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War On Black Money

Demonetisation is a courageous reform that will bring substantive benefits

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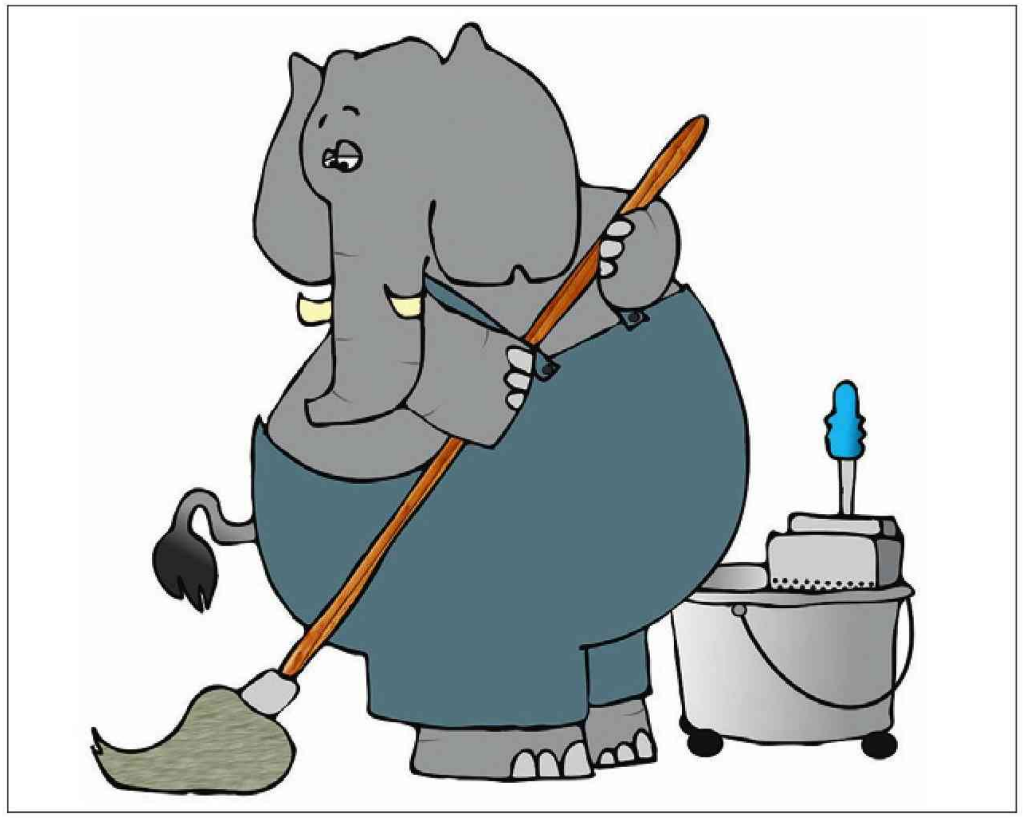

On November 8 Prime Minister Narendra Modi delivered a surprise reform to the nation: the government declared that the high-denomination 500 and 1000 rupee notes, which constituted more than 85% of currency outstanding in value, would be invalid as legal tender and could only be deposited into bank accounts until the end of the year.

This is a courageous and substantive economic reform that, despite the significant transition costs, has the potential to generate large future benefits.

India is largely a cash-driven economy, though a rapidly growing percentage of the population is becoming tech savvy. A shadow economy reliant on cash transactions and evading taxes, especially on high value transactions such as real estate purchases, gold, and intrinsically illegal activity, has taken deep and highly persistent root. Counterfeiting of Indian rupee notes and their subsequent use in funding of terrorist activities has also been an important concern.

While the pernicious effects of a large black economy and tax avoidance have been well recognised, no tangible policy action has been taken until now. Modi's radical move to invalidate the high denomination notes, in which the black economy primarily transacts, is a daring step.

Economically and politically powerful constituencies with considerable stake in the shadow economy have been upended. Undertaking this reform has required the political courage to impose predictable transition costs on the economy to lay the foundation for sustained future benefits – the converse of what one normally expects from one's politicians.

Some economists have advanced a criticism that this initiative is an abrogation of contract and trust in the currency. This is incorrect, as the policy allows for the exchange of old notes for new notes. Although the process is inconvenient, and subjects many households to hardships, it forces the cash from the black economy to be deposited into the banking system, potentially increasing transparency and expanding the tax base and revenues to the government from taxes and surcharges.

Inevitably, the Indian economy will move towards digitisation of economic transactions, with cash currency playing a relatively minor role. The argument that the policy is anti-poor is suspect as a significant fraction of the taxes and surcharges that will be collected from the reform initiative is to be allocated to social programmes.

Finally, it has been argued that the action is despotic. On the contrary, this action has been taken by duly elected officials within the framework of a democracy. To be effective, the policy required an element of surprise. Given this surprise factor and the magnitude of the reform, the rollout of the policy has generated predictable hardships.

The shortage of new currency notes and limits on withdrawals has led to considerable anxiety about wage and pension payments, and cash financing of even routine household expenditures. The frequent changes in rules during the past month, over how money deposited into accounts will be taxed, how much money may be withdrawn and which exemptions would apply, for instance, have led to unnecessary confusion.

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Nevertheless, there has been an impressive level of support at the grass roots level for this reform, as evidenced by the absence of any rioting, looting or acts of mass protest. But the policy makers must manage this transition process efficiently and with empathy, to ensure sustained support from the common man.

As per the Income Tax Amendment Act of November 28, 2016, the government will tax unaccounted income deposits at 50% and will only prosecute those who, upon investigation, are found to have engaged in illegal or criminal activity. This move is hoped to motivate the transfer of wealth from the black economy to the banks.

Several recent developments suggest that the demonetisation drive may well yield significant benefits.

First, around 80% of the currency in higher denominations has now been deposited back into bank accounts. Since individual deposits will now be matched with their tax returns and unaccounted deposits will be taxed, this will yield a windfall for the government permitting large increases in social expenditures.

Second, we already see an impressive switch into digital transactions. Thus, this one-time demonetisation itself could have long-term beneficial impact by nudging reluctant consumers into e-payments, whose transparency will ensure greater tax compliance and a higher permanent tax base.

Third, the government's action taken will put a major dent in counterfeiting. With the new notes being much less prone to counterfeiting, social benefits will be earned immediately.

In any other time, one would have to be unreasonably idealistic to expect, from politicians, a major economic reform, which offers substantive benefits in the future, but comes with significant political costs in the transition period immediately following the reform.

India, however, seems to have voted in a prime minister who is prepared to take on political risk in his efforts to fulfill his commitment to root out corruption – and has promised even more. We await his next steps.

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