

## Demonetisation: now a proven failure?

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### Arun Kumar

Demonetisation as a means of tackling the black economy was destined to fail. It was carried out on the incorrect premise that black money means cash. It was thought that if cash was squeezed out, the black economy would be eliminated. But cash is only one component of black wealth: about 1% of it. It has now been confirmed that 98.8% of demonetised currency has come back to the Reserve Bank of India. Further, of the 16,000 crore that is still out, most of it is accounted for. In brief, not even 0.01% of black money has been extinguished.

Black money is a result of black income generation. This is produced by various means which are not affected by the one-shot squeezing out of cash. Any black cash squeezed out by demonetisation would then quickly get regenerated. So, there is little impact of demonetisation on the black economy, on either wealth or incomes.

### Changing goalposts

The government is highly embarrassed, and to cover it up, it has again changed the goalpost. It now argues that it is good that black money has been deposited in the banks because those depositing it can now be caught. But the government had tried to prevent people from depositing demonetised currency by changing rules during the 50-day period. It is now fighting hard in the Supreme Court against giving one more chance to deposit the demonetised notes that may have been left with the old and the infirm.

The government changed the goalpost earlier in November 2016 when it suggested that the real aim of demonetisation was a cashless society. Now it says that idle money has come into the system, the cash-to-GDP ratio will decline, the tax base will expand, and so on. But none of these required demonetisation and could and should have been implemented independently. Further, anticipating the failure of demonetisation in 2016 itself, the government started saying that demonetisation is only one of the many steps to tackle the black economy.

The government's argument that cash coming back to the banks will enable it to catch the generators of black income, and there will be formalisation of the economy, does not hold. Much of the cash in the system is held by the tens of millions of businesses as working capital and by the more than 25 crore households that need it for their day-to-day transactions.

### Those who bore the brunt

So, large deposits by businesses do not automatically become black. The Income Tax department has to prove that the sums deposited resulted from generation of black income. But it does not have the resources for dealing with lakhs of tax payers. According to the Finance Minister, big data analytics would track black money holders who have deposited cash in their bank accounts. During the Income Declaration Scheme in 2016, the same was said. Nothing came of it and demonetisation was announced.

The big failure of demonetisation is that it was carried out without preparation and caused big losses to the unorganised sector. This has not been factored into the recent data on growth rate, so the loss to the economy would be in lakhs of crores of rupees. Farmers, traders and the youth are all agitating.

The black economy needs to be tackled, but demonetisation is not the way. The brunt of this move has been borne by those who never had any black money. The note shortage is slowly waning and the long-term economic and social effects are becoming evident.

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## **Dhiraj Nayyar**

For India to achieve prosperity for all, three ingredients are essential: a transparent, effective government, flourishing of competitive free markets, and huge investment in the poor. In 2012, two decades after liberalisation unleashed significant gains, the very foundation of future prosperity was under threat. Corruption had made the government dysfunctional, crony capitalists flourished at the expense of honest entrepreneurs, and rampant tax evasion meant that the state did not have enough money to invest in uplifting the capabilities of its most vulnerable citizens. It would have needed a major disruption to make a clear break from the *ancien regime*. Demonetisation did just that.

### **Short-term costs inevitable**

There were always going to be costs in the short run — people would be short of currency, businesses would be disrupted, consumption would fall, and GDP growth would take a hit. Critics are making much ado about the fact that 99% of the demonetised currency made its way into bank accounts rather than bonfires. This is hardly surprising, especially after the government announced the Pradhan Mantri Garib Kalyan Yojana where cash could be declared, deposited, and a hefty penalty paid. For any individual, it would make sense to retain some of her wealth rather than destroy it all. And for those determined to deposit their illicit wealth without disclosure, the cash has not become white. It will be scrutinised by the tax authorities and penalties levied.

Consider the gains that may accrue in the coming year once tax authorities have combed through accounts with suspiciously large deposits. According to Finance Minister Arun Jaitley, between November 8 and December 31, 2016, deposits between 2 lakh and 80 lakh were made in about 1.09 crore accounts with an average deposit size of 5.03 lakh. Further, deposits of more than 80 lakh were made in 1.48 lakh accounts with an average deposit size of 3.31 crore. These amount to some two-thirds of the value of the demonetised currency. Obviously not all of this amounts to black money, but even if, say, one-third is, it reveals that a significant amount of black money was sloshing around pre-November 8. That is now in the tax net. Moreover, the holders of these suspicious accounts will now be in the tax net for perpetuity, so the gain is not just one-off.

### **Move to a cashless economy**

The other significant gain which has begun to accrue, and will gather momentum, is the move to a cashless economy. In the long run, a move away from the use of cash is the surest way of curbing the black economy. In 2015-16, the value of transactions for debit and credit cards was 1.6 lakh crore and 2.4 lakh crore, respectively; in 2016-17, it was 3.3 lakh crore for each. Also, in 2016, the National Electronic Funds Transfer handled 160 crore transactions valued at 120 lakh crore, up from around 130 crore transactions worth 83 lakh crore in the previous year. Note that the

demonetisation impact would only have been registered in the final four to five of 2016-17. The gains in 2017-18 will be even more.

Prime Minister Narendra Modi's government has launched a multipronged attack on corruption and black money. Government discretion has been reduced particularly in the allocation of natural resources. There is a concerted attempt to improve ease of doing business, and technology is being used to deliver public services without leakages. It is far too early to write-off any of these efforts, and demonetisation. There is a future beyond the present.

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## **Pronab Sen**

Any policy has to be judged in terms of its original intention. It may later have all kinds of side-effects, positive and negative, but nevertheless the touchstone is its original intent. The original intent of demonetisation was to address the issue of black money, or what the Prime Minister called *kala dhan*. There is enough work that suggests that people with black money hold a very small proportion of it in cash. Most of it is usually invested in gold, or real estate, or in the stock market, or abroad, and the share of black cash is 6% of the total black economy. So, the policy was at variance with the intent *ab initio*.

## **Original intent**

The entire discourse regarding 3.4-4 lakh crore being extinguished and then coming back to the government in the form of special dividend by the RBI is something that the bureaucracy took up later. To the best of my memory, this was not what Mr. Modi himself said. Even if we go by the expectations of 3.5-4 lakh crore coming back, that has not happened.

Mr. Modi did talk about demonetisation as a way of addressing the large number of fake currency notes circulating in the economy. That time the estimate was 400 crore. Even here the intent was based on a false premise. As it turned out, it was closer to 40 crore. However, this premise was based on statistical studies of fake currency, so one cannot fault the Prime Minister.

Nonetheless, these two, and their linkage to terrorism, were the main components of the reason for demonetisation, and the outcomes for both of them in terms of the way they were articulated are abysmal.

Then the goalposts started shifting when it became apparent that the main reason was not justified by what was happening. First it was cashless, then less cash economy, then formalisation of the economy. The final step was in saying this would give IT authorities the information to go after people who had deposited black money.

As far as all these secondary objectives are concerned, one would have to take stock of them only as things pan out since these are part of longer-term phenomena. Let's first take the issue of a cashless economy or less cash economy. There are two ways this can happen. The first is a shift in payment patterns. There was certainly evidence that the number of electronic transactions went up. But after the money supply started coming back to some semblance of normal, those dropped. Whether Indians have changed the way they make payments is questionable.

Then there is the issue of identifying the holders of black money. When people put money into the

bank, something that is anonymous gets tagged with their name. However, not all of that money deposited is black. Perfectly white cash holdings were common. To be able to distinguish the black from the non-black would be the responsibility of the IT authorities. They have to analyse the deposits and correlate them with the tax payment records, which is relatively easy to do. What is difficult to establish is whether the person depositing the cash was liable to pay tax in the first place.

### **Asking questions**

What I find objectionable and worrying is that all of us have vilified the RBI and the banking system, neither of which had any prior warning about what was going to happen. The RBI tried its best, but its reputation has taken a serious beating.

On the other hand, what has the IT department done in the last eight months? Questions need to be posed to the IT authorities whether the whole demonetisation episode is not to be an unmitigated disaster.

*Pronab Sen is former Chairman of the National Statistical Commission and country director, India Central Programme of the International Growth Centre.*

### **(As told to Anuradha Raman)**

The new U.S. Fed Chairman is unlikely to opt for policies that might upset the President's plan

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