

Demonetisation, inequality and informal sector

It was on 8 November 2016 that Prime Minister Narendra Modi announced the demonetisation of Rs500 and Rs1,000 banknotes. One year on, the after-effects of the exercise are still being felt in the economy. But the real question is, did the exercise achieve the objectives for which it was undertaken?

Given that most economic indicators today suggest a worsening of the situation compared to a year ago, it is easy to conclude that demonetisation was the primary cause of the slowdown. While it is tempting to come to such a conclusion, the fact of the matter is that the economic slowdown predates demonetisation. This is now public knowledge, but that does not imply that demonetisation did not contribute to the slowdown, as many in the government would like to believe.

The impact on the economy certainly deserves attention and the consensus is clearly that demonetisation may not have caused it but it certainly contributed to the worsening of the economic slowdown.

However, the real benchmark on which demonetisation needs to be evaluated is the stated objective of the exercise: to eradicate black money. Other objectives spelt out were incidental and certainly did not require an extreme step such as demonetisation to be achieved.

Recent evidence on digitisation and the incidence of casualties in civil and terrorist strikes also undermines any argument that demonetisation was a serious effort in the direction of promoting a less-cash economy and clamping down on terror finance. Similarly, there is no credible information that counterfeit currency has disappeared from the economy.

However, even on black money, there is no evidence whatsoever to believe that demonetisation managed to eradicate the stock of black money held in the form of cash. The government's own study by the Indian Statistical Institute (ISI) pegged the extent of cash at less than 5% of the black economy. Other estimates are even lower. Even this minuscule stock of black money did not get extinguished as was expected. It is also clear that most of the post-facto hopes that tax enquiries and investigations will yield the expected gains are not going to materialize any time soon.

In hindsight, it is safe to say that not only was the implementation bad in design but even the concept of demonetisation weeding out black money was unrealistic. But the fact that it was a one-shot affair, without any accompanying efforts to root out the system which generates black money, also raises serious questions on the intent of the government to eliminate black money in the economy. A good example of this is the exemption that the government provided to political parties.

On growth rates, demonetisation only played a role of accelerator of the slowdown that was already there. While the National Democratic Alliance government's move did not yield any dividends to the government in monetary terms or in terms of the efficacy of the system to curb the black economy, it did contribute to reversing the revival of the rural economy, which was showing signs of recovery after two years of back-to-back droughts. The revival of the rural economy in 2016, which saw a good monsoon after being hit by low commodity prices and drought, was reversed by demonetisation. The impact on the rural economy was not only limited to agriculture but also the informal economy which was suffering from demand deflation.

While the debate on the impact of demonetisation on the black economy and growth rates will continue and will be subject to interpretations, there are some impacts which will take time to show

up or may even be invisible. And in this case, even the goods and services tax (GST) is as much responsible as demonetisation. The outcome is unintended but it needs to be highlighted. One of these is the impact on inequality.

Given that a large majority of the informal or unorganized sector has borne the impact of these two shocks, it has also led to a shift of incomes away from the informal sector to the formal sector. The formal sector was already well-equipped to deal with these changes, whether in terms of digitisation or tax compliance.

Over a period of time it is likely that the share of the formal sector will increase. But it will be at the cost of the informal sector. While this may exacerbate the level of inequality in the economy, it will also contribute to rising inequality through a lack of employment. And this is the second aspect which assumes importance given the concerns on job creation in the economy.

These are important issues not only in the context of demonetisation but also in general on how policymakers view the informal sector. The general perception is that these are entities who evade paying taxes and, therefore, are part of the black economy.

The informal sector, however, is not an aberration in our growth process. It is an integral part of the process of transition from a traditional economy to a modern economy. While it may not pay taxes and is largely dependent on cash, it plays an important role in providing jobs to millions of first-time workers and to millions of others who are moving out of agriculture to the non-agricultural sector. It provides the first exposure to many of these illiterate and low-skilled workers to the new economy. At the same time, it is also the biggest agency which does the painful task of re-skilling the majority of these workers—much more than any government scheme. Any attempt to reduce the role of the informal sector is only going to make the transition arduous and difficult for the economy.

But in the rhetoric of 'everybody is a thief', the real casualty are the informal enterprises. Attempts at forcing informal enterprises to become formal may kill the golden goose which has been taking care of the transitional pains of the economy by providing jobs. It has also acted as a sponge, creating incomes and demand when the agricultural sector was in stress. The short-term benefit of formalisation of the economy is at the cost of long-term loss of the crucial agency of the informal sector. The net benefits to the economy through income generation, employment creation and re-skilling of labour by the informal sector far outweighs any short-term benefits of tax collection through a process of forced formalisation.

The need of the hour is to protect and nurture the informal sector and handhold it to become formal in the process of growth rather than through surgical strikes a la demonetisation.

The lesson from demonetisation is the need for not only a better understanding of the black economy but also a better understanding of how the economy works, particularly the informal sector.

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