



DEMONETISATION TO OUST BLACK MONEY IN INDIA: A SUCCESS OR FAILURE?

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ABSTRACT

Demonetization of high valued Indian currency notes of Rs. 1000 and Rs. 500 on 8th of November 2016 has shaken the country by disrupting normal behavior of Indian politics, economy, and society. The ruling coalition quickly articulated this as a big-bang step to unearth black money and attached its success in the elections held in the country post-demonetization as an endorsement of people for the demonetization decision. The opposition, on the other hand, has termed it as an 'organized loot' and irresponsible step that adversely affected all sections of society, especially the poor who were dependent on a hard hit informal economy. Now, with 99 percent of the demonetized currency deposited in the banks, the government faces difficult questions, if the move was at all worth? Why the government announced it without due consideration and failed to foresee its adverse consequences. This paper, in the hindsight, revisits the expectations and objectives of demonetization, and critically analyses its both positive and negative effects.

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INTRODUCTION

Demonetization of high valued Indian currency notes of Rs. 1000 and Rs. 500 on 8th of November 2016 has shaken the country by disrupting normal behavior of Indian politics, economy, and society. The ruling coalition quickly articulated this as a big-bang step to unearth black money, impair terrorism funding and weed out fake currency from the system. The opposition, on the other hand, has termed it as an 'organized loot' and irresponsible step that adversely affected all sections of society, especially the poor who were dependent on a hard hit informal economy. Consequently, however, it rewarded the ruling Bharatiya Janata Party (BJP) by winning elections at every level held in the post-demonetization period, which reflected as an endorsement of people for the demonetization decision of the government. The public jury on the success and failure of the move has however remained inconclusive till the release of demonetization statistics by the RBI only recently. With 99 percent of demonetized currency deposited in the banks, the government now faces difficult questions, if the move was at all worth? Why the government announced it without due consideration and failed to foresee its adverse consequences.

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This paper, in the hindsight, revisits the expectations or objectives set for demonetization and critically analyses its both positive and negative effects. While doing so, as the event is most recent, the author depended on latest newspaper and magazine reviews, articles and reflections on the subject. Section 2 of the paper underlines the distinct forms of black money, their impact on the economy and potential impact of demonetization on them; section 3 lists the expectations or objectives of demonetization; section 4 discusses the success and failure of demonetization based on the expectations or set objectives, and finally, section 5 concludes the paper.

Forms of Black Money

Black money is referred to the income earned from any illegal activity, like drug trafficking, weapons trading, gambling, etc. or from any illegal practice like receiving a bribe, under-reporting income and evading tax, which is regulated and prohibited by the country laws. It is important to recognize that all black money is not same that it varies in terms of its source and nature and thus its impact on the economy. Therefore, the constituent of black money may be distinguished into three forms such as first, income earned from illegal activities; second, income earned from illegal practices; and third, income earned from legal activities but evaded tax. First, it consists of income earned from illegal activities like drug

trafficking, weapons trading, terrorism, organizing murder, gambling, selling counterfeit or stolen goods, etc. The presence of this form, if significantly large, is a serious threat to the internal and external security of the nation, apart from its severe negative impact on the economy. Proceeds received under this category are believed to be in large amounts, from underground economic activity and, as such, are not taxed. Mostly, they are hidden and spent outside the country or spent in the underground economy. It helps flourish the black economy at the cost of formal economy. Organization of production, employment, and trade under these illegal activities may be completely dependent on cash. However, the dependence on cash may not be entirely on the rupee, a significant part of its transactions may also be taking place in dollars or other currencies since it involves international transactions too. Though we have some evidence of the existence of this underground market, no reliable estimations are available except guesstimates. Guesstimates may over-estimate or under-estimate the real picture. Whatever may be its size, demonetization of high valued currency had the potential to severely, though temporarily, impair rupee component of this market. Nevertheless, assets of the black or illegal marketers are not affected.

Second, black income earned from illegal practices like corruption by politicians, government officials, traders, etc. is a less severe form of black income compared to the former but is a social parasite, as it increases inequality and diverts resources from the honest and hardworking workers to the most dishonest and illegitimate people. Most part of this income is also spent underground or in overseas markets, stashed in foreign currency outside the country, converted into undervalued properties, gold, and jewelry, etc. Relatively, a small part of it may be held in cash in India. Of late, there is increasing awareness and condemnation of corruption in the Indian society (Sood and Baruah, 2017). Thanks to Shri Anna Hazare movement against corruption. Demonetization of 500 and 1000 rupee notes was supposed to impact the cash component of these black money holders.

Third, this part of black income constitutes income earned from legal activities but evaded tax on it. Holders of this kind of black money are real estate owners and traders, medium and small level enterprises, businessmen, landlords, consultants, lawyers and doctors who do not disclose or under-report their incomes. The negative impact of this form of black income on the economy is much less severe than the former two. Because a major part of this income is consumed in India, therefore contributes to indirect taxes, though evades direct taxes.

While the former two forms of black income understates GDP through leakage of income, consumption demand and investment from the formal economy that leaves the Reserve Bank of India (RBI) and the government unaware of the extent of its existence making their monetary and fiscal policy less effective or ineffective, the third form of black income is expected to be covered under GDP accounting through expenditure method. Demonetization seems to have had a greater impact on the third form of black income holders, as they used to hide their past undisclosed tax-evaded income in cash for months and may be in years in order to accumulate sufficiently to be able to buy property, gold, high valued cars and luxury goods. The campaign for the promotion of digital payments is also expected to limit the capacity to hide income and evade tax in the future, while the same will have only

small or insignificant effect on black marketers or bribe-takers who would, in any case, transact in cash.

Expectations of Demonetisation

The decision to demonetize high valued Indian currency was based on the following aspirations. There was an anticipation of 3 to 4 lakh crores of Indian currency taking rounds underground (or illegally) evading tax and undermining the actual Gross Domestic Product (GDP) of the nation. This estimation has come from the belief, according to the World Bank estimation, that the size of the black economy in India was about 23.2% of GDP in 2007. It accounts about 37 lakh crores, i.e. 23.2% of 160 lakh crores of GDP in 2016. Even if 10 % (i.e. about 3 to 4 lakh crores) of it assumed to be held in cash that could be seized through demonetization would bring in enormous benefits to the economy and the government in financing development plans. There was also a hunch that a huge number of fake currency notes of high-value denominations is in circulation which is causing undue pressure on inflation, and thus, adversely affecting the stabilization policies of the Reserve Bank of India (RBI) and the government. Demonetization was expected to help not only weed out the fake currency from the system but also make it difficult to copy-printing of the new currency with advanced security features (Potnuru, 2016). Moreover, other positive effects on the economy foreseen through this cash clean-up drive are increased tax compliance, digitization, formalization of the informal sector, etc. that would lead to enhancement of GDP. Based on the above expectations, the government articulated the objectives of demonetization as follows: 1) to evict the fake currency notes of Rs. 1000 and Rs 500; 2) get rid of black wealth held in cash by the corrupt people; 3) bring back the hoarded money of small savers into the banking net; 4) based on the hints provided by bank accounts, undertake Income Tax (IT) raids to recover unaccounted wealth from suspicious individuals and corporates who possibly have evaded tax in the past; 5) finally, use the window of time to introduce digital avenues of payments limiting cash transactions.

Fallout of Demonetisation

As against the above targets, the demonetization report card is as follows. As per RBI report, only 7.62 lakh pieces of fake currency notes worth Rs 41 crores had returned to the banking system. Second, contrary to the belief of Rs. 4 lakh crores of black money that is expected not to be reported by hoarders with the fear of prosecution, only Rs. 16,000 crores (1 percent of Rs. 15.44 lakh crores of demonetized currency) did not come back to the system. This rules out any significant special dividend to the government and the RBI equivalent to the amount of black money, as was anticipated earlier. As a positive consequence of demonetization, the tax authorities, however, could discover an undisclosed income of Rs 17,526 crores and seizure of Rs. 1003 crores through searches and surveys so far. This number too is not significantly very high compared to the identification of undisclosed income and seizure of gold and cash during pre-demonetization years. For example, the Government of India's white paper on black money brought out in 2012 shows that in 2010-11, Rs. 775 crores worth cash and jewelry have been seized, which increased to Rs. 906 crores in the following year. Undisclosed income detected in 2010-11 was about Rs. 10,649 crores (Ministry of Finance, 2012). These numbers can roughly be

projected using their growth rates to a possibility of 1,003 crores of the seizure of cash and gold and detection of an undisclosed income of Rs. 17,526 crores that the IT authorities achieved in 2016-17. The Pradhan Mantri Garib Kalyan Yojana (PMGKY) which offered another opportunity to unaccounted cash holders to come clean and deposit their cash by paying 50 percent of it as tax, penalty and surcharge, and parking an additional 25 percent for four years without interest. This scheme too has not produced results as anticipated, only Rs 2,300 crores was collected against the I-T department's target of Rs 1 lakh crore. Together, all these direct monetary benefits accrued may accumulate to about 35,000 to 50,000 crores only. Third, though demonetization has successfully mobilized all money, including that of small savers such as house-wives, small traders and businessmen who hoarded money for several months and years, into the banking system. These funds with the banks are expected to be used for productive purposes by lending at cheaper rates of interest. Most of these funds, however, were short-term savings and therefore were expected to be withdrawn quickly rather than of any use for long-term lending purposes by banks. The black money holders who laundered money into the deposits up to the limit of rupees two-and-half lakhs in several bank accounts opened in the names of several people who are either relatives or otherwise agreed to park money in their accounts for a commission. Such deposits too were expected to be dried-up quickly when withdrawal limits were lifted. However, holders of the bank accounts that exceeded the limit of Rs. 2.5 lakhs were liable to pay taxes to the government. The latest Economic Survey estimated that demonetization has added 5.4 lakh new tax-payers in the financial year 2016-17 (Andrade, 2017). However, the average income quoted by these new taxpayers is only Rs. 2.7 lakhs, which would mean that they were required to pay tax on an income of Rs. 20,000 only, as income upto Rs. 2.5 lakhs is granted an exemption. Also, most of these new taxpayers may not continue to stay in the tax-net, as next year they are not required to deposit whole of their cash collected or accumulated throughout the year.

Another non-monetary benefit the government sensed followed by demonetization was that the period of re-monetization of currency provides a window of opportunity to convert the economy into a less-cash economy. This came as a big bonanza for digital payment platforms such as Paytm and other e-wallet companies which quickly experienced a surge in their of daily transactions from about 17 lakhs on 8th Nov to 63 lakhs on 7th Dec (a growth rate of 271 %), at the peak of the re-monetization period. In terms of value, it has increased from Rs. 52 crores on 8th November 2016 to Rs 191 crores (267%) in the same period. These windfall gains made the e-wallet companies to rapidly expand their operations. In terms of total volume of digital transactions from all service providers, it rose from 671 million in November 2016 to 957 million in December 2016 but dropped to 862 million in July 2017. In terms of value, the transactions spiked to Rs. 1,044,055 billion in December 2016 but dropped to only Rs. 107,481 billion in July 2017 (Matharu, 2017 and Menon, 2017).

Conclusion

Thus, if the slowdown in the economy post-demonetization by 1 to 2 percent of GDP growth rate constituting a loss of income of Rs. 1 to 2 lakh crores (Business Standard, 2017), plus the new currency printing (Rs. 7,965 cr.) and

transportation (Rs. 16,000 cr. as on 6th December 2016) costs, caused inconvenience and while standing in the queues loss of lives, etc. are considered, then the demonetization, as an economic case, does not stand the scrutiny. Clearly, the costs outweighed the benefits. Expected long-term benefits such as growth in tax revenue, digitization, and a decrease in corruption are not convincing or foreseen now for the future, as much as the dreams sold by the experts and the government in the beginning. The cause for dispiriting results of demonetization is that the case for demonetization has been made out of the excitement and only perceived understanding of its potential to curb black money rather than by backing up the decision through any systematic investigation and planning to implement (Chandrasekhar, 2017). While it is essential that India should reduce its dependence on cash and go digital as it moves ahead in the path of development, it is doubtful if the current campaign can work, as slogans for the cashless economy are not accompanied by costless or less-cost ideas in doing digital transactions. Neither the service provider companies including banks can provide digital services free of cost nor can the government subsidize them permanently. India needs to develop rapidly its IT infrastructure, achieve higher levels of education, and per-capita income, and way of living of people to become less-cash dependent economy. What needs to be done to curtail the black money is to fix the demand for black money that comes from political parties, real-estate business, government-private sector nexus rather than focusing on to curtail the supply of black money through cash-less measures.

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