

The fuzzy impact of demonetisation

DeMo does not seem to have impacted black money hoards. It may, however, lead to improved tax compliance in the long run

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The recently released Annual Report of the Reserve Bank of India for 2017-18 has revealed that 99.3 per cent of the high denomination notes were returned to the banking system. In other words, only about 0.7 per cent of the value may have been “extinguished” – this is the fraction that was being attributed to unaccounted incomes, if at all. This number should be taken with a pinch of salt, since for one, countries like Nepal and Bhutan where Indian currency has served as a proxy currency, are reportedly requesting for a facility to exchange notes held by their citizens.

Further, anecdotal evidence seems to suggest that citizens within the country could be holding some balances as well since they couldn't exchange the said amounts for a variety of reasons. Since the latter cannot be considered to be manifestation of unaccounted incomes, clearly, demonetisation as a means to dry up unaccounted wealth held in stocks of currency cannot be said to have yielded immediate results.

There has been considerable discussion on the likely impact of demonetisation on a range of parameters such as growth in the economy, compliance with tax regimes, and impact on the informal economy, to take only the economic factors. It is possible to argue that while the direct impact of demonetisation through currency not returning to the banking system did not play itself out, the measure could have had some indirect impact through improvement in compli-

ance for income tax.

The CBDT has provided some evidence on increase in the number of taxpayers as well as in the revenue collections, especially in personal income tax. The rate of growth of income tax collections, particularly personal income tax collections, has inched up over the levels reported since 2010-11 – the rates of growth in 2016-17 and 2017-18 are 21 per cent and 25 per cent respectively. The same holds for all direct taxes taken together.

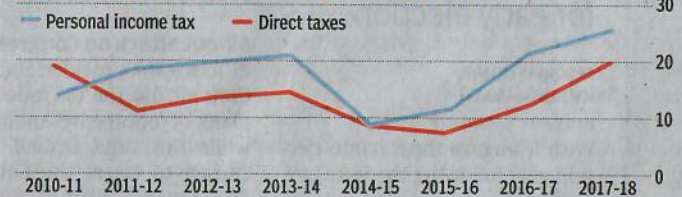
Further, the number of returns filed too has reported a sharp increase – in 2017-18 compared to 2016-17, the number of returns have grown by over 50 per cent in some categories of returns. However, when these numbers are put together, it is apparent that the average tax per return must have fallen significantly. In other words, a number of nil filers or people with little tax liability might now have been brought into the tax regime. This could encourage compliance in the long run, if the taxpayers can be retained in the system.

Growth impact

Turning to the impact on the economy, it is now recognised that there was a decline in the rate of growth of GDP in the months following demonetisation. Growth rate for the first quarter of the financial year 2017-18 dropped to 5.4 per cent. It is interesting to see what the expenditure side of GDP reveals. There appears to have been considerable increase in the expenditure on valuables during this period.

Such spending does not contribute to expansion in productive ca-

Growth in income tax collections



DeMo effect The full impact is yet to be unravelled V RAJU

capities in the economy, nor does it result in expansion in demand for other sectors in the economy. If one excludes expenditure on valuables from the calculations, the rate of growth of rest of GDP falls further to 4.1 per cent.

Even in the next quarter, the rate of growth without valuables is lower at 5.7 per cent as compared to 6.3 per cent with valuables. In other words, the immediate impact is a reduction in growth with the recovery led by government expenditure.

The second expected economic impact was a boost to the use of financial substitutes of currency as well as a shift from physical savings to financial savings. The Annual Re-

port of the RBI for 2017-18 suggests that net financial savings of households as a percentage of gross national disposable income had declined in 2016-17 to 6.7 per cent when compared to 8.1 per cent in the previous year. For 2017-18, it has increased to 7.1 per cent which is barely on par with the levels reached in the earlier years of this decade. The surge in the use of cash to exceed pre-demonetisation levels suggests that comfort in cash based transactions continues to persist.

In other words, the dramatic changes in the economy, and in behaviour that DeMo was expected to bring about, have not been comprehensively witnessed.

There are two other aspects one needs to look at. First, did informal substitutes to currency take root during this period? Here anecdotal evidence suggests that there was a surge in purchase of digital currencies with a premium in the Indian markets over the international prices. Exploring digital currencies might have happened in the natural course of things, but demonetisation, it is argued, has accelerated the interest in alternatives.

Formalisation push?

Second, formalisation of the economy as measured by the share of transactions on which taxes are paid should have received a boost. Unfortunately, we do not have evidence on this aspect of the economy, since the methodology of measurement of GDP only measures the formal sector and attributes the same growth to the informal component of the economy. Formalisation should have led to an expansion in the formal component at a cost to the informal component.

However, if one looks at trends in indirect tax collections as a proxy for formalisation in the economy, then the shift from informal to formal is not in evidence.

In fact, the lacklustre performance of GST collections seems to suggest that either the size of the informal sector in the Indian economy was not very large to begin with or that both these measures – demonetisation and GST – have not made a substantial dent on formalising this informal sector.

It is indeed worth attempting another base correction in GDP estimation to disentangle the impact on the informal economy.

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