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Follow-Up Reforms needed for a Demonetisation Dividend

A concerted attempt has been made by the Government of India to unearth unaccounted cash. Reports of the Reserve Bank of India (RBI) elicited the fact that cash in circulation was growing at an unprecedented rate when other indicators in the economy did not reveal any genuine reasons for such large amounts to be circulating. The manufacturing sector did not indicate any growth nor did construction, hence a year on year growth of about 15 % in the last two years was causing consternation. Given the serious situation which appeared to be emerging, as being brought out by many studies, the government had to resort to the surprise element in the ferreting out process. This will cause hardship for some time but will certainly address the 'stock' of accumulated black money. There is an urgent need to address the regeneration of black money which constitutes the flow element.

Vinod Rai[1]

From the midnight of 8 November 2016 the Indian Government withdrew the legal tender status of the Rupee 500 and Rupee 1000 denomination currency notes. As per the RBI Annual Report of 2015-16, there is Rs 16.42 trillion worth of currency in circulation. The rupees 500 and 1000 denomination notes comprise about 86% of this. The move to withdraw the legal

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status of these notes, or demonetisation of these currency notes, has been done with the twin objectives of combating the problem of counterfeit currency and unearthing 'black money'. Such objectives can be achieved only when the move is introduced suddenly and takes the people by surprise. No doubt the surprise element causes hardship too. The move has created quite a stir as it has taken everyone by surprise. The remarkable fact is that the government kept its intentions a well-guarded secret.

Demonetisation of currency notes of high value was last done in 1978 when rupees 10,000, 1000 and 500currency notes were delegalised. The Rs 1000 legal tender was reintroduced in 1998 to facilitate cash transactions of the public as the value of the rupee had depreciated substantially. The present move seems to have been triggered by the high volume of counterfeit currency that was finding its way into India through the porous borders with its neighbours.

Besides diluting the underlying strength of the economy, this has been the cheapest source of terror-financing targeted at India from outside its borders. To detect the source and conduit of these counterfeit notes, apprehend the culprits responsible for inducting such notes into India and weeding them out from an economy of this country's size through enforcement agencies, has been a gigantic task with which the government has been grappling for quite some time. The demonetisation of ₹500 and ₹1000 notes would cripple the design of terror-financing by India's overseas enemies, sometimes operating in connivance with unscrupulous elements within the country.

The latest step taken by the government will address several issues. It will reduce terror-financing, arms smuggling, corruption, drug financing and black money, and also improve transparency in tax compliance, increase government revenues, support electronic transactions, and reduce demand for currency in the medium-term. It is no doubt advisable to attempt rooting out corruption through policy initiatives rather than by chasing tax evaders through enforcement agencies, which is a discretionary exercise that creates opportunities for the enforcement agencies to manipulate the system for personal gain.

The country and government have been very concerned with the increasing menace of black money which was fuelling a parallel economy. The government had provided a window of opportunity for the citizens to declare their unaccounted wealth by 30 September 2016, pay the due penalty and have their currency holdings legalized under a voluntary income declaration scheme. The amount collected was about Rupees 62,600 crores (about US$10 b).

RBI has assessed that the currency circulation in India has been growing at around 15 per cent per annum, which is higher than the 10.7 per cent seen during the previous three years. The sudden increase in demand for currency has been discussed in various fora. The Annual Report of RBI for 2015-16 has made an assessment of the possible reasons for the spurt in currency demand in the last three years. The reasons identified are: sub-national State elections, festival spending, the jewellers' strike and banking habits. Unlike on earlier occasions, such currency did not come back into the banking system after the election/festivals were over. Even e-commerce transactions, which are mostly cash on delivery, do not fully explain the surge in currency demand. There could also be counterfeit currency which is going around.

The normal factors affecting currency circulation are not sufficient to explain the underlying reasons behind the unprecedented rise in currency in circulation, particularly when the manufacturing sector has not been doing well and when rural demand has been sluggish for the last two years. RBI on the other hand has been attempting to promote electronic transactions through several initiatives to help India move towards a cashless economy. It was becoming very obvious to the government that there were a multitude of factors which were adversely affecting this growth and which were causing a spike in the demand for cash. This had to be remedied.

According to a report, 'Cost of Cash in India', commissioned by MasterCard, India is still one of the most cash-intensive economies in the world with a cash to-GDP ratio of 12 per cent. This is about four times that of other economies such as Brazil (3.93 per cent), Mexico (5.3 per cent) and South Africa (3.73 per cent). The solution obviously would lie in electronic payments as the spin-offs include automatic audit trails, transparent accounting, and minimising the risk and cost of handling cash. But India is a vastly unbanked country, and many among the poor do not have bank accounts. While the government has been making efforts to switch to electronic payments, it cannot be expected that people, in rural areas, will switch to plastic in a short time-frame. The more disconcerting factor is the use of cash during elections by political parties. The practice of political parties mopping up large amount of election funds through opaque methods has been a major cause of the corporates and the construction sector resorting to generating and retaining black money. The public also relies upon gold, which is otherwise an idle asset. This leads to the worry that a sudden surge in gold imports may impact the balance of payments position.

The government appeared to have made up its mind to resort to serious measures to flush out black money. On the other hand, due to the technological progress made to detect high-value transactions in banks, all the tax-evaders and the people with undeclared income gained through illegal activities preferred to hold their unaccounted income in cash. Hence the need to resort to a strategy of demonetisation for unearthing such ill-gotten wealth. Demonetisation is a hardship-creating method to be resorted to as it impacts the common man very severely, but the efficacy of demonetisation in flushing out illegal wealth is at its highest only when it comes as a surprise. Hence the argument of short-term pain causing long-term gain prevails, leading to governments resorting to it.

While resorting to this surprise technique and seeking to reduce the hardship for the common man, both the government and the RBI had made elaborate provisions such as the following: allowing people to deposit their old notes with banks and post offices, producing proof of identity, until 30 December 2016; the limited exchange of the old currency notes for the new ones across the bank counters; no restrictions on non-cash payments through cheques, demand drafts, credit/debit cards, electronic funds transfer etc. Resorting to more elaborate arrangements ran the risk of comprising on the surprise element which would have given the black-marketers a possible escape route.

Economists refer to the availability of currency in any economy in terms of 'stock' at any point of time and the 'flow' of currency over time. Demonetising the legal-tender notes of certain values addresses only the stock element of the money in circulation. It renders worthless the amount of currency notes at *a point in time.* It does not address the future flow of currency. Thus, while the government may succeed in checking the amount of black money currently available in the economy, it needs to adopt a series of moves to ensure that regeneration of black money does not take place again. Setting up a special investigation team, as has been done by the government, is a measure which addresses the stock aspect of the currency. Considering the seriousness that the government seems to be attaching to eradicating the scourge of black money, and hence rooting out a parallel economy, it needs to immediately put in a motion a series of measures which will put a huge amount of jeopardy on those seeking to resort to creating black money again.

The process of addressing the generation aspect of black money will involve a whole series of systemic reforms that the government should introduce. The major measure among these is the regulation of all transactions in the real estate sector. This sector clubbed with gold is among the major areas where black money is parked. It is believed that the main reason why India did not suffer serious adverse consequences of the global economic slowdown is because of the existence of the parallel economy which kept business going. This ensured that employment did not decline and there was sufficient disposable income in the hands of people to keep demand for goods and services buoyant. Only a part of most real estate transactions passes through the banking channels. The remainder of the money generated in the real estate sector is not revealed as income and hence is not subjected to taxation. This part of a person's income thus constitutes black money and fuels the 'cash' part of the transaction viz. neither the buyer nor the seller declares either having paid this sum or having received it, respectively. Money thus generated obviously cannot be deposited with banks and hence has to be retained in large-denomination currency notes or invested in idle stocks of gold, unless it goes on to more real estate transactions by generating more unaccounted wealth. All transactions routed through the banking system are subject to an audit trail, while cash transactions can escape this and thereby support the parallel economy to thrive further. In fact, the ratio of deposit to gross national disposable income in India has been falling: it fell from 6 per cent in 2012-13 to 4.7 per cent in 2015-16. There does not seem to have been adequate political will in the past to curb this menace. This is the aspect that the present government will have to address – very soon too – such that the present action is followed up with consequential reform measures.

Another aspect which leads to additional generation of black money is the fact that Indian elections cost huge sums of money. These moneys can hardly come from retail contributions by political-party sympathisers. It has to come from big corporate houses. But contributions from corporate houses are largely from undeclared income and hence the contribution is not recorded, with the transaction being opaque. Thus the giving and receiving of such money are both illegal. Political parties spend humongous amounts on their election campaigns but only a miniscule proportion is declared by them as expenditure having been incurred. The Election Commission deploys many 'expenditure observers' during any election, yet the law is so ineffective that the scourge cannot be checked. The only method by which this funding can be checked is when all political parties see the futility of such huge spending and collectively decide to check it. How far the spending on posters, advertisements in print and electronic media and on expensive automobile rallies or 'air' transportation brings in as electoral dividend is anyone's guess. In view of the fact that the polity is becoming increasingly aware of the strengths and weaknesses of each party, the wisdom of such heavy spending is doubtful. Thus the reforms have to come from within the political parties.

It needs to be recognised that one move of demonetisation in the entire process of eradicating the scourge of black money will not provide the policy momentum to actually usher in reforms. The move would in fact lead to frustration and disillusionment among the people who might feel that, despite the hardship that they faced, this action, too, is soon forgotten with business returning to the usual mode. The latest governmental action is going to be disruptive in the short-run. The large cash-based transactions in the economy are going to see a sharp fall with goods such as mobile phones, televisions and other white-goods witnessing a decline in demand. The automobile sector which is recording growth, with Maruti (Suzuki) leading it, is certainly poised to see a decline in demand. Purchase of commercial and residential properties is bound to take a hit, with the construction sector bearing the brunt of it. Gold and bullion is also set to see a decline despite the spike witnessed on the day the demonetisation was announced. Eateries, travel and such other hospitality activities will also see an initial dip. All this will contribute to a slowdown in industrial growth thereby contributing to possibly a lower GDP and income growth.

However, if follow-up measures are taken, the black money which shows up in bank accounts would be put back into circulation through formal banking methods, thereby contributing to the formal economy. Routing some of the money through *Jan Dhan* accounts, as reports indicate, will not only bring it into the formal channel but also lead to redistribution of some wealth. It is also possible that lower property prices will boost the demand for housing and boost the construction sector. There will be a big boost to the country's start-ups operating mobile wallets and payment platforms. Consumers would be encouraged to gravitate towards digital platforms faster than in the recent past. The benefit from decline in black money circulation will lead to buoyancy in tax-collection, prompting a better business environment, encouraging transparency, and thereby, discouraging corrupt practices. Better tax-compliance will boost the tax-to-GDP ratio. A great benefit of this would be an improvement in the ease of doing business, which has seen very marginal improvement in the recent months (causing foreign direct investment to be sluggish). On the whole, in the medium- to long-run, these measures will integrate the parallel economy into the formal economy and hence improve fiscal numbers. Thus the widespread belief among economists is that, if follow-up action is taken in the coming months, the short-term pain of demonetisation would lead to long-term gain for the country and the economy.

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