

A Perplexing Approach to an Admirable Goal

Some thoughts on the ongoing Demonetization Exercise – Part 1 of 2

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There are many social, economic, and governance benefits that will accrue from reducing the level of cash transactions in any economy. This is especially true in the case of India, where the proportion of both cash transactions and undeclared (and presumably tax-evasive) transactions is extremely high – and much of this is for the wrong reasons.

The relevant question therefore is not whether the intent/goals of a demonetization exercise are defensible, but rather which of the many related but distinct goals are a priority for the government. We have heard at least four clearly stated goals:

- 1) Move to a cashless economy with all the associated benefits
- 2) Trap the holders of undeclared (Black) money and extract the appropriate dues
- 3) Catch the existing stock of spurious (counterfeit) money already in the system
- 4) Render useless the real/counterfeit money held by terrorist organizations & supporters

There are thousands of ways in which such a complex demonetization process of Rs. 500 & Rs. 1000 notes could have been structured. It is vitally important to understand the relative priority of these goals to identify the ideal approach to be taken. While there are many program features that can be debated, the primary trade-off in variables is between **Secrecy**, and **Frictionless Implementation** – which are directly contradictory to each other. At one extreme, **Secrecy** should be the most important design characteristic if the primary goal is catching hoarders of black money and/or fake notes/terrorist funds. However, a “Top Secret” approach in the pursuit of these goals will, by design, entail huge friction costs during the small window in which it must be implemented – and these costs will be borne by the overwhelming majority of the population.

On the other hand, a design motivated by **Frictionless Implementation** will greatly reduce the inconvenience to the great majority of the population, over the prolonged period during which it would be implemented. But any notion of **Secrecy** must be forgone, and along with it the likelihood of catching anyone unawares.

Let us now consider some basic aspects of the situation prior to demonetization:

- 1) Roughly 80% of the total value of currency in circulation is in the Rs. 500 & Rs. 1000 notes to be demonetized
- 2) Many sectors of the economy are almost exclusively cash driven (fishing, farming, retail, etc.)
- 3) Most citizens do not have access to and/or experience with alternate modes of transacting – such as ATM or Debit Cards, Cash Card, Mobile Money, or even Cheques.
- 4) The purchasing power of these notes is not so high that their use will largely be confined to the upper sections of society. For example, even domestic staff get paid

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multiple thousands of Rupees a month, and hence are likely to be paid in these to-be-demonetized denominations.

- 5) Even the Center’s/State’s welfare mechanisms (such as Old-Age Pension, Disability Support, MNREGA, etc.) result in such notes reaching the hands of the most vulnerable sections of society.

Under these circumstances, one can see a clear argument against an approach that prioritizes Secrecy at the cost of Frictionless Implementation. The friction costs of **Secrecy** are, a-priori, likely to be very high indeed given the huge proportion of the population – at all economic strata – that will be impacted by this demonetization.

Of course, all trade-offs must be considered in terms of a Cost vs. Benefit analysis, not Cost alone. So, if the costs of **Secrecy** (in terms of friction in the economy and on the lives of ordinary people) are likely to be high, what about the Benefits?

Since the government has chosen the **Top Secret** approach, it stands to reason that the greatest benefits are intended to come from the capture of Black Money & Terrorist Financing angles, as well as the capture/elimination of counterfeit angle. But how much potential benefit exists on these dimensions, and more importantly, was such a Top Secret Demonetization the right approach to achieve these ambitions? Consider the following points:

- 1) By the government’s own admission in the SIT report in 2014 (among other data points), it appears that only about 5% of the total extent of Black Money (ill-gotten and undeclared) assets are held in Indian notes. Rather the bulk of such assets are held in Land, Buildings, Businesses, Listed Equities, Unlisted Equity, and Offshore in various currencies and International Banks.
- 2) There don’t appear to me noticeable concerns about the extent/proportion of Counterfeit currency in circulation in the country broadly, though this may not be the case in border areas such as Kashmir. The Finance Minister’s own statement in the house earlier this year stated the proportion as 0.02%.
- 3) The history of catching big fish in any government-laid trap is spotty at best at a global level, and woefully poor in the Indian context. The level of ingenuity in India usually means that rich and powerful people will find a way to escape the net – usually at the expense of the weaker sections of society.

Considering both the potential costs, and the possible benefits, it is hard to make a technical case for greater **Secrecy**, at the expense of greater **Economic Friction** that will negatively impact a large proportion of the population. It is indeed possible that other motivation/factors/timing played a big part in what was, technically, a far-from-ideal approach. For example, political motivations or election cycles may have driven the decision. Or perhaps the intent was to create an in-built aversion to using cash notes going forward. Since such speculation is both limitless, and at some level, pointless, it is not worth pursuing in this assessment. Instead let us focus on execution and outcomes.

The next part of the article will discuss potential steps to ensure successful execution, and increase the probability of successful outcomes.

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