Tectonic Purge

Changing the Growth Trajectory

The Sunday Statesman

20 November 2016

Over the long weekend, I had planned to escape the toxic air of Delhi and flee to the tranquil hills of Uttarakhand to breathe some fresh air, but had to drop the plan abruptly for want of cash. For the same reason, we have not been able to buy any fish, fruits, vegetables or medicines ever since ₹ 500 and ₹ 1000 notes were withdrawn last week, and been forced to survive only on roti and dal of which we had a stock. Given the unending queues at the bank, the plight is likely to continue for some more time. I am sure most of you are also being forced to go through this logistics nightmare. But I am not complaining. Reforms are always painful, and the pain is necessary to cleanse the body politic of harmful viruses. But in its significance and potential benefits, this step was indeed a master stroke. In one swift move, the Government has eliminated most of the black money currently circulating in the economy, even though the growth in some sectors may suffer in the short term, bringing down the growth rate of GDP during the current fiscal.

The measures were not unexpected though, they are the logical culmination of a series of relentless steps the Government had taken over the last two years against black money –Jan-Dhan Yojna and opening of bank accounts for everyone, renegotiating the tax treaties and automatic information exchange agreements with other countries and tax havens, the Black Money Act, 2015 and Benami Property Act, 2016, nudging people to declare their undisclosed income through the Income Declaration Scheme, and some other measures. The demonetisation was only to be expected as the next logical step.

As is often misunderstood, black money is not necessarily generated through corruption, neither is all the black income necessarily cash income. Many normal business transactions legitimately generate large volumes of cash – for example, textiles, jewellery, luxury goods, household appliances etc. Professionals like doctors and lawyers also trade mostly in cash. Demonetisation may disrupt such businesses by curtailing consumer spending on these goods and result in their negative growth for some time. While businesses and people dealing with legitimate cash have nothing to fear, the ban on higher denomination notes is sure to hit those who are holding large amounts of black money in cash. Much of the black cash may never surface at all. We, the common man, will only suffer some temporary inconvenience, but no financial loss or harassment by tax authorities.

The total amount of black money currently circulating in the economy is anybody’s guess. The size of India's black economy had expanded rapidly over the 1970s and 1980s, but since then has been contracting slowly. A recent study estimated it at 20% of GDP or about ₹ 30 lakh crore. Majority of this black money is believed to be locked up in physical assets such as real estate and gold. The withdrawal of higher denomination notes will certainly and severely impact the real estate sector, especially the secondary market transactions where 60:40 ratio is believed to be the norm between legal and black money.

India's economy remains overwhelmingly a cash-driven economy. In 2015, 78% of all consumer payments in India were made in cash, against 20% to 25% norm in developed economies. The total value of currency in circulation in India today amounts to ₹ 17 lakh crore, and 86% of that cash, amounting to ₹14.6 lakh crore, are only in ₹500 and ₹1000 denomination notes. While the total number of bank notes in circulation rose by 40% between 2011 and 2016, the circulation of ₹500 notes rose by 76%, and that of ₹1,000 notes by a whopping 109%, during this period.

The most corrupt who are having the largest stocks of illegal cash will obviously suffer, because they cannot easily deposit the money that would be under surveillance and risk going to jail. So these moneys do not surface at all, and as pointed out by experts, since the notes are a liability on the account of RBI even though the liability may be notional, RBI's and hence the Government's liability on this account is automatically reduced. The rest of the illegitimate cash will get sucked out of the black money market to enter the normal financial system, where they will contribute to tax along with a 200% penalty.

Given the estimated size of India's shadow economy of ₹ 30 lakh crore, ₹ 7 lakh crore, or 50% of the total value of ₹500 and ₹1000 denomination notes, might be a conservative estimate of the black money lying in cash. Even if 10% of this is destroyed, the rest will enter the banking system, where, along with penalty, they are likely to contribute between ₹ 4 to ₹5 lakh crore as tax to the Government coffer, which almost wipes out our entire fiscal deficit. In one deft stroke, the Government has ensured an almost deficit-free year, and hence obviating the need for fresh borrowing. It can use the excess liquidity to significantly increase the investment in income- generating capital assets, and also in human capital, both adding to future growth.

Now think of the cascading effect of this. As the black money gets sucked out of the market, several sectors like real estate will be forced to correct their current prices, leading to a fall in inflation. All the moneys that will now enter into the formal financial system will continue their contribution to future taxes, as their tracking by tax departments will become easier. As inflation falls and taxes increase, government finances will improve. If the Government uses this increased liquidity judiciously and do not squander it in useless populist schemes, the fundamentals of economy will get stronger, and accelerated GDP growth will more than make up for the temporary loss we are likely to witness in the short term. As inflation drops and liquidity improves phenomenally, interest rates will certainly drop giving a significant boost to economy, by far more than the RBI can ever hope to do through manipulation of its policy rates. There will of course be a transfer of investment from physical assets like real estate and gold to financial assets as people will shift their investment preference - to dollars or equity where they can still save taxes. Coupled with lower interest rates, this will in turn boost the corporate sector, hopefully creating the badly-needed jobs. The excess liquidity with the bank will also help them manage their NPAs to some extent.

The black money market will of course spring up again, it definitely will, and high denomination cash will continue to be used as conduits for corruption and hoarding of black money. But there are two aspects to it. The first is psychological - people who have lost money now will think twice before hoarding cash. This psychological aspect can be a very important determinant of behaviour. The second is based on pure economic logic. The accumulation of black money can reach dangerous levels only over a period of time, and is triggered by retrograde economic relationships established through political machinations – retrograde because that they hinder the normal operations of market forces. Left to itself, the invisible hand of the market has a way of wiping out anything that affects its normal operation. The current built up of black money can perhaps be traced to those days when the marginal tax rates were as high as 97% and there were various other distortions arising from the faulty command and control economic model that we followed. The Janata Party's 1978 demonetisation of ₹1000, ₹5000 and ₹10000 notes did not help because those days, these notes constituted only a tiny fraction, about 1.6%, of the total value of currency; even in 2001, their value was only 25%, against 86% now. Besides, the tax system today is much simpler, rational and taxpayer-friendly; it is poised to become even more simpler in future, thus creating an in-built disincentive against black money. Governments today can also be expected to display more maturity and not to interfere in the market unnecessarily. When the cost of tax compliance becomes lower than the cost of tax evasion, generation of black money becomes uneconomical. Thus in future it may take much longer to build up the stock black money to a level where it will start distorting the normal economic processes.

The ₹2000 notes may also be demonetised in not-too-distant future, scooping up whatever will be left of the black money currently in the system, and ₹1000 notes reintroduced. But as of now, this step is truly 'surgical strike' against black money that may change our growth trajectory for the next decade.