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Interview



Demonetisation Measures May Not Really Help in Curbing Black Money: M. Govinda Rao

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The manner in which demonetisation took place on November 8, 2016, has affected India's informal sector. The plight of vegetable vendors, who depend on cash-based transactions, is evident in Khammam, Andhra Pradesh, on November 16, 2016. Photo: G.N.Rao

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*Prime Minister Narendra Modi's announcement demonetising high denomination notes on November 8, 2016, will do little to address the prime objective of flushing out black money but will adversely affect the economy in the short term, especially the informal sector, which is predominant in India, says **M. Govinda Rao**, a Member of the Fourteenth Finance Commission and Emeritus Professor, National Institute of Public Finance and Policy.*

Rao has held a number of advisory roles in India and abroad, and was member of various high-level committees including, the Economic Advisory Council to the Prime Minister of India (2004-2012), the Financial Sector Legislative Reforms Commission (FSLRC) (2011-13), High Level Expert Committee on Universal Health Coverage (2011), High Level Expert Committee on Efficient Management of Public Expenditure (2011-12); Advisory Group of Eminent Persons to Advise the Finance Minister on G-20 matters (2011-12). He was also Chairman, Expert Group on Taxation of Services (2001-02).

In an interview with S. Rajendran, Karnataka Representative, The Hindu Centre for Politics and Public Policy, Rao, who is also Advisor, Deloitte Touche Tohmatsu India LLP, and Chief Economic Adviser, Brickwork Ratings, speaks on the impact of the recent demonetisation measures on India's economy, commercial banks, agriculture and industry, and the people. Excerpts:

How do you view the present round of demonetisation measures? Will it help in curbing black money and in particular the parallel economy?

The Prime Minister's announcement on November 8 demonetising the currency notes of Rs. 1000 and Rs. 500 has sent shock waves. With 86 per cent of the currency in circulation rendered invalid, the country which predominantly transacts with hard currency is in tailspin. Ostensibly, the measure has been taken with the principal objective of curbing black economy, though other objectives like ending terror financing and nullifying the counterfeit notes have also been mentioned.

“The efficacy of the measure in curbing the black economy is limited”

However, the efficacy of the measure in curbing the black economy is limited. First, demonetisation will not deter earning illegal incomes and evade taxes. The principal sources of black economy generation in activities like political funding and election expenses, real estate transactions, construction, tax evasion and bureaucratic corruption will continue.

Even in sectors like education and health, there is widespread illegal gratification from admission to courses to the appointment of Vice Chancellors. Second, the measure will not impact much on the stock [of black money] as not all currency accumulation is illegal and overwhelming proportion of the black economy is either stashed abroad or held in real estate and gold and it is estimated that only about 6 per cent of the black economy is held in cash and only a small proportion of this may not find its way into the banks.

Corruption of personnel in the bureaucracy and that of politicians has touched new heights. Will demonetisation help in checking corruption given the fact that officials and politicians will design new ways to amass illegal wealth irrespective of the measures adopted by the government?



Incentive for bureaucratic and political corruption exists when they have the power of giving favours such as permits, licences and overlooking illegalities. Similarly, influential groups give election funds to prominent political parties and these are not subject to public audit or scrutiny. Although the Election Commission has stipulated a ceiling on election expenses at Rs. 70 lakhs for a Lok Sabha seat and Rs. 28 lakhs for a seat in State legislature, these are breached with impunity.

Demonetisation has very little impact on the processes of bureaucratic and political corruption. They may lose only the cash held by them in demonetised currency notes if they are not able to deposit them in banks. Unless there is State funding of elections and a system of accountability to political parties is made effective, generation of black money will continue.

More than 200 years ago, Kautilya wrote: "Just as it is impossible not to taste honey or poison that one may find at the tip of one's tongue, so it is impossible for one dealing with government funds not to taste, at least a little bit, of King's wealth." So long as the bureaucracy has the power to endow and as long as the probability of detection and extent of punishment are negligible, corruption will continue.

A Media Studies report has shown that nearly Rs. 30,000 crore was spent during the 2014 general Elections while the expenditure shown by the political parties and the candidates was around Rs. 7,000 crore. Is the election process the root cause of corruption in the country and what are the changes that need to be brought about?

There is no accountability on the donations from interest groups received by the political parties nor is there a system to monitoring their expenses. They are not subject to public scrutiny and are not covered by the Right to Information Act. The ceiling on expenditures stipulated by the Election Commission is breached with impunity to bribe the voters, to buy votes. Although the Central Information Commission in 2013 ruled that political parties are public authorities, except the left parties which opened up their finances for public security, all other national political parties closed their ranks and continued to violate the ruling by rejecting the right to information.

Donations to political parties in an opaque manner by interested parties persist and the limits on election expenses stipulated by the Election Commission for the Lok Sabha and the Legislative Assembly election continue to be violated with impunity. If the government was serious in tackling the issue of black economy, it should have made a beginning by declaring itself to be subject to public scrutiny.

Will the largescale use of plastic money help in reducing illegal wealth and the measures that need to be adopted to promote optimum use of the banking system?

The large scale use of plastic money will help to bring the informal economy into the formal mode, but will have only a marginal impact on illegal wealth accumulation. The "Know Your Customer" (KYC) details will increase the probability of detecting large illegal transactions.

However, those earning illegal incomes do not have to undertake transactions through plastic money. They can still do so with hard cash. The fact that there is so much cash transaction taking place even in urban areas where transacting businesses through banking channels is much more convenient shows that widespread use of plastic money may not be a dampener in transacting illegal businesses. As mentioned above, only about 6 per cent of the black economy is held in cash and the rest in physical assets or stashed abroad and the plastic money has no impact on these sources of black economy.

Your advice to the Union Government and in particular to the Prime Minister in improving the financial health of the country and its people.

There are wide ranging incentives for the generation of black money in several sectors. The processes of generating black money in each sector is complex and corrective measures need to be carefully calibrated. Simplification of laws and procedures and creating and deterrence for receiving and accepting bribes are important. This involves concerted action by both Central and State governments. As mentioned earlier, state funding of elections and requiring political parties to be subject to independent audit too is important.

“ *There are wide ranging incentives for the generation of black money in several sectors* **”**

Expansion in the scope of tax deduction at source, and simplification of tax laws by phasing out tax preferences will help to reduce tax evasion. If the Goods and Services Tax (GST) is implemented, seeding of Permanent Account Numbers (PAN) in GST number could substantially improve compliance. It is also important to improve the capacity of the tax administration in data mining and unearthing doubtful cases of evasion to increase the probability of detection. Reducing stamp duties, abolition of capital gains tax in buildings and inclusion of real estate transactions in GST will also help.

The National Institute of Public Finance and Policy (NIPFP) has made detailed studies on the process of generating black economy and the measures to deal with them in a number of sectors including construction education, healthcare besides tax evasion and it would be useful to place the report in public domain and act on the recommendations.

Reduction of money in circulation, particularly of the higher denominations, is likely to result in a reduction in economic growth, particularly in the short term. What are your views on this?

Economic growth will be adversely impacted on account of demonetisation in the short run. The immediate impact is to compress the demand and due to shortage of cash. Currency in India is like blood in the human body. As 86 per cent of the currency demonetised in a country where the transactions predominantly conducted in cash, the measure will bring large parts of the economy to a grinding halt.

The effect will be on agriculture, small industries and unorganised services. The farmers will find it difficult to sell their products and will not have the cash to purchase seeds, fertilizers and pesticides and that would adversely affect the growth in agricultural output. Small scale industry will have difficulty in purchasing inputs and paying wages. The sectors like trade, tourism, hotels and restaurants will see substantial compression of demand. Adverse effects on sectors like construction will be substantial and overall the prices of dwellings are likely to decline along with employment and incomes of construction workers. The demand for daily necessities will decline. The adverse effect on economic activity will be more where the informal sector is predominant and thus, poor people and less developed regions will suffer more than the more affluent and advanced regions.

Will demonetisation and the consequent fallout in the black money getting back to the banking system, help in rationalisation of the tax structure (reduction in tax rates and better compliance).

It is believed that some portion of the demonetised currency deposited in the banking system will get taxed either because the depositors play it safe and declare or the tax department will dig into doubtful cases to uncover suppression of incomes. To what extent this measure will enhance revenues is however, difficult to predict. Furthermore, increase in revenues may be partially, if not fully offset by compression in economic activity.

Even if the tax revenue increases, it would be inappropriate to change the tax structure for two important reasons:

First, any increase in revenue will only be a one-time increase and it would be unwise to change the structure based on this.

Second, there is nothing to say that the prevailing income tax structure is the source of black money. Income tax collection is a function of rate of tax, probability of detection and the penalty rate. The 1997 budget brought down the marginal tax rate to 30 per cent and has remained reasonable since. Indeed, the focus will have to be on tax administration to increase the probability of detection and penalty rate but that has nothing to do with demonetisation.

There is talk of an Expenditure Tax (Banking Transaction Tax) being introduced to replace Income Tax. What are its pros and cons and do you think that India is ready for this switchover?

The Pune-based think tank Artha Karanti has been advocating the proposal for replacing all taxes including the income tax with a bank transaction tax. I hope the government does not fall into it. If it did, it will be the most retrograde step for any market economy seeking to increase the formal sector.

Any transaction tax, however small, will increase the transaction cost. If the tax is levied every time deposits and withdrawals are made, the cost of doing businesses will increase. In other words, such a tax will act as a tax on financial savings and investment.

“I sincerely hope the government will not fall into such a trap.”

As a transaction tax falls on every transaction, and funds are deposited and withdrawn several times in conducting businesses, the tax will cascade to make the system non-competitive. This will also encourage people to conduct businesses using cash and the economy rather than becoming more formal will be pushed into becoming informal. It will be difficult to find out the tax component in a business. This will discourage people to get into the formal financial sector and the objective of inclusive banking will suffer. I sincerely hope the government will not fall into such a trap.

What will the series of moves - demonetisation, fixing caps on exchange of notes, withdrawals, combined with the inadequate stock of currency notes - mean for the banking sector, in the short and long terms?

The government is working on a trial and error method in fixing the caps for exchanging demonetised notes. It appears, there is not enough supply of new currency notes to replace the denominated ones nor is the logistics ready to carry out such a massive transition. First the government fixed the limit for exchange at Rs. 2,000, increased it to Rs. 4,500 on November 14, and reduced it again to Rs. 2,000 on November 17. The misalignment of new Rs. 2,000 notes with the ATMs is another problem.

As far as the banking sector is concerned, ever since demonetisation was announced, the focus has simply been to exchange notes. It has not time for undertaking other regular banking activities such as accepting regular savings and time deposits, lending to commercial activities, discounting bills of exchange, issuing letters of credit and undertaking agency functions. It will take considerable time for the banks to return to their normal banking activities. The banks will also find themselves having surplus deposits and park their funds with Reserve Bank of India and this can result in lowering of deposit and lending rates. The RBI itself will perhaps reduce the policy rate in the next monetary policy announcement on December 7.

Do you see a transformation of the Indian banking system, as we know it now, on the cards?

Demonetisation, over the medium and longer term can help in people moving over to other more formal modes of transaction using credit cards, internet and mobile banking. This could also help to spread financial literacy in total areas. There is also a possibility that people in far flung and rural areas may actually decide to keep the money in smaller denomination notes (Rs. 100) having had a traumatic experience of not being able to withdraw their own money from the banking system.

“ *A number of additional measures are needed* **”**

Spreading of financial literacy and banking habits will require supplementary measures as well. If the government moves to attach *benami* properties, and scrutinises the large investments in gold and real estate over the last decade in a systematic manner, the incentive to hoard black money in these forms will be reduced. Coupled with policies to lower stamp duties and abolition of capital gains tax can help to develop organised market for immovable properties. In other words, a number of additional measures are needed. Banking system on its part will have to move forward in innovating new products and make it attractive to investors.

Demonetisation has resulted in a windfall in deposits of all public sector banks consequent to which their balance sheets are bound to be better. Will this have an impact on the proposed merger of banks?

The sharp increase in the deposits of demonetised notes with the banks would shore up the balance sheets of the nationalised banks in the short term. The increase in low-cost current and savings deposits (2 per cent - 3 per cent) and their deployment in investments which will fetch them 6 per cent - 7 per cent returns will create a spread of 2 per cent - 3 per cent. Furthermore, armed with excess liquidity and given a more benign inflation environment, the Reserve Bank of India may reduce the policy rate which will help the banks to make significant treasury gains. In the second half of the year, the banks which have been showing losses in consecutive quarters could show profits.

“ *The Reserve Bank of India may reduce the policy rate* **”**

However, on the flip side, full disclosure of Non-Performing Assets (NPA) following the asset quality review may take some shine away. The liquidity crunch in small and medium enterprises is likely to add to the NPAs. Moreover, the banking system is also likely to feel the impact arising from lower consumption and investment in activities like real estate and construction.

I do not see a reason why this should impact on the merger of the banks. The objective is to rationalise the banking system and improve its long term economic viability and this is not likely to be impacted by short term effects of an extraordinary measure.

[M. Govinda Rao has held a number of advisory roles in India and abroad. He was a Member of the Economic Advisory Council to the Prime Minister of India (2004-2012), Member of Financial Sector Legislative Reforms Commission (FSLRC) (2011-13), Member, High Level Expert Committee on Universal Health Coverage (2011); Member, High Level Expert Committee on Efficient Management of Public Expenditure (2011-12); Member, Advisory Group of Eminent Persons to Advise the Finance Minister on G-20 matters (2011-12); Chairman, Expert Group on Taxation of Services (2001/02),

His past positions include Director, National Institute of Public Finance and Policy, New Delhi (2003-13), Director, Institute for Social and Economic Change, Bangalore (1998-2002), and Fellow, Research School of Pacific and Asian Studies, Australian National University, Canberra, Australia (1995-98). He is a Member of Research Advisory Panel of South Asia Network of Economic Research Institutions (SANEI) and a Member of the Independent Commission for the Reform of International Corporate Taxation (ICRICT), New York. He has authored 14 books and over 80 research articles in refereed journals. His most recent publications include Growth and Development Performance of States in India (co-author: Arvind Panagariya; Oxford, 2014) and Making Miracles in Indian States (co-editor: Arvind Panagariya; Oxford, 2015).]

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In a journalistic career of over 35 years with The Hindu in Karnataka, he has extensively reported on and analysed various facets of life in the State. He holds a Master's degree from the Bangalore University. The Government of Karnataka, in recognition of his services, presented him the Rajyotsava Award — the highest honour in the State — in 2010.)

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