

DEMONETIZATION: ITS SOCIO-ECONOMIC IMPACT AND REFLECTIONS FOR FURTHER REFORMS

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Abstract

On the evening of November 8, 2016, Prime Minister Narendra Modi has declared that Rs 500 and Rs 1,000 currency notes would no longer be regarded as legal tender. India lost 86% of its monetary base as a result of this demonetization and in this single move, the Government has attempted to tackle all the three issues affecting the economy i.e. a parallel economy, counterfeit currency in circulation and terror financing. However, it is estimated that between 90 to 98 percent of all transactions in Indian economy simply runs on cash and almost one third of working capital in Indian business comes from black money. Thus, the “common man” is facing hardships in purchases of daily needs like food, medicine, bus and rail tickets, and so forth due to long queue & non availability of sufficient cash in banks. Hence, in the short run, there will be negative impact on the manufacturing sector and small scale businesses and in turn people particularly poor will be badly affected due to lose of their employment, and ultimately stagnant industrial growth. It is estimated that Indian black money in cash constitutes only 5 to 6 percent of India’s illicit wealth on which taxes are not paid. The rich park illicit wealth in Indian and overseas real estate, shares, gold and overseas bank accounts so it is necessary to overcome such channels of investing illicit money through strict implementation of laws as well as introducing effective and safe digital system in the Indian Economy if government really wants to tackle the issue of corruption, black money, illegal funding of terrorism etc. The aim of this paper is to evaluate the socio economic impact of demonetization in India. The paper also focuses to examine lapse in the effective implementation of demonetization and the reflections for further reforms to get desired results.

Keywords: Demonetization, Corruption, Black Money, Economy, Reforms.

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Introduction

Demonetization is an established practice in monetary policy to tackle black money. In the wake of the promise made by Indian Prime Minister Narendra Modi to curb black money from the economy, on the evening of November 8, 2016, he declared that Rs 500 and Rs 1,000 currency notes would no longer be regarded as legal tender and people were given 50 days to deposit these currency notes in their bank accounts or exchange them for new notes at banks and post offices. He estimated that forcing people to exchange the country's largest currency notes for new banknotes would allow the government to crack down on "black money" means unaccounted cash holdings that haven't been taxed but under the law, it should be. He also argued that it would strike at domestic terrorist financing operations by capturing counterfeit money and rendering the legitimate cash they kept in the shadows worthless. According to Reserve Bank of India figures as of March 2016, currency in circulation amounted to Rs16,415 billion of this, Rs500 notes accounted for 47.8% in value and 38.6% of Rs1,000 notes. Together, they were more than 86% of the value of the notes in circulation. Thus, the role of cash and high-value bank notes in the Indian economy cannot be understated. However, as a result of demonetization, India lost 86% of its monetary base and in this single move, the Government has attempted to tackle all the three issues affecting the economy i.e. a parallel economy, counterfeit currency in circulation and terror financing.

There are questions whether the "masterstroke" is masterful enough. "Black money is not synonymous with corruption; it is rather one of several symptoms of corruption," notes Rajesh Chakrabarti, professor and executive vice dean of the Jindal Global Business School at Jindal Global University. Pointing out that only a small percentage (by some estimates as low as less than 6%) of the unaccounted wealth is held in cash, Chakrabarti says: "This intervention is a one-time draining of this current stock of black money but unless the root causes of corruption are removed, corruption will continue. It is sort of like a dialysis, more of a short term cleaning up than a solution of the problem. It needs to be repeated periodically."

However, demonetization is not a new phenomenon and many countries across the world in past had tried to regulate their currencies through demonetization such as Ghana in 1982, Nigeria in 1984, Myanmar in 1987, Soviet Union in 1991, Zaire in 1993. The main aim of these countries was to curb black market and corruption, reduce tax evasion and manage liquidity. Most of these countries failed in their aim and even the public of Ghana was losing faith in the banking system

and switching over to foreign currency and physical assets after demonetization. However in Russia earlier a part of Soviet Union, the 1991 attempt led to a successful re-denomination of the ruble in 1998 where three zeros were removed. This was followed by another currency switch in 2010 when two more zeros were removed from the old currency. The 2010 attempt was not as successful as the timing coincided with a poor harvest.

Socio-Economic Impact of Demonetization in India

“This announcement appears to be the most significant change made by Modi government to date,” says Girish Vanvari, partner and head (tax), KPMG in India. “Its impact could be even bigger than GST (the Goods and Services Tax which is still running the gauntlet of politicians).” Adds a report by Crisil, a global S&P company: “Tuesday’s move could change the face of the Indian economy, improve the government’s fiscal position and tax compliance. The size of the cash economy will shrink, as will black money generation avenues, because of the better cash-flow trail.” “This [demonetization] is a step which will make a positive difference, if the transition challenges get handled well by the administration,” says Jitendra V. Singh, Wharton emeritus professor of management. “We will need to be careful of potential attempts to derail this positive agenda.” The International Monetary Fund (IMF) echoes those sentiments. “We support the measures to fight corruption and illicit financial flows in India,” said a spokesperson. “Of course, given the large role of cash in everyday transactions in India’s economy, the currency transition will have to be managed prudently to minimize possible disruption.”

The ATM networks have been hit by total chaos, while the Reserve Bank of India is struggling to print replacement currency. More than 60 deaths have been reported among people forming long lines at banks. The “common man” is facing hardships in purchases of daily needs like food, medicine, bus and rail tickets, and so forth. Consumer goods sales are reported to have dropped by one-third. Farmers have difficulty buying seeds and fertilizer and selling crops and perishable produce. Around 50 percent adult population of India have no bank account and even account holders like factory labourer, rickshaw drivers, street vendors, domestic workers etc. in the cities have to wait in line for hours means loss of their daily wages. The construction industry has been badly hit with significant wage implications for its casual workforce.

Banning widely used banknotes would have a huge impact on any economy. In the short run, this is a terrible setback for the international standing of the Indian economy. Modi’s sudden ban

instantly meant that 86 percent of all the cash in circulation in India was no longer considered legal tender, which means that businesses could refuse to accept those notes as a form of payment. It is estimated that between 90 to 98 percent of all transactions in Indian economy simply runs on cash and almost one third of working capital in Indian business comes from black money. Therefore, at this time, there is demand sluggishness in the economy leading to practically no private sector investment so that there will be negative impact on the manufacturing sector and small scale businesses and in turn people particularly poor will be badly affected due to lose of their employment, and ultimately stagnant industrial growth and expect the growth of India's booming economy to slow substantially in the final quarter of 2016. The only way to bring this up is to divert more funds into investments which will happen when the cost of capital comes down.

Modi's demonetization initiative has caused chaos across the country mainly in the short run. People want new banknotes, but the current supply of them isn't close to meeting demand. That's created headaches for people as they wait in long lines outside ATMs and banks, which routinely run out of cash. For people who rely on daily cash earnings to survive, it can mean not being able to obtain food. Marginal farmers looking to sow their next set of crops can't buy the full quantity of seeds they need. Property sales, which typically require huge cash investments, are slowing. It's even reshaping cultural life: weddings, which can cost millions of rupees, are taking a serious hit. A lot of marriages are being postponed, and those that are managing are doing so by borrowing from relatives and friends.

The primary reason Modi initiated the ban is to force people with illegal cash holdings to deposit the money into bank accounts and pay taxes on them. The goal is also to eradicate black money, counter tax evasion and destroy counterfeit currency. The government recently released data that showed that in 2013, merely 1 percent of Indians paid taxes. Kaushik Basu, former chief economic adviser to the Indian government, recently noted at the New York Times, the most reliable estimate of India's "shadow economy," or the untaxed part of it, puts it at one-fifth of the country's GDP. The policy is poorly implemented and the costs may likely to end up more tangible than the benefits. Further, many experts don't even have faith that this is an effective way to counteract tax evasion.

All previous instances of large-scale overnight currency cancellations were in countries ravaged by hyperinflation or facing state or economic collapse. Such shock therapy in a major economy

is without precedent, so no one can predict the long-term structural impact and the full range of intended, pernicious and perverse consequences. However, hope that the ban serves as a natural prompt for India to transition to a cashless society. Further, forcing people and businesses to use banks and digital payments will help to bring them inside the tax net. In most large economies, cash is around 5 percent of GDP but in India it is 12 to 14 percent and less than one-third of Indians have access to financial institutions, while most banks are concentrated in cities, most Indians live in villages and thus, it is very difficult to bring the digitalization system in Indian Economy effectively. Therefore, Govt. should cautiously take effective steps so that in the long run, desired results can be obtained in Indian economy.

Reflections for further Reforms

The idea of demonetization in India is good but it will do little to flush out significant proportions of illicit wealth while the poor keep their money in cash, the rich park illicit wealth in Indian and overseas real estate, shares, gold and overseas bank accounts. It is estimated that Indian black money in cash constitutes only 5 to 6 percent of India's illicit wealth on which taxes are not paid. Out of this, a lot of money is in circulation in everyday transaction like if someone is building a house; the bill is not paid through banks for sand, bricks etc. This money goes into the other systems though it has been drawn from bank. Thus, the costs of demonetization may likely to end up more tangible than its benefits. Further, many experts don't even have faith that this is an effective way to counteract tax evasion.

Small manufacturers, traders and farmers, daily wage labourers are suffering due to lack of proper planning, intelligence and foresight to pile up enough 100 Rupee notes and other smaller denomination notes in the market before taking this step. Real estate and retail jewellery sectors that attract a significant amount of black money will be affected adversely. For real estate, in particular, this could be bad news as because of the economic slowdown, house prices have been moderating and is expected to result in a 20-25 per cent cut in prices after demonetization.

Government must have issued the strict guidelines for the bank to ensure the link of every account with Aadhar Number within a certain period so that different bank accounts of a particular person/firm attached with a particular Aadhar Number could be searched out to identify the fake accounts before demonetization making it difficult for a person to deposit the unaccounted money in such bank accounts. Despite the fact that half of Indian adults have not

bank accounts, government should have given the one time option of exchange Rs 500 and Rs 1,000 old currency notes of just Rs 4000 for a week after demonetization and banks should have been directed to open their bank accounts to stop the chances of conversion of unaccounted/black money of other persons.

Similarly, government must have ensured the sufficient availability of swap machines for the businessmen and also start the move to motivate them for the use of such machines. As the cash transactions in this economy are far more than the total number of electronic transactions done on a daily basis so that Government should have initiated to start the move to motivate the public for cashless transactions at least six months before demonetization. Further, Finance Ministry must have issued direction for banks making compulsory to issue ATM-cum-Debit Card to every saving bank account holders and not to take annual charges as well as service charges for making payment by the use of such card. The government should strengthen the law for punishment in case of cyber crime as well as effective measures should be taken by the government for safe use of digital mode of payment to create confidence among the common people in regard digital payments.

The government should have not given the huge time of 50 days to the public for the deposit of Rs 500 and Rs 1,000 currency notes. Further, the government should have not given more than two chances to the public for depositing such old currency notes in their bank accounts (one before 15th December and one immediately after 15th December, 2016) to stop the unauthorized use of such banned currency after demonetization mainly by the businessmen. Option of using Rs 500 and Rs 1,000 old currency notes either should have not given to the public at petrol pumps & gas agencies, in public transport, railways & airlines etc. for a long period or government should have developed proper mechanism to put check on the illegal way of exchange of old currency notes of Rs. 500 and Rs 1000 with legal tender currency at these places. Further, before taking the step of demonetization, government should have taken steps to ensure the online record of every immovable property and their attachment with Aadhar Number of the property owner so that benami property could be identified as major portion of black money was invested in real estate and it certainly not affect the common man.

The government said that a person mainly housewives will not be required to explain the source of their cash holdings upto Rs. 2,50,000. But it may be that the person deposited their unaccounted money in the account of a number of poor/middle class people and later on transfer

this money in their personal/firm accounts by Cheque/RTGS etc. Thus, it is suggested that every such account holder may be asked to explain the source and reason of withdrawal keeping in view his track record of withdrawn or his income profile. Further the person in whose account, money has been transferred should be asked to clarify the reason of transfer in his account. Some say that people are facing problems because the limit of withdrawal has not been kept at a higher level. If this would have been kept at a higher level, there were chances that the recycling of black money might begin. Thus firstly, the ideal money in circulation has to come to the banking channels is necessary.

First and foremost, India does not have an ID authentication system due to which many of the bank accounts belong to non-existing identities or pseudo identities who are shadows of same person means one person and several existences. So much part of black money is already in the bank accounts with various accounts associated to the same person due to identity fiasco. Even Aadhar card saturation report if you observe for many states, the saturation is above 100%. For example August 15, 2016 saturation report shows Delhi with 102% which means for every 100 citizens the repository has 102 distinct bio-metric data seeded. Further, in reality, post demonetization, the black money holders are now trading with the poor to collect copy of their Aadhar cards to get more money converted in a day. So effectively they are able to convert their currency into new denominations as one black money holder use several Aadhar cards, some of them are fabricated as banks have no time to authenticate or cross check. The government has no mechanism even to identify what is happening in real. Unfortunately, at many bank branches, the bank employees are helping the black money holders to exchange their currency unlawfully.

Government should ensure the end of political corruption which is main reason of acute poverty & backwardness of country as none of corrupt politicians involved in gigantic scams like Coal gate, Common Wealth Games, 2G, National Herald, scams in states etc. is arrested & convicted by the law. It is merely a tall talk to bluff public. If government is sincere & honest in governance, it should first set example by bring all the political parties under RTI and enforcing effective Lok Ayukta Bill to arrest corrupt people. The government can not make any development whatever efforts are done unless conviction of corrupts are done and there assets are seized. Only tall talk & bluffing tactics by different politicians can not bring peace & prosperity in this country. So government should also take drastic steps against wealthy &

corrupt politicians, businessmen, bureaucrats, government employees etc by arresting them and seizing all their assets.

If really, we want corruption free, fair, equitable and equal society then either government must fix some criterion for the use of government funding in election for political parties after nationalizing their existing funds and properties or make it compulsory for them to follow the digital/cheque system in taking donation as well as proper & effective auditing of their accounts to maintain transparency. Moreover, government should ban to receive any donation by such political parties who has not fight any election in last 5 years as well as make it compulsory for them to pay income tax on the amount they have received as donation till date and also empowered the Election Commission of India to cancel their recognition. The government must get proper and effective auditing of government expenditures done. There is a huge inefficiency of governmental system which is wasting resources and breeding corruption and black money. This will help the government to reduce taxes and ease the burden on ordinary people.

Due to high direct and indirect tax rate, there may be more tax evasion. A better solution would have been to simplify, rationalize and reduce taxes; cut regulations and curtail officials' discretionary powers; eliminate loopholes; and widen the tax net. Further, a major cause for the persistence of poverty and growth of corruption in India is regulators and tax inspectors who harass entrepreneurs at every rung of economic activity because of the maze of regulations and their discretionary powers.

Conclusion:

Demonetization is both extraordinarily blunt and risky as much of Indian Economy, especially outside big cities, where cash transactions are most common and financial infrastructure least developed, the sudden invalidation of a vast amount of outstanding currency represents a significant monetary shock. Not all of India's shadow economy which provides real employment and income; if not real tax revenues, can migrate quickly and easily above board. Whatever cannot easily be shifted represents a potential loss of economic activity, and a drag on broader Indian economic growth. Similarly, if a cash crunch forces small firms without access to credit to shut down, the eventual alleviation of the cash shortage might not lead to an immediate and complete revival of economic activity. Managing an economy's money is among the most important tasks of the government.

The stock of the black economy constitutes a major part of the GDP is significant. It hopes the step of demonetization will reduce the burden of RBI's liabilities as well as the deposits of commercial banks will lead to a rise and later on there will be decrease in lending rates plus fiscal deficit. So far, it can be said that this is a historical step and should be supported by all. One should look at the bigger picture which will definitely fetch results in the long term. This is what the people have been asking for a long time which has finally happened.

According to Mauro F. Guillen, a Wharton management professor and director of the School's Lauder Institute, "In the short term, [the move] could stifle some businesses that are legal and clean, if they use cash payments. But everyone will adjust. And while it can hurt some small businesses and individuals, it is better to do it than not." Guillen adds that large-value currency is an "important source of problems" such as corruption, black money, terrorism and counterfeit money. "The euro zone will be eliminating the largest euro note. The U.S. is also trying to reduce the number of 100 dollar bills in circulation."

No doubt, it is remarkable that PM Modi has taken this bold step. Clearly, there will be howls of protest from some. It is the fact that who has the stacks of Rs500 and Rs1,000 bills and cannot account for them, such parties will not be happy with this step. But for the ordinary Indian, while there may be some discomfort during the transition, this will be fine in the longer term. It is hoped that there may be some positive impact on our economy such as hard cash held as black money will be brought into the system which is traceable and taxable henceforth thereby increasing the government revenue. To the extent of penalties imposed by the Income Tax department on the illegal conversion of black money into white money, the revenue to the government will increase in the immediate future. Unaccounted monies held as cash which was not productive will become productive as it enters the legal system. Counterfeit money in circulation which was an ongoing menace all over India will cease to exist with immediate effect. Funding of terrorist and other illegal activities will be curtailed as they generally are funded by black/counterfeit money. To the extent the black money held by the political parties is flushed out, the elections in the near future will be more cleaner and transparent. With huge cash at the disposal of the banks, the borrowing of money will get cheaper providing impetus to economic growth. The government can avail finances at lower rates and speed up the infrastructural spending creating huge job opportunities.

However, black monies invested in other forms of investment like in jewelry, real estate, gold, shares, immovable properties in the name of fictitious persons etc. are absolutely untouched and will become new black money as the assets are sold and will be out of the legal system once again. Even vast amount of money are held at the places of worship in India as they are exempt from accountability and scrutiny. Unscrupulous people will again use this route to convert their monies from black to white within a short span. As two third Indian population lives in rural areas without proper access to banking and internet facilities, the cash crunch will destabilize the rural economies in the short run. Consumption of goods and services will decline with no black money at disposal leading to deflationary pressure on the economy and consequently, production of goods and services will decline impacting the GDP growth in the near future. The proportionate increase in the tax revenues generated by the black monies coming into the legal system may be negated by the loss in the tax revenues due to lower industrial and service activity.

In nutshell, this measure of demonetization is a measure that temporarily brings into the system the unaccounted money and generates additional taxes in the near future. Whether this measure is detrimental or beneficial is based on the amount of black money being brought into the system, not just cash but assets held in various forms. It is to be seen if benefits exceed the hardships that people are currently undergoing. If indeed the measure is selective, it will not serve the intended purpose. Diversified portfolio of black money, unless brought under this scheme, will not yield the intended result as black money in cash constitutes only 5 to 6 percent of India's illicit wealth on which taxes are not paid. Thus, after taking effective steps to bring the black money invested in the form of real estate, shares etc. under the system through their attachment with the Aadhar number of the owner and digitalization of their record etc, the government should again declare the demonetization of Rs. 2000 currency note with its effective implementation consideration the lapses of present demonetization.

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