Black Money And Demonitization In India; A Glimpse

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ABSTRACT

In 2016 The Government of India declared that the Rs 500 and Rs. 1000 denominated currency notes will stop to be legal tender. The move was besieged towards tackling corruption, black money and terrorism. After initial euphoria, questions began to materializewhat are the expenses of this demonetization? Will it be valuable if people can still create new black money thereafter? Will it amplify the GDP? Will it augment inflation? What about tax revenues? We will look for answers.

Keywords: India, black money, demonetization.

BLACK MONEY AND DEMONETIZATION

To start off, black money is a wider communalailing and demonetization is but one step in the war adjacent to black money.Black money and black economy are also two dissimilar constructs. The terms shadow economy and underground economy is also used as synonyms for black financial system. Black money is the currency of black economy. It refers to against the law money earned from all the illegal sources which has not been disclosed to the Indian government. The advantage of black money is that it links into the genuine economy, uses the recompense of the legitimate economy but does not pay the expenses.

RESEARCH ON TACKLING BLACK MONEY

The subject of black money has been well-explored. The National Institute of Public Finance and Policy has been on the go in study about black money. Their 1983review of estimates of Black Money1 led to ainformation on Aspects of Black Money2 in 1985. The information of 2012 titled Measures to deal with Black Money in India and Abroad3 and the 2012 White Paper on Black Money4 by Ministry of Finance covers the different research studies and updates them. These studies however have not been capable to decide a constant estimation of the black economy. The estimates, together with from other sources, vary from 15% to 45% of the total economy. The papers, however, give a broad field of mechanisms to deal with black money.

Separately from the above Indian initiatives, there have been global initiatives to attempt "underground economy" or "shadow economy". Primarily, the principles wait the same. Internationally, I find, they focus more on facilitateintentional compliance than enforcement. Maintaining belief and assurance in tax system takes precedence5. They also suggest risk based monitoring mechanisms, coordination amongst revenue departments and education among other things6.

1http://www.nipfp.org.in/publications/working-papers/1509/

2http://www.nipfp.org.in/book/927/

3http://dor.gov.in/sites/upload_files/revenue/files/Measures_Tackle_BlackMoney.pdf

4http://finmin.nic.in/reports/whitepaper_backmoney2012.pdf

5Comparing how some tax authorities tackle the hidden economy by UK National Audit Office Rand Europe 2009

6Reducing opportunities for tax non-compliance in the underground economy – Information Note dated January 2012

Principles Of Tackling Black Money

The first law is that take out the systemic sting that leads to formation of black money in the first place. Blame lies with the tax sector. Black money is nil but money generated in reasonable transactions which are secret from government so as to keep away from paying the transaction cost (usually tax) in the legitimate economy7. This is generally done by using physical cash. This cash thereafter must be processed to change into utilization or investment. Black economy refers to different activities, transactions etc. that help process this physical cash, make returns on this cash, facilitate utilization using this cash etc.

The next principle has two parts. First, not all cash transactions are automatically black money transaction. They suit black money transactions only if they are secret from the legitimate economy. Hence a shop-keeper who does not give receipt but declares the sale (it's only hypothetical) does not generate black money. On the other hand, a shop-keeper who gives a receipt but discloses other receipt book to the tax authorities (happens all the time) creates black money transaction. Next, the black money must at some time or other be plugged into legitimate economy. Thus, it cannot be done using user-created money that cannot be exchanged with local currency. Hence it depends on legal tender. It means somewhere down the chain there must exist a person for whom division of this black money is legal cash income which he can use for his own utilization in legitimate channels. Generally this is the construction worker, or other poorest of the poor who will give definite services and his income will remain under the Shadow Economy Friedrich Schneider & Colin C. Williams, organization of Economic Affairs, 2013government radar. It can also be against the law traders in gold or diamonds etc. who can change this into valuable items that have quasi-official tender status.

The third insight is that black economy is constantly fed by parts of white economy that go underground. Quite a few people who do not want to support black money contribute to it. They are either coerced – say developer forcing consumer to pay him in cash or government administratorlooking for bribes in cash. Hence, avoid white currency from becoming black the starting point. The recommendations of information titled Measures to tackle Black Money in India and abroadexplain some strategies. The core principle is to raise the cost of converting legal money into cash (wherein government loses talent to track it) and falling the cost of electronic convey also promotes electronic transactions.

Black money flows from side to side a separate channel. Such channel has communications to handle black money. The information is black money seldom remains in cash. It moves into high worth items like valid estate, diamonds, gold, films etc. The people complicated in these sectors have well-evolved mechanisms to take up black money. in one direction is to create entire value chains that use only cash. It is simple in sectors where workers/suppliers are unorganized, contract workers – e.g. manufacture films production etc. Bringing systematic regulations that make it easy for the participants in the value chain to admit electronic payments will curb black money.

Black economy depends on black money financiers. These are money lenders earning like 2% per month on their investments for financing the actions in black money friendly sectors picture financing, production financing, financing retailer, dance bars, alcohol, etc. These financiers also need enforcement mechanism to make sure their money is safe. Obviously they ally with criminal elements. Al Capone, the famous Chicago mobster, was previously an enforcer but later a financier.

Black money faces the equal invest or use choice as legitimate money. On the savings side, it seeks sectors that are sociable for black money. So those people who purchase many apartments from developers and developer afterward sells these for revenue are contributing to investment side when their agreements are not registered and do not pay stamp duty. Jewelers and traders of valuable stones as well contribute supportively in this area.

On the consumption side, black money seeks to purchase three things legitimate goods that can be consumed openly (i.e. normal things in abnormal amounts – say many shoes, many suits etc.), illegitimate goods that can be consumed in secret (banned or imported exclusive foods – caviar or costly wines, costly furnishings, home decorations etc.) or stored secretly (high-end safes, etc.). Within these sectors there exist trails that lead to the people notice the money.

Black money is also used in officialfunds. Foreign channels play importanttask. Quite substantial investments in P-Notes areessentially round-tripped black money. The solution aspect of these instruments is creatingsecrecy by being away from arms of the laws of the country from where profits can be fed into the legitimate hands. In such cases, the foundation of income is illegal. Hence, many businesses in tax-havens such as Mauritius, Cayman Islands etc. exist to changeillegal money into legal money.These investments come under the purview of currency laundering.

Incentives for electronic communication help check use of cash. Income tax deductions on credit cards or e-payments up to a certain limit can incentivize electronic transfers. South Korea used credit card income deduction experiment has been hailed as a success by OECD.

Strategies For Tackling Black Money

The distillation of various approaches can be summarized as under:

1. Establish identity of persons (through PAN Card, Aadhar Card etc.) operating in the country – citizens and foreigners.

2. Enable low the cost direct bank transfers (Implementation of NEFT/IMPS/RTGS and other formats) including direct transfers of subsidies to the beneficiaries under the Aadhar scheme.

3. Enable electronic register of assets (Underway through electronic land records, digitization of revenue records)

4. Reform tax system so that cost of compliance is lower than cost of tax evasion. (Through initiatives such as Saral forms, e-filing, self-declaration etc.) Indirect tax system through simplification (GST).

5. Widen the net for disclosure by filing Income Tax return. (Auto-processing returns for tax refunds)

6. Regulations that increase costs for black money creating activities. (Prevention of Corruption Act etc.)

7. Create attribution chain for funds entering and exiting the country (such as through P-Notes, FDI, Prevention of Money Laundering Act etc.)

8. Create e-trails of both incomes and expenditure.

9. Control on holding of cash and physical money including Indian and foreign money. (FEMA, recent demonetization)It is clear that black money clean up is underway on many fronts. Many of the pieces of puzzle have been put in place.

Semantics Of The Current Demonetisation

Demonetization is the mechanism by which the government states to withdraw the money which is current legal tender. The government being sovereign can take such decision. The effect of this announcement is that the currency notes in circulation will now cease to be valid tender and can only be exchanged at the banks. Demonetization of higher denomination notes as an idea has been around8.

There are two important issues with respect to the present demonetization. First that the notes ceased to be legal tender from midnight of 8th November just 4 hours after announcement. So in effect the only places where they will be accepted will be banks. Second, even the banks have been given time until when they can accept the notes – 30th December. Third, the cash swap carries restriction. Thus, in effect the announcement forces these notes into the bank's deposits within a short period of time.

As per RBI estimates9, 15billion notes of 500 denominations (approx. Rs. 7853.75 billion) and 6 billion notes of 1000 denominations (approx. Rs. 6325.68 billion)

8Proposed by various people such as Arthakranti and also by Peter Sands in essay titled Making It Harder for the Bad Guys: The Case for Eliminating High Denomination Notes, M-RCBG Associate Working Paper Series | No. 52 in February 2016 and later discussed by Lawrence

Summers and others exist. In addition, RBI estimates that fake 0.2 million notes of Rs. 500 and 0.15million notes of Rs. 1000 were discovered. The actual number of fake notes in circulation will be higher. These will be worthless from 09 November 2016 but you can get the credit for the money held as these notes in the form of bank deposit. Naturally, those who can disclose deposits equal to the amount they hold in cash will have no problem.

Hasn't It Been Done Before?

Indeed, it has. The first demonetization took place in 1946 and Rs 1000 and Rs 10,000 notes were demonetized. Later in 1978, Rs. 1000, Rs. 5000 and Rs. 10,000 were demonetized. This is the third time demonetization has taken place.

The critical difference is in the quantum however. The first and second demonetizationseffected really high value notes which formed a small part of notes in circulation. We can arrive at the estimates by comparing the denomination of the note with the annual per capital GDP. In 1960, India's per- capita GDP was Rs. 400 (then currency), in 1978 per capita GDP was Rs. 1722/- whereas today it is Rs. 103,000/- (today's currency). 10Thus in 1960, a 1000 Rupee note was 2.5X and in 1978 it was 0.5X per capita GDP, considerably easy to withdraw. The second aspect is that today the 500/- and 1000/- currency notes represents ~85% of physical money in circulation. At that time, it was considerable less11.

World Bank data in currency of respective year. Earliest data available is 1960 so we have used 1960 data. Devaluation was in 1946 which was way before this year.The numbers based on estimates by various agencies.

RBI earlier removed pre-2005 notes of all denominations from circulation as they have fewer security features compared with subsequent notes. The process of removing the older notes from circulation continued for nearly one year. The deadline was extended till December 2015 and those notes continued to remain legal tender till November 8. This was not exactly demonetization but removing from circulation and has now subsumed into the present demonetization.

Why Attack The Cash?

First, who holds black money in cash? Mostly corrupt people. Their pay-offs are in suitcases and hoarded in their houses. These are balances held till they find their target investments. A lot of black money itself is mainly held in gold and land.

As explained earlier, cash, i.e. black money is the currency of black economy. The government cannot do much about black money that remains stagnant if it remains a legal tender. But remove the legality of it and the government is able to alter the cost-benefits equation of corruption. Demonetization attacks the currency supply of the black economy. But removing the cash available to buy these gold and you affect the supply chains in black economy. When the flow gets interrupted the cost of corruption increases and payoff reduces dramatically. Such action attacks the chain that processes black money.

It is possible that as a result land prices and gold prices will fall. If land prices fall, middle class will be able to purchase land. If gold purchases are reduced, the fore pressure on INR will ease a bit. Thus, legitimate money which was beingpriced out of the economy gets an opportunity. Further, it prevents the blackmoney processing chains from forcing white money into black.

Inflationary Or Deflationary

Firstly, part of the actual money in circulation is never recovered. Depending on various conditions, at least 20% of this paper money will never reach banks. This stock of money is lost. Many believe this to be deflationary. It isn't. Since this money was never within the legal purview it was meaningless anyways. From government's point of view, it was like the money we forgot in an old diary and the diary was lost. This money did contribute to the economy but to smaller extent.

Some say "but this money was being used to buy Audis and other luxury goods". This is weak argument. Audi as a company does not receive unaccounted money (if they do that is criminal as well). The black money chain in such cases effectively starts with the dealers who game the system by discounting the vehicle or by making the vehicle pre-owned, prior owner being the dummy person. In either of these cases the black money is circulating to other illegal users. If such deals are curtailed it is good – not bad. In any case a black money purchaser who pays Rs. 2.5 million to buy Rs. 4 million Audi then can buy a Skoda legitimately.

Will It Work?

One argument is we tried it in 1978 and failed. Of course we failed. First the notes demonetized were too large for the size of the economy. Second, we can fairly estimate that the black economy may not have used the super high value notes as much too. The present action has better chance of success as it proceeds logically. First, people across India were given an Identity card (Aadhar), then bank accounts were opened for them (Jan-Dhan), and people across India can transfer money using SMS today. No strategy can succeed without proper systems in place. This time there are better mechanisms that people can switch to.

Another argument is that people can deposit the money now and withdraw cash five months later for black money transactions. Of course they can. But there are various laws in place that track the cash withdrawer. These guidelines were framed for Prevention of Money Laundering Act. As per RBI rules under that, every withdrawal needs a PAN card reference. Further, every branch manager is required to file detailed statement of weekly/monthly cash transactions. The cost-benefit for legitimate fellows becomes high. It is easier to monitor for the tax authorities. One person claims to have sent his 200 or so employees to convert old currency into new currency. Thus, per day at Rs. 4000/- per person he is converting Rs. 0.8million into cash. So has the system failed? The answer is no. It appears from the logical approach followed by the government that this is merely the beginning of effort against black money. I suspect these two mechanisms will be taken care of in subsequent actions.

The more fundamental answer is that black money is not a pool but a chain. Break the chain or make the chain costly and you inconvenience the poor who did not have access to bank systems. But with Jan-Dhan accounts, poor have ready access to banking channels (though not credit). So if you are law-abiding citizen then you can sail through mostly unscathed no matter how poor you are.

Do Terrorists Carry Money In Trunks?

One of the stated aims of the demonetization was to tackle terrorism. It has met with lot of ridicule. People are asking if terrorist do carry money in suit cases while coming across the borders. Again these people are missing the point.In fact, money laundering is one of the most important financing mechanisms for terrorists. It was after 9/11 that the US initiated substantial push towards enacting of anti-money laundering laws to prevent financing of terrorists. The anti-money laundering investigations fail when the money trail leads to cash. In India the terror-finance trail starts and ends with cash making it impossible to get early alerts of terrorist active in the country. Demonetization will upset the financing chain for the terrorists.

As noted, black money is the currency of black economy. It is the black economy, including financiers that need extra-judicial enforcement mechanisms. The terror groups are at the apex of criminal elements that provide this enforcement mechanism. If film producers do not pay their financiers, they get call from D- company – in effect an enforcement call. The black economy is also as innovative as any other. The criminal elements then seeking alternative revenue streams indulge in various terror activities. The terror finance chain comprises gold, diamonds and counterfeit currency. The counterfeiters don't keep the money in cash but quickly convert it into legitimate, legal bank accounts through SMEs and other small businesses. Using these fronts these terrorists use this money to buy information and access. The actual terror attack is only the "last-mile" effect. The ultimate "attackers" are usually pawns without any knowledge of systems.

Yet, the main effect of demonetization and subsequent introduction of new notes will be to increase the costs of the counterfeiters. It will serve to shock this supply chain.

Other Black Money Creators

There are other critical elements in black money chain or black economy. These elements represent turning smaller amount of white money into black by aggregation and misrepresentation.

For example, take NGOs. Some of the NGOs existing only on paper. Their model is thus. These NGOs collect legitimate amounts from citizens and push it into causes like animal shelters, girl child, and medical aid to needy etc. The main problem is that the costs of these NGOs are unreasonably high. They also commit fraud by misrepresenting number of animals and kind of facilities etc. creating a source of black money for the promoters who get salary and or benefits like cars and drivers from the NGOs.Cooperative banks are another piece of the puzzle. These accept smaller deposits from individuals and loan to founders and directors. The process is illegal and escapes the law only because it is not regulated by the RBI but by Politicians who are themselves directors in such institutes.

Government aided/recognized schools, colleges and institutions which look innocuous and have no actual teachers, students or infrastructure but simply using approvals from complicit education officers create a chain wherein legitimate money turns into black money. Others institutes have proper systems, but use management quota to pool students' money into black money pools for the founders. Some use both mechanisms.Such entities are inherently different from SMEs which exist to service the needs of a wealthy black money holder or create black money through banks. These elements will be hit substantially by the demonetization and their promoters will be forced to declare these amounts or destroy them. However, the issue is that they can continue to create black money sources since their model has not been dismantled.

Role Of Religious And Other Public Trusts

The model of trusts is a little different but they are as important elements in processing black money as SMEs and others listed above. The trusts are both receptacles and users of black money. They are not creators.

Some allow devotees to make small but numerous donations while spending substantial amounts on expenditures related to their promoters. Others are created out of anonymous black money donations with specific beneficiaries. Their nature makes them a hot-potato issue where they seem to be untouchable by any government, religious entities being protected by constitution.

These trusts will die over time as their feeder mechanisms are constrained. Yet, the reason they are highlighted here is because within the next two months we will see a lot of trusts being formed with weird articles of constitution that violate the basic premise of laws on public trusts.

So Will Demonetisation Eliminate Black Money?

Not by itself. It is just one move of one piece in the chess board of black money. To check-mate the black money king, you have to win the board. There are various steps required as detailed above. Government can play all these moves and still fail if they play improperly. All we can say is that Government is playing well. But will it succeed? The efforts will bring massive amounts of cash into the banking system – a benefit in itself. Once the money is in the legitimate channels, it should be better utilized and revenue will be generated from its use. If that is success enough then yes.

Then again the government has tackled GST which represents 2/3rd of its revenues. It has tried to increase the size of the pie on which taxes are imposed by forcing the transactions into formal economy. The next part is reform of Income Tax which will tackle the remain 1/3rd of the revenue. Then will come loophole plugging. There seems to be well thought out method to this madness. Rest time will tell.

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