

Maximum pain

Objectives of demonetisation could have been served better by doing a cost benefit analysis



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THE RBI ANNUAL Report reveals that almost all demonetised notes have been returned to the central bank. This number does not include the old notes with District Central Cooperative Banks for the short window when they were allowed to accept deposits. It also does not include the notes within Nepal. The shortfall of Rs 16,050 crore between the notes in circulation when the notes were demonetised and those that were returned, could therefore also be made up once these notes are returned to the RBI.

It should come as no surprise that almost all the notes have been returned, including the stock of black money held as cash. To the extent that it was possible to exchange money legally, individuals did so. When cash limits for withdrawal made it difficult, friends and families participated. The inconvenience of long queues was overcome by household staff. A private company offered booking of "chhotus", who would stand in long queues for people for Rs 90 an hour until their turn came. Bank employees were averse to being unhelpful to regular customers and found ways to serve them. Innumerable ways were found to work around the changing rules of exchange, cash limits, indelible ink and specified uses of old notes.

Those who could not exchange money legally found money changers. Innumerable anecdotes, media reports and arrests of bank staff tell stories about how this was done all over the country. When the government announced that old notes could no longer be exchanged, but only deposited, new ways of changing the stock of unaccounted cash emerged. Individuals with bank accounts, including Jan Dhan accounts, and companies showing cash accrual from sales came into business. Large amounts could be laundered through this route as it did not involve immediate cash payouts by banks, since cash shortages still persisted with the RBI and banks scrambling to reissue the economy.

It was to be expected that even if people have to pay tax on their hoarded cash, and a change fee, they would prefer to do that rather than lose the whole amount. Data

International evidence suggests that few countries address the problem of black money by demonetising their currencies. If the problem is large-scale crime, corruption, bureaucrat-politician nexus, tax evasion etc. the answer lies in reforming the criminal justice system, law and order, administrative reforms, bringing transparency in the functioning of the state and rationalisation and simplification of the tax system. In this context, the GST will be a far more effective mechanism to bring down tax evasion in indirect taxes considering the greater incentive for compliance that its design holds.

from Prowess, a database of companies in India, shows that in the quarter of demonetisation, when purchasing power had fallen sharply, net sales by companies rose significantly. At the same time, the number of tax payers and tax collections rose. The tax department is said to have found thousands of shell companies which were possibly engaging in the activity of depositing money in their accounts during the demonetisation period, claiming that it was cash from sales. This provided a means for laundering money.

The total currency in circulation, according to the RBI's annual report, is about Rs 2 lakh crore short of the pre-demonetisation period. This is partly due to the increase in focus on printing of lower denomination currency notes. Initially, the RBI had focused on printing the Rs 2,000 notes to rapidly reissue the economy. In addition, there could be some reluctance to hold cash. The replacement of cash transactions by digital transactions, the slowdown in small-scale industry, in the rural economy, construction and other informal segments of the economy could also lead to somewhat lower demand for cash. However, it is less probable that the cash of black money holders has not been withdrawn because they are unlikely to leave that in the bank accounts of the money launderers for long. It might have partly been settled for bitcoins, gold, or similar assets that are difficult to trace.

There is no doubt that those with holdings of unaccounted cash lost some of their wealth in the process of laundering it. To some extent, taxes were paid on it in the process of legitimising it. But in addition to that, illicit wealth was redistributed from black money holders to money launderers. Whether the money launderer was a company owner, a bank employee or a Jan Dhan account holder, there was now a need breed of criminals with wealth obtained from illegal means. The total reduction in black money was therefore much smaller than what might have been envisaged.

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money by demonetising their currencies. If the problem is large-scale crime, corruption, bribery, bureaucrat-politician nexus, rent seeking, tax evasion etc. the answer lies in reforming the criminal justice system, law and order, administrative reforms, bringing transparency in the functioning of the state and rationalisation and simplification of the tax system. In this context, the GST will be a far more effective mechanism to bring down tax evasion in indirect taxes considering the greater incentive for compliance that its design holds.

The real rationale for new notes by the RBI is a rather innocuous paragraph hidden away in its Annual Report. It says: "As a standard international practice, the design and security features of banknotes are reviewed periodically. In line with this practice, a new series (Mahatma Gandhi New Series) of banknotes in new design, dimensions and denominations, highlighting the cultural heritage and scientific achievements of the country, was introduced during the year. As part of this process, banknotes in the denominations of 500 and 2000 were introduced on November 8, 2016. New design notes in other denominations are due for phased introduction." (Section VIII.15, RBI Annual Report 2016-17).

The best way of achieving this objective would have been to slowly replace old notes with new ones, giving the public adequate time to exchange and deposit old notes, as is also "standard international practice". The outcome would have been the same. The pain would have been much lower.

This episode in India's policy-making highlights an essential tenet of policy-making—the need for a cost benefit analysis. For any objective that is to be achieved, we need to examine various policy options and analyse their costs and efficacy. For an economy on the path of reform, with many more reforms still to come, long-term sustainable impact can be achieved only when we strengthen the policy-making process as well.

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