# Pro-growth, pro-poor

Black money is like a chameleon. Its multiple forms — in cash, real estate and gold, in tax havens, shell companies and benami properties — make its detection difficult. That is why when asked the reason for frequently changing goalposts after demonetisation, Prime Minister Narendra Modi replied, “One must distinguish between niti and rann niti.”

The war against black money is a war for the poor. Constant revenue leakage impairs the state’s ability to provide improved infrastructure, security to life and property, rural roads, sanitation, healthcare amenities and growth opportunities necessary for an equitable and cohesive social order. No one recognises this more than PM Modi. This explains the government’s resolve for an integrated strategy to combat black money through a robust legislative and administrative framework, IT systems and processes that are better equipped to integrate and mine data. Exaggerating the transitional irritants of these measures almost amounts to celebrating black money.

Apart from demonetisation, the government has constituted a Special Investigation Team (SIT) to unearth black money, enacted The Black Money (Undisclosed Foreign Income and Assets) and Imposition of Tax Act, 2015, to deal with black money stashed abroad, and amended the Benami Transactions Act, 1988 to enable the confiscation of benami property. Ripping away the mask of shell companies destroys their anonymity. The government has engaged with foreign governments to facilitate the exchange of information under various double tax avoidance treaties.

The main objective of fighting black money is to improve tax compliance and broaden the universe of activity and transactions under the tax net. The early evidence after demonetisation suggests a meaningful increase in the tax base. The number of taxpayers increased from 55.9 million in 2015-16 to 65 million in 2016-17. There is, of course, a natural increase in taxpayers every year. But the 16 per cent increase in 2016-7 is unprecedented. There was also an almost 27 per cent surge in new income tax filers in 2016-17 — compared to 20 per cent in the previous year and 5 per cent the year before that. Direct tax collections between April and July 2017 increased by more than 19 per cent over the same period in the previous year. This is impressive since the nominal GDP grew by just 9.3 per cent in the April to June quarter.

This broadening of the tax base has several macroeconomic implications. First, the extra resources it generates can be spent on important public goods and welfare programmes, including those pertaining to health and education. Public spending on health, education and physical infrastructure not only boosts economic efficiency and growth but also makes a deep dent on poverty and income inequality.

Second, by broadening the direct tax base, a successful fight against black money reduces the reliance on indirect taxes. This is significant because indirect taxes are regressive, and should be modest in a relatively poor country such as India. The fight against black money, therefore, is also a battle to make the tax system more progressive. Third, a broader tax base — all else being equal — can result in authorities lowering tax rates, especially for those at the lower end of the income spectrum. Lower tax rates can then improve tax compliance, leading to a virtuous cycle of an ever-broadening tax base and lower rates.

Fourth, by definition, black money stays out of the formal financial system. Domestically, it is either saved in unproductive physical assets (gold, real estate) or in currency-in-circulation. Consequently, the more the black money in an economy, the lower the formal financial savings. This will result in higher interest rates than necessary, or a larger than required current accounts deficit. Both are distortionary from a macroeconomic perspective. Indeed, the flood of deposits

after demonetisation — and the fact that a large fraction of these deposits have remained with the banking system (because currency in circulation is lower in the new equilibrium compared to what it was before) — has boosted financial savings and asset prices. It has allowed for structurally lower interest rates, with banks slashing their MCLR rates by 90 basis points after the post-demonetisation influx of liquidity.

Fifth, black money seeks alternative destinations through capital flight in the form of export under-invoicing or import over invoicing. Both widen the current account deficit and the balance of payments, thereby creating artificial stress on the external sector and the rupee.

Broadening the tax base by mounting a fight on black money is, therefore, both pro-growth and pro-poor. Since the marginal propensity to consume is progressively higher at the lower end of the income spectrum, a rupee transferred from the rich to the poor also boosts aggregate demand, and therefore leads to growth.

The direct tax base is likely to broaden because of various other government initiatives. The goods and services tax (GST) will undoubtedly broaden the indirect tax base. The value added tax that existed before this tax regime did not span the entire spectrum of the economy. Once taxpayers are in the net for indirect taxes, they will potentially also be in the net for direct taxes, thereby potentially broadening the direct tax base. The GST will enhance productivity, efficiency and growth in the long term. By helping mobilise more direct and indirect tax revenues in the medium term, it will also allow these resources to be used on merit goods, growth multipliers and reduce income equalit

Waging a war on black money does come with the near-term costs. To the extent that small and medium enterprises were outside the tax net — and are also marginal job creators — there were bound to be short-term transition costs. But they pale in comparison to the expected medium-term benefits and larger social good.

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