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Institute of South Asian Studies
National University of Singapore
29 Heng Mui Keng Terrace
#08-06 (Block B)
Singapore 119620
Tel: (65) 6516 4239 Fax: (65) 6776 7505
www.isas.nus.edu.sg
http://southasiandiaspora.org



Demonetization – Evaluating the Costs and Benefits

Official data released a few weeks ago have indicated that the negative impact of the Modi government's decision to demonetize high value currency has not been as heavy as feared. Notwithstanding this better than expected growth estimate, demonetization has taken a heavy toll. Output of as much as one percent of GDP may have been lost. Besides, hundreds of millions of people, especially low income households, suffered pain and hardship. To compensate for that, the government will have to show benefits by way of a sustainable increase in the tax to GDP ratio and enduring improvement in the investment climate.

Duvvuri Subbarao¹

The Central Statistical Organization (CSO) of India reported a couple of weeks ago that the Indian economy grew at a robust 7 percent in the third quarter of the fiscal year (Oct – Dec 2016) belying the widely held view that economic activity, especially in the informal sector, would take a severe beating as a result of the demonetization of high currency notes effected in November 2016. For sure, the estimated growth was slower than 7.4 percent, recorded in the previous quarter, but significantly higher than the consensus prediction that the growth rate would decline to near 6 percent. Even more strikingly, the CSO estimates that growth for the full fiscal year (April 2016 – March 2017) will be 7.1 percent, exactly

¹ Dr Duvvuri Subbarao is Distinguished Visiting Fellow at the Institute of South Asian Studies (ISAS), an autonomous research institute at the National University of Singapore. He is a former Governor of the Reserve Bank of India, and author of *Who Moved My Interest Rate? Leading the Reserve Bank of India through Five Turbulent Years*, Penguin Group, 2016. He can be contacted at subbarao@gmail.com. The author bears responsibility for the facts cited and opinions expressed in this paper.

the same as its earlier estimate made before taking into account the impact of demonetization.

Economic Growth Shrugs Off Demonetization?

The estimates put out by the CSO strongly suggesting that the economy, like the voters in the five recent state elections, has shrugged off the negative impact of demonetization has come as a positive surprise for the government, as a negative surprise for the opposition, and has left analysts and commentators befuddled about what exactly is going on in the economy. During the poll campaign in the state elections held over the last few weeks, the Prime Minister used the growth estimates to get back at the opposition, which had pilloried his government earlier on for the ham-handed implementation of the currency swap scheme. The opposition, in turn, questioned the credibility of the numbers; and analysts were busy explaining why the figures had turned out as rosy as they did contrary to their dire predictions.

As an aside, it must be noted in this context that the GDP growth numbers of India had become quite contentious ever since the CSO shifted to a revised methodology of estimation in 2012-13 to make Indian numbers consistent with international standards. The most common criticism of analysts has been that the revised methodology flatters the aggregate growth number, putting it at odds with other more frequent data which point to an economy expanding at a significantly slower pace. Even against that backdrop, the most recent CSO estimates have been bewilderingly upbeat.

What Explains the Bewildering Growth Estimates?

Among the many explanations analysts have proffered for the better than expected numbers are the following:

- It is the informal economy (agriculture, construction and unorganized manufacturing and services) that has been most affected by the demonetization. The quarterly GDP data proxies informal economic activity through some adjustment of the formal sector economic activity numbers. There may be a positive bias in the calculation as the formal economy was less impacted by

demonetization. There will be a significant downward correction when the full year estimates are made after the year end.

- The Diwali festival which marks a high spending phase came in 2016 in October, before the demonetization decision. Diwali spending was higher than normal because of the ‘feel good’ factor of a good monsoon and the massive pay-outs to the civil service as a part of the pay revision affected earlier in the year.
- Some businesses overstated sales to explain away large amounts of cash holdings.
- People splurged with the old currency even if it meant buying stuff at a hefty premium.

How Much Growth has Been Lost?

The flattering growth estimate may indeed have been a result of combination of all these factors. However, the contention over the veracity of these numbers, undoubtedly clouded by politics, has bypassed a more important question which is this: How much growth has been lost because of demonetization? To get a handle on this, the comparison of the estimated growth should be, not with the number predicted by analysts, but with the counterfactual. What would the growth have been absent demonetization? It will be instructive to flesh this out a bit.

As per the revised figures of the CSO, the economy expanded at 7.9 percent last year (2015/16). During the current year, there are several factors that would potentially boost economic activity compared to last year. Rural wages have risen; the monsoon has been the best in years; the pay increase of civil servants has boosted spending; and government expenditure too has increased. On that basis, a reasonable, if also conservative, estimate of growth during the current year, absent demonetization, would be 8.1 percent, just 20 basis points above last year’s number. So, if the economy is estimated to grow only at 7.1 percent as per CSO estimates, the loss to economic activity would be a full percentage point of GDP.

That argument raises the following question. If the cost of demonetization has been as high as one percentage point of GDP, what have been the benefits? Is the net cost benefit calculus positive? The rest of this paper is devoted to addressing this question.

Benefits from Demonetization

The benefits of demonetization can be broadly divided into fiscal and macroeconomic. The fiscal benefits are quantifiable and accrue to the government. The macroeconomic benefits are not fully quantifiable and accrue to the economy at large. Even where quantification of macroeconomic benefits is possible, it would be analytically challenging to isolate the impact of demonetization from all other factors that influence these variables.

Fiscal Benefits from Demonetization

Although the government did not say so explicitly, the initial expectation, or at any rate speculation, was that the government would get a windfall fiscal bonus as a result of demonetization. The reasoning went as follows. Of about Rs.15 trillion of demonetized currency, about 20 percent, or roughly Rs.3 trillion, would be destroyed by those who hoarded black money. The Reserve Bank of India, as the issuer of currency, will then be able to write down its liability to that extent, book a corresponding profit, and as required under law, transfer the 'surplus profit' to the government. The government could then effectively play Robin Hood with this bonanza, returning it to the poor in the country in some form or the other.

As it turns out, that scenario did not play out. The Reserve Bank is yet to come out with the exact amount of demonetized currency deposited in banks during the currency swap period, but anecdotal evidence suggests that as much as 97 percent of the high denomination currency found its way into the banking system, effectively closing the possibility of a windfall fiscal bonanza to the government.

The only option for the government to get a fiscal benefit now is through identifying black money from the deposits made into banks. While the currency swap was in progress, in December 2016, the government got parliamentary approval for an amendment of the income tax law which allows it to let off people who admit to black money from criminal prosecution for tax evasion but: (i) levy tax at a penal rate of 50 percent; and (ii) impound

25 percent of the admitted black amount as an interest free deposit for four years. Ostensibly, the intent was not only to encourage those who hoarded black money to come clean but also to reveal their identity so that the tax authorities can keep a check on them in future years too.

There is time till March 31 for admission of black money under the amnesty scheme. Although admissions so far are reportedly small, the expectation is that most people would move in the last week before the deadline.

Quite independently of the of the tax amnesty scheme, the government has indicated that all suspicious deposit activity during the currency swap period will be investigated by the tax authorities to detect money laundering. To this end, in the first instance, the government has reportedly sent notices to about 1.8 million depositors to explain the source of their money and has indicated that this is just the start of the process.

Given the high political stakes for the government, apart from the economic costs of demonetization, it is a fair bet that the government will bend over backwards to maximize the detection of black money from the deposits and collecting tax out of that. How much additional tax should the government garner to justify loss of output of as much as one percentage point besides the huge pain and hardship suffered by millions of poor people whose livelihoods so critically depend on the cash economy? This is obviously a matter of judgement, and my judgement is that the cost benefit calculus would not even begin to look balanced unless the government collects additional tax of at least one percent of GDP which translates to Rs.1.5 trillion. This implies, given the 50 percent tax rate, that the government should identify black money of at least Rs.3 trillion.

Macroeconomic Benefits from Demonetization

The macroeconomic benefits of demonetization will materialize through a variety of routes.

- If corruption declines and ease of doing business improves as a consequence, investment will pick up with an enormous multiplier impact by way of more jobs, higher incomes and even better distribution of incomes.

- Savings will shift from being physical to financial again with a huge potential boost to the economy.
- Elimination of, or at any rate minimizing fake currency, will choke financing of terrorism, trafficking in drugs and other contraband which will go a long way in improving the investment climate.
- Transition to a digital economy will bring in benefits by way of economic efficiency.

But these macroeconomic benefits are neither inevitable nor automatic. As almost everyone writing on it has pointed out, demonetization has at best choked black money at a point of time. There would be no lasting impact if its regeneration is not prevented. In its Press Note of November 8, 2016² announcing the demonetization, the government has indicated all the steps it had taken over the last two years to curb black money:

“In the last two years, the Government has taken a number of steps to curb the menace of black money in the economy including setting up of a Special Investigation Team (SIT); enacting a law regarding undisclosed foreign income and assets; amending the Double Taxation Avoidance Agreement between India and Mauritius and India and Cyprus; reaching an understanding with Switzerland for getting information on Bank accounts held by Indians with HSBC; encouraging the use of non-cash and digital payments; amending the Benami Transactions Act; and implementing the Income Declaration Scheme 2016.”

Preventing Regeneration of Black Money

The government seemed to imply that it acted according to a game plan over two years and demonetization had come as the logical endgame. In any case, what will determine the lasting impact of demonetization is how effectively its regeneration is prevented and how ruthlessly wrongdoers are punished.

² Government of India Press Release of November 8, 2016: http://finmin.nic.in/press_room/2016/press_cancellation_high_denomination_notes.pdf

The legal and institutional framework for getting down to this job is already in place. The roll out of the goods and services tax (GST) is on the anvil and this itself, notwithstanding how it has been diluted, should prevent black money by providing an audit trail. The tax authorities too have the competence, the big data and algorithms to detect and identify suspicious financial activity.

Many people believe that donations to political parties which are non-transparent are a big source of black money. The budget presented to the parliament at the beginning of February 2017 had gone some way in reforming this. These reforms, although far from being comprehensive, are politically bold and constitute a good beginning.

There have been some apprehensions that the government might resort to ‘tax terrorism’ in its assault on black money, in the process scaring potential investors as also harassing honest tax payers. The relevant amendments to rules giving tax officials powers to search without assigning any reason and to attach any property for six months without approval from higher authorities have added fuel to these concerns. Some of these concerns are legitimate given the record of corruption and harassment by tax authorities; but it is also fair to say that the menace of black money cannot be meaningfully attacked unless tax authorities have the power for quick and effective action. The onus of using the higher power responsibly and wisely will be entirely on the tax authorities.

Onus on Government to Show that the Cost Benefit Calculus has Been Positive

In conclusion, it is true that the growth estimates for the third quarter and also for the full year have surprised on the upside. But to use those data points to declare victory is premature, misleading and facetious. All that the numbers suggest is that the costs of demonetization have been somewhat less than initially feared. But a loss of GDP of one percentage point, especially in a country where hundreds of millions of poor people struggle for daily survival, is a huge cost. It is for the government to prove that the pain and hardship have been worth it by delivering significant and enduring benefits.

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