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Pros and Cons of Demonitization as a Major Economic Leap Forward

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ABSTRACT: Marking half of his elected term as India's Prime Minister, Narendra Modi, announced the Policy of Demonetization. Primarily aimed at eradicating black money, this policy caught the nation off-guard, resulting in financial chaos. The old unit of currency and its highest denominations that were the notes of rupees 500 and 1000 were demonetized and pulled out of the total cash flow in the country. These two denominations constituted 86% of the domestic cash supply. The objective of this paper to systematically analyze the consequences of this bold and unexpected policy through the secondary data. This policy change was strategically placed to block financial funding to terrorist organizations at the Kashmir border.
KEYWORDS: Policy, Demonetization, Economy, Government.

In the face of development, the demonetization policy also took a step forward in achieving cashless economy by creating Digital India through the electronic interface for government agencies to practice e-Governance.

The initial reaction to the policy has been strongly in favor, with many experts branding the move as bold and necessary. The International Monetary Fund issued a statement supporting the policy as the right move against corruption and black money, white global credit rating agencies like Standard & Poor's forecast improvements in India's fiscal position and tax compliance. Despite the massive inconvenience to the general population, the move enjoys strong public support, mainly due to expectation of long-term benefits.

The Indian black economy is proving to be a systemic challenge to development in India. Estimated at 25% of the GDP, the black economy has caused the cost of capital to rise. A robust black economy reduces the tax base and diverts funds that can be used for development and social programs.

In November 2016, the Modi government rolled out the Demonetization Policy to fight black money. Its objectives were to:

1. Stop tax evasion and widen the tax base
2. Bring back black money into the money supply to acquire funds for government expenditure on social programs and to relieve banks off their liquidity burden.
3. To deter corruption and counterfeiting
4. Choke avenues of funding to terrorist outfits on the Kashmir border and by Naxalites on the east coast.
5. Prompt a shift to Digital India through electronic interface for government agencies to practice e-Governance and shift consumption and spending to phone networks to broaden the tax-base and move towards a cashless economy

Despite strong public support and estimated economic benefits and tax revenues, in the long run, the policy faces several challenges to successful implementation.

1. Detrimental effects on economic activities in the short run, especially on MSME's and low-income households who deal largely in cash and can be unbanked.
2. Severe lack of capacity in printing new currency, recalibration of ATMs and ensuring access to liquidity to remote areas.
3. Lack of digital infrastructure to immediately meet the follow-up requirements of the policy.
4. Convoluted tax system that needs streamlining
5. Lack of compliance and norms of systemic malpractice in real estate

Demonetization is a necessary step in India's fight against black money and corruption with poor implementation. However, going forward, the following recommendations will help with successful implementation.

- Abolish capital gains tax on sale of property
- Reform capital controls to end Hawala
- Streamline the tax system in favor of simplicity and promote GST
- Administrative reform to contain government failure
- Electoral reform to reduce dependence of political system on black money funding
- Promote Digital India and the use of big data analytics.

Definition and extent of the problem

What is black money? The National Institute of Public Finance and Policy (NIPFP) defines black money as 'the aggregates of incomes which are taxable but not reported to the tax authorities.' Although black money generation in some countries is due to widespread organized crime, the root of the problem in India lies in corruption, malfeasant economic activity and extremely poor implementation of laws and regulations. The four primary sources of black money expansion are legal income concealed from public authorities to:

1. evade payment of taxes
2. evade payment of other statutory contributions,
3. evade compliance with provision of industrial laws such as the Minimum Wages Act, and (4) evade compliance with the (cost of) administrative procedures (time, money).

It is estimated that India possesses nearly $460 billion worth of black wealth in tax havens across the world, which only includes money held in bank deposits, invested in shares and/or debt securities. It is widely known that a major chunk of the black economy is parked in physical assets such as real estate, jewelry and art. This is but one estimate, with other estimates indicating that the total size of the Indian black economy is just under 25% of India's GDP. To put this in perspective, the size of India's burgeoning parallel economy is larger than the entire economy of countries like Argentina and Thailand. The black economy in India emerged in the 70s and 80s, soon after the period of Emergency.

Its absolute size has increased with the increase in India's GDP, reaching 50% of net GDP in 2008 according to some estimates. The cost of heightened interest rates in the black economy coupled with the lack of liquidity in the mainstream banking system has led to an increase in the cost of capital.

The Policy Decision: Demonetization

On November 8, 2016, as the United States voted Donald Trump in as their new President, Prime Minister Modi and Finance Minister Jaitley rolled out the Demonetization policy in India. In an unscheduled live televised address to the country, it was announced that the policy would be enacted on November 9th, ceasing the usage of all notes of the denominations of 500 and 1000 as legal tender. The policy further includes the issuance of new tender of denominations of 500 and 2000. Following the policy rollout, the Sensex and Nifty stock indices plummeted over the next two days, although this was partly chalked up to Trump's win.

This is not the first-time India has witnessed a demonetization policy. Previous governments have attempted this in 1954 and 1978 as a measure to combat counterfeit money. Other countries that have taken similar policy decisions include Ghana in 1982 in order to control capital flows, Nigeria and Myanmar in 1984 as a part of a nationwide crackdown on corruption, the Soviet Union in early 1991 to increase the value of the Soviet Ruble in global financial markets and more recently, Australia, which shifted to notes made of polymer to eliminate counterfeiting rackets. Other LDC's have attempted demonetization as a policy measure to counter hyperinflation. This, however, is the first case of this scale, with the policy rendering 86% currency in circulation and 55% liquidity in M1 terms (currency in active circulation plus demand deposits) useless.

Why Demonetization?

The objectives of the demonetization policy are manifold. Currently, only 1% of the working population in India pays Income Tax and only 15% is in the tax net. The tax-to-GDP ratio for India is 17%. India has the world's 7^{th} highest GDP in nominal terms and 3rd highest in PPP terms. Even compared to countries with similar per capita GDP, India's tax-to-GDP is 5% below average. This policy aims to put a stop to "tax cheating" – evading taxes or other statutory obligations such as skirting minimum wage laws.

Secondly, it is a strategy to combat black money since it is difficult to hold large sums of money in smaller denominations. It further aims to bring back a bulk of black wealth into the economy or whiten it.

Thirdly, demonetization is an anti-corruption strategy to expose public servants with lump sums of black money. Therefore, it serves as a complementary policy decision to the Lokpal Bill, which will benefit from the impact of demonetization in terms of a wealth of information and new cases of black money and corruption within the government.

Fourthly, it is a crackdown against terrorist outfits on the India-Pakistan border and the Naxalite movement along the eastern coast that finances its operations and procures arms and ammunition using illicit wealth.

Cash constitutes a staggering 14% of India's GDP compared to the 5% average for the rest of the world. Despite being a world leader in IT services, most small and medium enterprises still, deal in cash. Demonetization is chasing the larger objective of pan-India shift to an electronic interface. The government hopes to shift all payments to phone networks to instantly broaden the tax base and to initiate a shift to e-governance that will weed out corruption due to lack of access to information on the part of several agencies still following colonial-era protocols.

Following the policy rollout, the Reserve Bank of India released guidelines for exchange and deposits of the demonetized notes with the new tender. Under the government's estimate of a 50-day period to acclimatize to the new regulations, citizens can exchange and/or deposit old notes until December 30, 2016. However, caps were set on both exchange and deposits and all banks are monitoring and collecting information on transactions.

Implementation Analysis: Strengths and Challenges

Initial reaction from experts around the globe and the people of India has been overwhelmingly in support of the policy, despite obvious challenges on the ground. The strengths and benefits due to demonetization are already taking shape, with long-term returns estimated to outweigh both the costs of implementation.

Strong momentum and public support

The initial reaction to the policy has been strongly in favor, with many experts branding the move as bold and necessary. The International Monetary Fund issued a statement supporting the policy as the right move against corruption and black money, white global credit rating agencies like Standard & Poor's forecast improvements in India's fiscal position and tax compliance. Despite the massive inconvenience to the general population, the move enjoys strong public support, mainly due to the expectation of long-term benefits. Appendix 2 displays infographics from surveys taken in mid-December that show that two-thirds of rural India support the policy while over three-fourths of semi-urban and urban India supports demonetization.

Economic benefits

The size of the formal economy is expected to increase substantially, as are the long run tax revenues as a result of demonetization. As more people are forced to disclose their real incomes and start paying taxes, it is estimated that government revenue will increase by $45 billion. The Indian banking sector, which has been facing liquidity problems and fighting non-performing assets (NPAs), will benefit from the $22 billion increase in deposits collected since the policy rollout on November 9.

Increase in financial inclusion

One of the objectives of demonetization is to increase access to financial services, especially in rural India. Due to the policy's timeline based implementation and caps on exchange, the unbanked will now be forced to open bank accounts to deposit money. While this includes money earned through legitimate means but saved in the form of cash either due to lack of access to banking or lack of trust in banking, a major chunk of this money is illegal. Bringing this money into the banking system serves the objectives of the Jan Dhan Yojana (People's Wealth Program).

Boost to internet-based start-ups

Cities like Bangalore, Hyderabad and Ahmedabad have witnessed a massive surge in internet-based start-ups over the past half a decade. The effect of demonetization on Internet start-ups has been substantial. Not only have established car-ride ventures like Uber and online retail firms like Flipkart and Amazon have seen a surge in card payments compared to cash-on-delivery transactions, but their competitors have benefited as well.

Demonetization has positively impacted the market for Internet based ventures. The positive externality extends to other industries such as the smartphone industry and internet service providers.

This can be traced through the sudden increase in use of mobile wallets such as Paytm and in app downloads. Estimates indicate that the mobile wallet in India will grow at a Compound Annual Growth Rate of 140% by 2018 compared to the global CAGR of 34%. These changes may have a positively spiraling effect. Not only are currently existing tech and internet start-ups capitalizing on this shift, but this has increased the scope for new internet start-ups and with that, a decrease in unemployment among the millions of unemployed IT engineers. Until recently, the Digital India program was seen as overly ambitious due to the slow pace of growth in digital infrastructure. With the launch of 4G internet, using mobile phones as a point of sale (PoS), the point of purchase and point of acceptance have the potential to decrease the digital divide and increase financial inclusion.

The increase in payment on mobile phone networks serves to instantly broaden the tax base. This shift in technology also has implications in improvements in education. Whether these changes are only in the short run or persist for longer is a question that needs further research.

Alignment to global trend

India may be the first to implement demonetization, but going cashless is a part of the ongoing discourse in both the United States and the Eurozone. Efforts to demonetize the $100 bill and €500 are gaining popularity among economists to improve the efficacy of monetary policy. Supported by multi-pronged approach to repatriate black money. This is not an isolated attach on black money. The Modi government has signed agreements with the Swiss Financial Market Supervisory Authority (FINMA), the United States government and the governments of France (Monaco) and Liechtenstein to share banking information aimed at repatriating Indian black money stowed abroad. This has been domestically supported with Voluntary Disclosure Schemes (VDS) under legislations such as the Disclosure of Foreign Black Money Act and met with limited success. Despite these benefits, there are several challenges to implementation and concerns regarding its impact.

Stifling effect on MSMEs

Small and Medium Scale Enterprises (MSMEs) in India largely finance their operations and working capital requirements using cash. Many such legitimate businesses will be stifled in the short run. The government responded to petitions by modifying the caps on withdrawals and exchange, but the size of the sector makes it impossible to ease the burden on everyone.

Severe capacity issues

The move to demonetize has been at best a good move with bad implementation. The announcement was made in relative secrecy, with the move being hidden even from lower branches of the government to prevent an information leak alerting tax evaders from making preparations. This was a huge trade-off between secrecy and preparedness. Following the rollout, the government's capacity to print new currency has been severely tested. There is a large decrease in productivity and a corresponding nationwide increase in queues outside ATMs. There is a lack of capacity in reconfiguring ATMs. The problems are more severe in rural areas. Only a third of the adult population has banking services with a bulk of the banks located in cities while a majority of the population lives in villages. Recalibrating ATMs in remote areas and ensuring access to liquidity in banks in rural areas is a major implementation challenge due to capacity constraints. This has a massive negative spillover on the agricultural sector. The timing of the policy implementation coincides with the harvest season, destroying crop yields and leading to bankruptcy. There is a fear of an increase in farmer suicides.

Poor incentivization

In theory, the policy creates an incentive for compliance by providing an incentive to increase use of the banking sector and increasing reliance on digital frameworks for transactions and payments. However, the incentive may not be strong enough due to two reasons:

(1) lack of capacity restricting implementation and

(2) the incentive works on those with reasonably small sums in the demonetized tender, while those with larger sums have already parked their black money in other assets. This can be corroborated by the statistic that only 10% of the currency in circulation rendered useless has been recovered in the form of deposits while 90% is still outside the tax net. Correspondingly, there has been a surge in gold purchases and prices.

Infrastructure limitations

The move to digitize business and shift payments to phone networks to broaden the tax base requires an infrastructure to be in place. Does India have enough computers, fibre optic cables, 3G and 4G towers and the technical support to sustain the digital architecture to digitize businesses and run e-Governance? Not currently.

Inaccurate understanding of black money

Economists from Jawaharlal Nehru University and Jindal School of Business have pointed out that the policy assumes black money to be cash held by firms and individuals as the primary source of black money. However, much of black money is parked in real estate, gold, shares, offshore accounts and foreign currency. Black money decreases if deterrence increases. Demonetization only attacks existing currency but neither deters the generation of black money nor stops the regeneration of black money through the new tender. Furthermore, with the issuance of the 2000 Rupees note, it will be easier to hold larger sums easily. The argument against this is that increased monitoring and efficient tracking will curb the regeneration of black money. However, the policy has no provisions to increase the government's capacity to track suspect transactions or better collect and analyze financial intelligence. Some experts argue that this is not a case of a good policy with bad implementation but rather a bad policy to begin with. This view is gaining traction since the shock resulting from the policy seems to be disproportionate to the scale of the problem. This, however, cannot be ascertained without further research and monitoring the effect of the policy with time.

Convoluted tax system

Demonetization assumes that tax evasion is a chief factor for black money expansion. However, it fails to account for the fact that India has an extremely poor tax structure, often cited by foreign companies invited to invest in India to boost FDI. The tax system must be streamlined and integrated with the new policy direction. The Goods and Services Tax (GST) is a landmark move by the current government, passed in 2015. Its implementation is a cause for concern due to opposition in the Parliament.

Limitations to compliance due to norms of systemic malpractice in real estate

If I were to sell a piece of land, the norm in the real estate sector is that I would receive a certain proportion of the price – say 50% – in black money through cash. If I want an entirely white transaction, I would have to sell at a substantially lower selling price. Such norms in practice forces the general population to engage in financial malpractice. The practice is to sell at the market valued price but by paying in black money, both parties receive a share in taxes unpaid.

Expectations of economic fluctuation

The effect of demonetization on expected inflation is high. India's fiscal history shows that major economic policy decisions leads to fluctuation. The need for a note of high denomination is partially motivated by the devaluation of lower denominations with inflation. Since inflation is often in the form of food inflation, low income households are most affected. On the contrary, sectors known to be hotbeds for black money such as real estate are currently undergoing a disinflationary trend. From a macro perspective, estimates indicate that the rate of growth of GDP will be halved in 2017, with this trend predicted to persist until 2018.

The Way Ahead – Recommendations

This is a non-exhaustive list of recommendations that will help achieve the objectives of the demonetization policy going forward.

Abolish capital gains tax on sale of property

Real estate is the most popular avenue to park black money in India. Real estate transactions are also an obstacle to compliance. If capital gains tax on sale of property is abolished, a person selling land will demand the money be paid by cheque (in white) since s/he will no longer be paying tax on the money. This move can be extended to purchase and sale of gold. Gold is often viewed as an asset to hold black money. To project gold as an investment, abolishing capital gains tax on gold declared as wealth tax and held for over three years will make gold equivalent to stock, eliminating black money in the gold sector.

Capital Controls reform to end Hawala

Hawala transactions are a long-used tradition in cross-border trade in the Indian subcontinent. The cost of business in India and the time to set up a business is among the highest in the world, a major obstacle to India's efforts to attract FDI. This is further substantiated by India's standing in Chinn-Ito Index for measurement of capital-account restrictions rankings, where India ranks at the bottom of the table.

Streamlining the tax system

The current tax system is too convoluted, making evasion and tax fraud virtually inevitable. The current tax system should be overhauled for a new system that favors simplicity. If the Goods & Services Tax (GST) is passed soon and the GST and Income Tax become the primary taxes at the central level, compliance will increase and avenues of corruption will reduce drastically.

Too much government leads to corruption

Government intervention is often justified by market failure. However, the involvement of government leads to corruption, which is government failure. Assuming more government implies more failure, administrative reform is essential to curbing black money and corruption at the roots, ensuring demonetization is not futile. India should consider enacting something along the lines of the Federal Administrative Procedures Act in the United States which imposes benchmarks on transparency and efficiency on federal agencies.

Electoral Reforms

The Supreme Court of India has stayed all orders to stop demonetization on the grounds that the challenges to implementation will soon be overcome and will lead to achieving larger objectives such as electoral reforms. Elections are expensive and fought with large streams of black money. Electoral reforms must follow demonetization to end the dependence of political parties on black money funding.

Promote Digital India and the use of big data analytics

The hardships faced due to poor implementation notwithstanding, this is an opportunity to boost India's capacity to collect financial information and upgrade its monitoring and tracking capacity. Promoting the use of big data analytics can play a vital role in the successful implementation of demonetization by helping to:

- Uncover suspect and concealed transactions – A wealth of transactional information is being made available in the rollout phase of the policy. Using big data can help uncover trends in suspect transactions, making institutions like the Financial Intelligence Unit more efficient.
- Help further programs like the Aadhar Initiative by scaling up data mining and analysis
- Deter terrorism funded by black and counterfeit money by using big data to analyze unusual currency transfer patterns for terror activities, which are geographically-limited in India.