Show me the money

Ban on Rs 500, Rs 1000 notes deals with stocks of black money. But push to a cashless economy is premature

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THE SUDDEN AND dramatic announcement by the prime minister banning Rs 500 and Rs 1,000 notes issued by the Reserve Bank of India has a number of objectives. Among them are tackling counterfeit notes, curbing black money and restricting finance for subversive activities. While progress will be made by suddenly making the present high denomination currency illegal, we need many more steps before the desired objectives can be fully achieved.

One of the main objectives of replacing old currency notes by printing new notes is to tackle the problem of fake currency notes in circulation. In India, there is fear that counterfeit currency is being used for financing terror as well as other subversive activities. If security features of the present notes are weak and there is rampant counterfeiting, there is a need to replace these with new notes that have better security features. Usually, this is done gradually. So, for instance, the RBI could have started issuing new Rs 500 notes, allowed old notes to be exchanged for new ones and issued a deadline after which the old notes would not have been legal tender.

This is typically the strategy followed by most central banks, who are, in general, in a constant battle with counterfeiters. Curbing counterfeiting of internationally accepted currencies like the US dollar, which is used all over the world for legal and illegal activities is supposed to be a constant challenge.

In India, the problem of fake rupee notes has been noticed for many years. It has been difficult to estimate the size of the fake notes in circulation. It is not known whether the counterfeiting is done in India or across the border. Currency notes with better security features are certainly welcome, though it is not obvious that such a sudden move would make a big difference to this objective. It could have been done slowly with banks not giving out old notes until the last hour.

While the ban may address the problem of the stock of black money in cash, the question is will it encourage people to disclose all income and start paying taxes on it? Or does that require simplification and rationalisation of the tax system? As long as agricultural income can be used as a route to avoid taxes and indirect tax rates have multiple rates and exemptions, the problem of tax evasion is unlikely to go away.

Then, the objective of curbing black money. Black money is money that has not been declared as income to the income tax authorities. It is not necessarily obtained from crime or corruption. It may be acquired by not showing the output of a factory and not paying excise on it. All black income is not held in cash. For instance, it may be in foreign bank accounts. Similarly, all cash is not black income. Legitimate businesses deal with large amounts of cash. Petrol pumps, white goods dealers, textile merchants and jewelers often have large cash holdings by the end of the day with many consumers paying in cash.

Cash will either have to be exchanged by the holder at a bank himself or through someone. For some days, it will be disruptive for business. It would not be surprising if, in some time, a black market pops up to exchange old notes for new notes, thereby converting black money into white. This could be in the 50-day period in which the old notes can be exchanged with new ones. There would, no doubt, be a discount, if this happens.

But the ban will certainly hit those who are holding black money in cash. Corrupt bureaucrats, politicians and many more with piles of cash must be wondering how to handle the situation and how long to wait before they try to solve it. Since the present high denomination notes are going to be replaced by new notes, it is not that cash will no longer be used for corruption and storing black money — though it is likely that dollars, gold or diamonds could become more popular for such illegal purposes due to the fear of such a ban recurring.

However, while the ban may address the problem of the stock of black money in cash, the question is: Will it encourage people to disclose all income and start paying taxes on it? Or does that require simplification and rationalisation of the tax system? As long as agricultural income can be used as a route to avoid taxes and indirect tax rates have multiple rates and exemptions, the problem of tax evasion is unlikely to go away.

On the negative side, the disruption in transactions could hit the emerging growth of consumer demand. In 1978, India denotified the 1,000 rupee note, and nothing much happened. A black market sprang up, people who had these notes took a loss while selling off these notes to people who could claim these as legitimate income. At the time, those notes were 0.6 per cent of the cash in circulation. Things are more daunting this time as 85 per cent of the cash in circulation is in the old Rs 500 and Rs1,000 notes.

A monetary economics perspective is useful. In India, there is one concept of money supply for the formal economy (the total money in all banks) and another concept of money supply for the informal economy (the cash in circulation). We will have an 85 per cent reduction in money supply for the informal economy for some days. Money is the means of transacting in the informal economy — payments will be held up and purchases will be postponed.

Some see this move as a way of pushing the country forward towards a cashless economy. There are two problems with this perspective. First, it is not that high denomination currency notes will go away. The existing notes will be replaced by new notes. Second, the cashless ecosystem is not ready to support a whole range of new users; this push is premature. Those who move from the denotification of the Rs 500/1,000 notes will not take to electronic payments. Their quest could instead take them to new notes, gold, US dollars and the bitcoin.

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