

The Economic Analysis of Law in Pakistan¹

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One of the most important functions of law is to assign rights and liabilities in such a way that disputes do not arise. The failure to prevent disputes in a society indicates that the structure of the law is inefficient. Since the focus of law and economics is on efficiency (see Box 1) and how people respond to incentives, one way to carry out the economic analysis of the law is to use the framework of market capitalism. Driven by the idea of the invisible hand, the fundamental point of capitalism is that individuals should be able to use their capital freely, without the state's interference. It implies that individuals' legal ability to move capital should be frictionless.

Box 1: The Economic Analysis of Law

Law and economics, also known as the economic analysis of law, focuses mainly on two things. First, the theoretical analysis focuses on efficiency. Law and economics stresses that markets are more efficient than courts. Second, law and economics emphasises on incentives and people's responses to these incentives. Law and economics is more likely than other branches of legal analysis to use empirical or statistical methods to measure individuals' responses to incentives. The private legal system must perform three functions, all related to property and property rights. First, the system must define property rights (property law). Second, the system must allow for transfer of property (contract law). Finally, the system must protect property right (tort and criminal laws). A legal system should provide clear definitions of property rights. Ideally, efficiency implies that, in a dispute regarding the ownership of a right, the right should go to the party who values it the most. According to the economic analysis of law, the characteristics of efficient property rights are universality (everything is owned), exclusivity (everything is owned by one agent), and transferability. Law and economics can also explain the results of inefficient property definitions. Most of the doctrines of contract law seem consistent with economic efficiency. Law and economics study of contract law has shown that, in general, it is efficient for parties to be allowed to write their own contracts, and under normal circumstances, for courts to enforce the agreed-on terms, including the agreed-on price. The courts will generally not enforce contracts if performance would be inefficient, but, rather, will allow payment of damages. Contracts and contract law are also designed to minimise problems of opportunism.

Source: Adapted from Rubin, P.H. "Law and Economics". The Library of Economics and Liberty < <https://www.econlib.org/library/Enc/LawandEconomics.html> >

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Looking at the available evidence, it emerges that the law-economics nexus in Pakistan can be discussed with a focus on land, which still is the most important form of capital in the country. Therefore, if we talk about the ability to move the capital, it means the ability to deal with land in Pakistan. Unfortunately, Pakistan's laws, especially those related to the land, are not well informed by economic theory, resulting in inefficiencies, among other things. The reasons are both historical and religious.

The main issues and problems identified in concerning law and economics in Pakistan are (i) Identification of the ownership of land; (ii) informalities in the land-related transactions; (iii) complications in the laws; (iv) overwhelming and needless litigation; and (v) economic inefficiencies created by the taxation structure and other aspects of commercial law.

I. ABSENCE OF RECORDED TITLES

The basic land-related issue in Pakistan is the identification of the ownership of land since it is not definitively known who owns the land. This issue has arisen because of the absence of a centralised system of recorded titles. The state neither records the title nor does it provide a guarantee to the title. It only records who has the possession and who is liable to pay land revenue tax. Even the land records that exist are incomplete. The gaps exist for historical reasons. The rulers of the Subcontinent, including the Sultans of Delhi, the Mughals, and the British relied heavily on land revenue tax to run the state. This is the reason that the Punjab government department that deals with the land is called the "Board of Revenue". Although the original land revenue tax system was abolished in 1977, the structure remains the same.

(i) The Registry System

The way land records are structured has important consequences for economic efficiency and the functioning of the legal system. In case of a land dispute between two parties, it is up to the concerned parties to settle the dispute and establish the title in different ways. One way to establish the title is through a registry. An individual can have the title just because they got the registry from someone else who, in turn, might have got it from someone else and so on, creating a long chain. The chain system is problematic because if someone loses one link of the chain, it can result in the loss of the possession.

The registry system is only evidence of the title. A registry, therefore, is liable to be challenged easily. Moreover, the registry rules allow anyone to register, in theory, anything; the registrar does not have the authority to decline. The lacunae in the system become clearer when compared to systems in place in other countries. In the US, for example, a property is either recorded or it does not exist as far as the state is concerned. The state does not recognise unrecorded liens and guarantees decentralised titles. There is no equivalent of this in Pakistan for the real estate.

II. INFORMALITY

The problems are accentuated when the land-related transactions are conducted outside the registry framework, which itself is incomplete.

(i) Oral Transactions

For example, oral transactions are still valid in Pakistan whereas, in England, the oral sales were banned in 1604 by the Statute of Elizabeth. The problem with oral transactions is, of course, there is no written record.

(ii) Earnest Money (بیعانه)

Similarly, the earnest money, which is an agreement to sell, is an unregistered document. The informality in the transaction leaves room for both the parties, the buyer and the seller, to renege on their promise if the price changes. Since there is no documented proof of the payment of the earnest money, the matter goes immediately into the disputed question of fact. A solution to this problem is, and this is where government intervention might be useful, is to use escrow methods. In the US, for example, when an agreement is reached, the amount of the sale is deposited in a bank. Once an agreement is reached, the bank releases the money subject to the clearance of the title and other procedures.

(iii) Equitable Mortgages

In Pakistan, the system of “equitable mortgage” is still in place, which is an unrecorded document. It means that the registry-holder, even if the property is in someone else’s possession, can claim an equitable mortgage. The problem is that if a property that has changed ownership thrice or four times and if one of the title deeds is missing, there is no way to know where that title deed is and whether the property is pledged with a bank or not. Therefore, there is no good reason to still have equitable mortgages.

(iv) The Power of Attorney

There are problems even with the registered documents. For example, even though the power of attorney is a registered document, the related procedural issues are not transparent because the power of attorney does not have to be registered where the property is located. For example, someone in Karachi, who has the power of attorney of the property located in Lahore, might use it illegally.

III. COMPLICATED LAWS

Besides land title being incomplete and unregistered legal documents, even the laws related to the land that are formal and recorded, are complicated.

(i) The Law of Preemption (حق شفیع)

One such complication arises from the right of preemption for rural land. According to this law, if someone decides to sell a property, their neighbor has the right to buy the property at the demanded price. Although it is very hard to prove the right of preemption as the person claiming the right first has to make an oral offer before making a formal offer, it wastes valuable time.

(ii) Will

The absence of wills in Pakistan creates further complexity, especially for rural areas where there are joint landholdings. In rural areas, the land splinters by the operation of law the moment someone dies because there is no formally recognised system to establish inheritance. Therefore, the heirs have to go to the court to establish inheritance, which results in needless litigation.

(iii) Benami Law

The Benami law (which in English law is called a “resulting trust”) has added another layer of complexity. For example, someone who buys property but registers it in someone else’s name can claim ownership even after a long time has elapsed. However, it is very difficult to prove that the payment was made by someone other than the titleholder. The Benami law is problematic because according to this law a Benami property can be confiscated. In other countries, such as in India, according to the 1996 Benami Act, the property belongs to the person in whose name it is registered. There is no need for the state to get into who has kept the land as a Benami property. The state should not concern itself with who paid the money.

(iv) The Rent Laws

Economic inefficiencies also occur because of the rent law. The problem arose from the 1959 West Pakistan Urban Rest Restriction Ordinance, which was applied nationally. Under this law, every lease deed was a lease forever. Once, a property was rented, the only way the tenant could be forced out was if it could be proved that the tenant had defaulted. Although it is a factual thing, every factual thing needs to be proved in the court. In Punjab, after a law was passed in 2008, landlords are now allowed to get rid of the tenant on the day the lease ends, provided the lease is registered. In KP and Sindh, however, the same problem persists. Informal estimates show that from 2000 to 2005, 6% of all the Supreme Court judgments dealt with rent. In Karachi, for example, the landlords are interested in renting out the property only to multinationals and foreigners because it is hard to get the property vacated once locals occupy it. The average time to get rid of a stubborn tenant is about 10 years.

IV. NEEDLESS LITIGATION

A dire consequence of the complexities arising from the unclear and complicated laws is that everything needs to be proved in a civil court. Consequently, civil courts deal with an enormous amount of useless litigation every day, which should not exist otherwise. According to one estimation, the civil litigation in Pakistan is about 60-70 percent land-related. Even about 40-50 percent of criminal litigation is also land-related, most of which is avoidable. To make matters worse, most of the land litigation lasts for generations.

The situation calls for the establishment of clear property rights so that the courts’ interference is minimized. In every society, certain types of cases would inevitably arise, such as murder, robbery, or kidnapping but land-related issues are largely avoidable. For example, in Punjab, all the rent-related litigation has ended after 2008 after the

promulgation of the rent law. The result is that now people are willing to build houses to rent out, which has a huge multiplier in terms of economic activity. It is a trend that was not prevalent before the 2008 legislation.

Another factor contributing to an overwhelming amount of litigation is that Pakistan's justice system is understaffed. According to a crude estimation, the lower judiciary consists of 5000 judges and the superior judiciary has only 120 to 130 judges.

(i) The System of Appeals

A part of our legal system, which is also a remnant of the colonial heritage, is the extent to which verdicts can be appealed. In colonial times, the British judge had the discretion of what he wanted to take up. However, the difference is that at that time, the cases were limited in number. In the US, all the cases that go to court are normally decided by a jury. The decision of a jury is final and mostly cannot be appealed. In Pakistan, there have been no juries since 1953, and every decision is made by the judge who also has to justify his decision with reasons. However, the verdict is challenged from one judge to another creating a tall pyramid. In the US, for example, the pyramid is small, in which there are about a million cases at the lower level, about 1000 cases at the middle tier, and only 10 cases at the supreme court level. The US Supreme Court takes up about 80 cases a year. On the other hand, in Pakistan, the Supreme Court takes up to 5000 cases a year, the Lahore high court 100,000 cases a year, and more than a million cases remain pending in the lower court.

(ii) Judges' Discretion

Currently, the problem is that the judges take up all the cases. The case that cannot be appealed, can be revised, and the cases that cannot be revised, can be writ. Such a problem arises because there are no bright-line rules (see Box 2) in Pakistan. In the absence of bright-line rules, any verdict or decision can be challenged. The problem is further accentuated if the judge does not have time to decide or stay orders are obtained (see Box 3). The result is massive pendency because of two factors. Firstly, our system produces a lot of litigation, which should not arise, to begin with. Secondly, even when the cases are decided, they do not achieve finality.

Box 2: Bright-Line Rules

A bright-line rule is a clearly defined rule or standard in the US, composed of objective factors, which leaves little or no room for varying interpretation. The purpose of a bright-line rule is to produce predictable and consistent results in its application. Or, objective rule that resolves a legal issue in a straightforward, predictable manner. A bright-line rule is easy to administer and produces certain, though, arguably, not always equitable results.

Source: < <https://www.definitions.net/definition/bright-line+rule> >

Box 3: The Politics of a Stay Order

In Pakistan people engage in civil litigation for tactical reasons; they obtain a stay to bring the opposing party to the negotiating table. This has interesting implications for the politics at the bar council level. The president of a bar association, for example of the Lahore Bar Association, can charge 2 million rupees a case because being the president of the bar, increases the ability to obtain a stay in a case. This implies that the system is distorted at a functional and foundational level.

V. COMMERCIAL LAW

Other than in Karachi, the commercial law cases are very few in Pakistan for mainly two reasons. Firstly, the legal system of Pakistan is obsessed with the land as even commercial cases are judged through the lens of the land. Secondly, the commercial laws in Pakistan are such that the private sector's risk and economic efficiency aspects are not taken into account.

(i) Taxation

One of the problems arises from our taxation structure. In most countries, the legislature sets import duties. In Pakistan, on the contrary, the law operates in reverse. A look at the central excise or the sales tax acts reveals that the laws operate mostly based on exemptions. For instance, everything is taxed at 100 percent but certain exemptions are given, which are controlled by the FBR. However, the exemptions can be changed overnight, through a statutory regulatory order (SRO). This again exists for historical reasons, where the taxation has historically remained with the bureaucracy and the taxation even today is run by the FBR.

The problem with this practice is that the relationship between risk and reward is not understood by the bureaucrats. Because the taxation is operated through executive action, which can change overnight, people quite often find themselves in a situation where the tax rate is changed after they have started a venture. For example, according to Section 31A of the Customs Act, the "rate of duty is the rate when the goods land", which is quite puzzling because it increases the risk of businessmen if the rate is changed before the goods land. It is also applicable to sales and other taxes. Due to uncertainty created by such laws, foreign investors are also reluctant to bring in the FDI in Pakistan. The bureaucracy does not understand the private perception of risk.

(ii) Limited Liability Companies (LLCs)

In terms of law and economics, a limited liability company (LLC) is one of the most foundational legal reform. In an LLC, the liability of shareholders is minimized because it lets a businessman invest in a venture and limits the loss than can be incurred. In Pakistan, however, the concept of LLC has been tampered with. Till 2004, in Pakistan's prudential regulations there was a clause that required every director of a company to give a personal guarantee, which defeats the purpose of an LLC. In short, businessmen can be liable for any default of a company.

(iii) Commercial and Institutional Arbitration

The arbitration law in many countries of the world these days is plug and play. This means that a law can be picked up from one area and applied to the area where the law is needed. In Pakistan, firstly, there is no institutional arbitration. Secondly, according to the 1940 Arbitration Act, even after a party gets an award, the opposing party can take it to the civil court. Thus, the process starts all over again because everything is liable to be appealed.

(iv) Alternative Corporate Structures

In Pakistan, there is a need to move from traditional business organization structures to alternative structures that make it easier for people to organise without going through the whole hassle of a company. Currently, the requirements for a company and its management are overwhelming, and most businessmen do not want to deal with such procedures. Therefore, what is needed is to come up with simpler mechanisms for formalisations. One such option is a limited partnership, which started in England circa 1930s and is present in India for almost 30 years now.

The difference between a general partnership and limited partnership is that in general partnership, every partner is liable for all the debts of a partnership. On the other hand, in a limited partnership, there is one general partner who is fully responsible while everyone else is a limited partner whose liability is liable only to the extent of their share in the company. The difference between a limited partnership and a company is that the partners do not have to file accounts every year. The Securities and Exchange Commission of Pakistan (SECP) has allowed limited partnership. However, such partnerships are not being used because the accounts need to be filed every year, defeating the purpose of a limited partnership.

(v) Bankruptcy Law

Capitalism, in essence, is a marriage between capital and entrepreneurs. If the marriage fails, it needs to be ended. In other words, the entrepreneurs have the option of bankruptcy if the venture fails. However, in Pakistan, bankruptcies are almost non-existent. Although there is an option of filing for bankruptcy, not many companies opt for it because there is no benefit for the entrepreneur in filing for bankruptcy. Thus, there is a need to introduce easy bankruptcy rules in Pakistan, such as in the US where benefits are given to the entrepreneur, subject to certain laws. In the present situation, once a company fails there is no recourse for the businessman other than to destroy it, which destroys valuable resources.