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India's Demonetisation: The Pain-Gain Imbalance

On 8 November 2016, India demonetised around 86 per cent of its currency in circulation by declaring bank notes of 500 rupees and 1000 rupees as illegal tender. The ostensible objectives behind the move were to seize black money and fake currency and facilitate the country's transition to a more digital and cash-less economy. Two months after demonetisation, there is focus on what it achieved. This paper analyses whether demonetisation was able to unearth black money. It also discusses the impact on the Indian economy and the importance of establishing that the pain and hardship caused by the move was indeed worthwhile.

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The 'Black' Balance

The Indian Ministry of Finance's notification on 8 November 2016, declaring bank notes of 500 rupees and 1000 rupees as illegal tender from 9 November 2016, highlighted three specific concerns precipitating the action. These were the widespread use of fake currency notes and the difficulty of distinguishing fakes from genuine, the use of fake currency for financing terrorism and drugs and the storing of unaccounted wealth through high denomination bank

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notes[2]. The move resulted in withdrawal of around 86 per cent of the currency in circulation amounting to approximately 15 lakh crore, or 15 trillion rupees.

The question uppermost in everybody's minds is how much of the demonetised currency has been eventually recovered by the banks through the deposit of old currency notes, now being referred to as special bank notes (SBNs). This is reportedly one of the several questions that the Public Accounts Committee (PAC) of the Indian Parliament has sought answers for from the Reserve Bank of India (RBI) and the Ministry of Finance[3].

If the money recovered from SBNs is less than what was demonetised, the deficit can be considered 'black' money comprising unaccounted cash and fake currency that has been driven out of circulation by demonetisation. But if what is recovered is as much as what was declared illegal, then technically, either there was no black money held in cash, or what was held found ways of becoming legitimate. The latter is a more plausible explanation with hoarders of unaccounted cash having discovered ways of circumventing demonetisation largely by depositing money into banks by misusing other people's accounts, particularly the 'Jan Dhan' accounts[4]. Notwithstanding this rationalisation, return of the whole or almost all of the demonetised currency provides no statistical evidence of unearthing black money.

The RBI is yet to indicate how much money has been returned to the banks. After the end of the deadline of 30 December 2016 for returning old currency notes, it issued a statement indicating that the SBNs received by the banks are being counted carefully by tallying accounting entries with physical cash balances for avoiding estimation errors that can creep in from double-counting[5]. But earlier, on 13 December 2016, the RBI had reported that till 10 December 2016, 12.4 lakh crore, or 12.4 trillion rupees of old notes had been returned to banks[6]. This meant that with nearly three weeks to go, banks had got back around 83 per cent of the currency declared illegal. It is possible that the eventual amount recovered could well be

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[2] Ministry of Finance (Department of Economic Affairs), Notification, New Delhi, the 8th November 2016. http://finmin.nic.in/172521.pdf Accessed on 6 January 2017.

[3] 'House Panel can call PM Modi on cash ban if RBI's reply not satisfactory', The Economic Times, 9 January 2017; http://economictimes.indiatimes.com/news/economy/policy/house-panel-can-call-pm-modi-on-cash-ban-if-rbis-reply-not-satisfactory/articleshow/56416552.cms Accessed on 10 January 2017.

[4] These are zero-balance accounts opened with banks under the financial inclusion programme of Prime Ministers' Jan Dhan Yojana (PMJDY) launched in August 2014. Till 4th January 2017, 26.51 crore, or 265.1 million accounts have been opened under the scheme, out of which around 93%, i.e. 246 million accounts are zero-balance. http://pmjdy.gov.in/account Accessed on 9 January 2016.

[5] 'Clarification regarding Specified Bank Notes (SBNs)', Reserve Bank of India, 5 January 2017. https://www.rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=39163 Accessed on 6 January 2017.

[6] https://www.rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=38886 Accessed on 6 January 2017.

very close to what was demonetised, raising doubts over whether the move was successful in recovering black money.

The Income-Tax department has indicated that around 3-4 lakh crore, i.e. 3-4 trillion rupees of ‘potentially’ tax evaded income has been deposited in banks following demonetisation[7]. This would be around 20-25 per cent of the currency declared illegal. While more clarity on final numbers are awaited, it is important to note that the rest of the money that has come back to banks is not tax evaded income and is ‘clean’ wealth held by citizens. Even if it is assumed that the currency mop-up has recovered some black money, it has at the same time sucked out an enormous amount of legal wealth. The withdrawal of this legal wealth produced a cash crunch with disruptive consequences for the economy as discussed later.

Attack on Black Hit White

Black money usually refers to income obtained through illegal means and not declared to national tax authorities. A White Paper on Black Money brought out by the Ministry of Finance of India in May 2012 went back to the definition of black income used by the National Institute of Public Finance and Policy (NPFP) in 1985 for explaining black money. According to this definition, black income is ‘the aggregates of incomes which are taxable but not reported to the tax authorities’. Such income arises from deliberate under-reporting of output and transactions for avoiding direct and indirect taxes. The White Paper argued that black money, in addition to the illegal wealth accumulated for avoiding taxes, also includes undisclosed legal incomes for avoiding payments under statutory contributions and various industrial laws[8]. It is evident that black money is generated not only through illegitimate, criminal activities like drug trafficking and smuggling, but also from under-reporting of legal economic activities. The latter usually manifests under conditions of high tax rates encouraging tax evasion and poor enforcement enabling non-compliance with regulations.

Non-disclosure of income and transactions and accumulation of black money is easier in economies that have large informal sectors with high volume of cash transactions. The large

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7 ‘Rs 3-4 lakh crore of tax evaded income deposited in banks post demonetisation’, The Hindu, 10 January 2017; http://www.thehindu.com/business/Economy/Rs.-3-4-lakh-cr.-of-tax-evaded-income-deposited-in-banks-post-demonetisation/article17017778.ece Accessed on 11 January 2017.

8 ‘Black Money’, White Paper, May 2012; Ministry of Finance, Department of Revenue, Central Board of Direct Taxes, New Delhi; http://www.finmin.nic.in/reports/WhitePaper_BackMoney2012.pdf

'informality' in India can be gauged from the fact that more than 90 per cent of the workers in the country are informally employed[9]. Such large presence of the informal sector and informal actors in the national economy generates large volumes of cash transactions. Given the relatively small outreach of the formal sector and its regulations, a lot of transactions in the economy go unreported. The bulk of these are in cash. If parts of these can be formalised by bringing them into the tax net, the structural character of the economy can become 'less cash' and more formal.

Trying to flush out black money in a heavily cash-based and informal economy like India by making the bulk of the legal tender illegal has major repercussions. There is no doubt that the illegal hoarders of cash would be adversely affected by the move. But so would be many others.

There is an opportunity cost of holding on to money. The money would have fetched returns if it were deposited in banks or invested in financial instruments. But if individuals, households and enterprises hold on to cash regardless of the opportunity cost, there must be good reasons for doing so. These include the importance of cash for transactions.

Transacting in cash in India is often a necessity, not a choice, particularly for routine daily needs. These transactions are not undertaken in cash for avoiding scrutiny or disclosure. They are carried out in cash because of the non-formal character of the transaction. Households, for example, buy daily groceries from neighbourhood and roadside vendors using cash. The same households might be engaging in bulk purchases of other items from organised retail stores or hyper-marts, or ordering their requirements online, through digital payments. But the latter purchases do not obliterate the former given their specific needs. Indeed, beyond cities and large towns, the option of using digital payments become much less as the number of digitally-enabled enterprises and individuals reduce, thereby increasing the inevitability of cash transactions for practically all purposes.

Demonetisation created difficulties in carrying out numerous cash-based 'necessary' transactions like the example above. One can argue that in some instances, informal sector actors like vegetable vendors who deal in cash, become large hoarders of unaccounted cash, which, if disclosed and taxed, would have added to the public exchequer. Incomes like these are probably part of the 'potentially' tax evaded income that has been deposited in banks after

[9] Statistical Year Book, India 2016; Ministry of Statistics and Programme Implementation, Government of India; Page 7, Para 32.13, Chapter 32. http://mospiold.nic.in/Mospi_New/upload/SYB2016/CH-32-LABOUR-EMPLOYMENT/ch32.pdf Accessed on 10 January 2017.

demonetisation and alluded to earlier. But as opposed to some informal actors who might have amassed large cash, there are several others whose net earnings in cash would nowhere be close to the lowest threshold levels of taxable income. It is the latter along with subsistence retailers, producers and consumers that have been significantly affected by the sudden withdrawal of currency. This is evident from the large amount of non-tax evaded income that has been deposited in banks, which would include small savings held in cash as well as cash kept aside for essential transactions and meeting exigencies.

The Economic Impact

The poor and economically marginal are neither sources nor generators of black money. But an attack on black money in the way it came could hardly have avoided inflicting pain and hardships on those who are not 'black'. This is apparent from the share of potentially tax evaded income (or black money) deposited at banks being far less than the non-tax evaded white money. Declaring the latter illegal tender had the obvious implication of inflicting a contraction in economic activity in the short to medium term.

Cash crunch affects economic activity both from the supply and demand-sides. On the supply side, it adversely influences production and brings down output. In the Indian context, this manifested in various forms, one of the most common being difficulties encountered by agricultural and industrial producers in buying inputs and raw materials. On the demand side, the manifestation has been primarily through lower consumer demand. Less cash and lower purchasing power has meant reduced consumer purchases across various sectors of the economy.

The Central Statistics Office (CSO)'s first advance estimate of GDP growth for 2016-17 pegs 7.1 per cent for the year compared with 7.6 per cent in 2015-16. The CSO's estimate is identical to the RBI's projection[10]. The estimate has not factored in the impact of demonetisation since it is based on statistics available for various parameters for the first seven-eight months of the financial year, whereas demonetisation was announced on 8 November 2016. The next estimate of GDP growth is expected to be released by CSO on 28 February 2017, which would give the

[10] a) Press Note on First Advance Estimates of National Income 2016-17, Central Statistics Office, Ministry of Statistics & Programme Implementation, Government of India, 6 January 2017; http://mospi.nic.in/sites/default/files/press_release/nad_prn_6jan17.pdf b) 'Minutes of the Monetary Policy Committee Meeting December 6-7 2016', Press Release, Reserve Bank of India, 21 December 2016; https://www.rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=38984. Accessed on 11 January 2017.

GDP growth for the third quarter (October-December) and would have a more updated assessment of the annual GDP growth. The updated GDP growth might well be lower than 7.1 per cent given that several sectors, such as agriculture, manufacturing, construction, real estate, tourism, hotels and transport have been affected by the cash crunch and are likely to grow at lower rates than those projected in the current estimates. Indeed, several credit rating agencies feel the GDP growth for the year could drop well below 7.0 per cent depending upon the duration of the cash crunch[11]. The International Monetary Fund (IMF) has slashed India's expected GDP growth for 2016-17 to 6.6 per cent from 7.6 per cent projected earlier, strengthening apprehensions of a one percentage point decline in GDP[12].

Will Gain Follow Pain?

The wait has begun for numbers that would throw light upon various outcomes of the demonetisation exercise: the amount of money returned to banks, the share of black money in the returned deposits and the hit taken by the economy due to the disruption caused as reflected by the third quarter and full year GDP growth rates. Whatever the numbers eventually reveal, demonetisation will be remembered for the adjustment pains it inflicted on people. People have by and large withstood the pain in the hope that the exercise would substantially rid the Indian economy of black money. These hopes will be dashed if black money continues to flourish in the economy notwithstanding demonetisation. Some quarters have begun apprehending that many holders of illegal cash found ways of dodging demonetisation and can get away unpunished. If that is indeed so, then demonetisation would lose the moral and virtuous planks on which it has been championed by its proponents and endured by people. The loss of legitimacy and credibility would be a great pity.

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[11] 'Demonetisation impact: Govt's GDP growth forecast overestimated, says rating agencies', The Indian Express, 8 January 2017; http://indianexpress.com/article/business/economy/demonetisation-impact-govts-gdp-growth-forecast-overestimated-says-rating-agencies-4464284/ Accessed on 11 January 2017.

[12] 'IMF slashes India's growth forecast to 6.6% from 7.6%', The Times of India, 17 January 2017; http://timesofindia.indiatimes.com/business/india-business/imf-slashes-indias-growth-forecast-to-6-6-from-7-6/articleshow/56608202.cms Accessed on 17 January 2017.