are given a voice in the governance system. The Indian local government system consists of similar deliberative bodies called gram sabhas. Besley et al. (2004) find that the existence of gram sabhas increases the ability of disadvantaged households to benefit from local government poverty alleviation schemes in India. Evidence suggests that these forums have a higher likelihood of success if they are: (i) tied to institutions that enable community mobilization; (ii)

based on sources of information that citizens find credible; and (iii) backed by oversight institutions that are willing and able to act on information about malfeasance and non–performance of governments and politicians (Khemani et al. 2016 and World Bank 2016).

Next is a summary of the discussion about challenges that lower tax morale and weaken quasi–voluntary compliance. It also lists a menu of proposed reform measures that correspond to each challenge.

Challenges affecting tax morale and measures to address them

Challenges related to:	Nature of challenge	Measures to address challenges
Tax system outcomes	Perceptions of lack fairness	– Taxpayer education – Simplified tax processes and policies – Taxpayer facilitation measures – Rationalize of penalties – Accessible appeal mechanisms
	Perceptions of Inequity	– Transparent information disclosures about distribution of tax burden. – Introduction of simplified but equitable valuation method
Tax governance outcomes	Weak reciprocity	– Provision of information to enable taxpayers to monitor tax–expenditure links at the level of uper tier governments and neighbourehood councils – Earmarking tax revenues at the level of upper tier governments and neighbourhood councils – Strengthening the urban property rights to realize the capitalization of the benefits of public investment. complemented by transparent information disclosures about changes in property values.
	Weak accountability	– Provincial capacity to comission third–party audits of all tiers of local government – Participatory and delibrative institutions for citizen budgeting and budget monitoring at the neighbourhod level

ACCOUNTABILITY

CHALLENGE

Low own-source property tax revenue in KPK has led to:

- Large deficits in critical municipal good provision
- Weak tax morale due to the weak link between provision of tax services and receipts
- Little accountability of local governments

WHAT NEEDS TO BE DONE?

Implementation of a plan by the KPK government to pay 85% of collected tax receipts to local municipal authorities

? HOW?

- Use Institutional and information interventions to strengthen taxation and spending linkages
- Conduct surveys to properly capture location and characteristics of the property
- Gauge impact of reforms on tax morale, government accountability and tax collections
- Publicize property taxes as 'benefit taxes' to citizens
- Devolve tax rates to local governments to make revenue targets more aligned to expected expenditure

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