

In India, Black Money Makes for Bad Policy

By **KAUSHIK BASU** NOV. 27, 2016

NEW DELHI — On Nov. 8, the Indian government announced an immediate ban on two major bills that account for the vast majority of all currency in circulation. Indians would have until the end of the year to change those notes for other bills, including newly minted ones.

On Wednesday, the government released via a smartphone app called “Narendra Modi,” named after the prime minister, the results of a survey purporting to show 90 percent support for its so-called demonetization policy.

The poll was rightly criticized. In the two weeks after the measure was announced, millions of Indians stricken with small panic rushed out to banks; A.T.M.s and tellers soon ran dry. Some 98 percent of all transactions in India, measured by volume, are conducted in cash.

Demonetization was ostensibly implemented to combat corruption, terrorism financing and inflation. But it was poorly designed, with scant attention paid to the laws of the market, and it is likely to fail. So far its effects have been disastrous for the middle- and lower-middle classes, as well as the poor. And the worst may be yet to come.

India has a large amount of what is known as “black money,” meaning cash or any other form of wealth that has evaded taxation. According to a 2010 World Bank estimate, the most reliable available, the shadow economy in India makes up one-fifth of the country’s G.D.P. (A 2013 study by McKinsey, the consulting firm, puts the figure at more than one-quarter.) Black money tends to exacerbate inequality because the biggest evasions occur at the top of the income spectrum. It also deprives the government of money to spend on infrastructure and public services like health care and education. According to the World Bank’s most recent estimate, from 2012, India’s tax-to-G.D.P. ratio is about 11 percent, compared with about 14 percent for Brazil, about 26 percent for South Africa and about 35 percent for Denmark. The government’s wish to tackle these problems is laudable, but demonetization is a ham-fisted move that will put only a temporary dent in corruption, if even that, and is likely to rock the entire economy.

Many Indians have been scrambling to change their old notes, causing snaking queues in front of banks and desperation among the poor, many of whom have no bank account and live from cash earnings.

Anyone seeking to convert more than 250,000 rupees (about \$3,650) must explain why they hold so much cash, or failing that, must pay a penalty. The requirement has already spawned a

new black market to service people wishing to offload: Large amounts of illicit cash are broken into smaller blocks and deposited by teams of illegal couriers.

Demonetization is mostly hurting people who aren't its intended targets. Because sellers of certain durables, such as jewelry and property, often insist on cash payments, many individuals who have no illegal money build up cash reserves over time. Relatively poor women stash away cash beyond their husbands' reach, as savings for the children or the household.

Small hoarders often fear being questioned about the source of their money — they are accustomed to being harassed by tax collectors, among others — and may choose instead to forgo some of their savings.

People have also been skimping in response to the new policy, causing demand for certain basic goods to fall, which has hurt farmers and small producers and could eventually lead them to scale back on their activities.

And even more pain is around the corner. With so much money in circulation suddenly ceasing to be legal tender, India's economic growth is bound to nose-dive. Another risk is that the Indian rupee could depreciate as a result of people and investors moving to more robust currencies.

The government's demonetization dragnet will no doubt catch some illicit cash. Some people will turn in their black money and pay a penalty; others will destroy part of their illegal stashes in order not to draw attention to their businesses. But the overall benefits will be small and fleeting.

One reason is that the bulk of black money in India isn't money at all: It's held in gold and silver, real estate and overseas bank accounts. Another is that even if demonetization can flush out the black money that is held in cash, with no improvement in catching and punishing tax evaders, people with ill-gotten gains will simply start saving in the new bills currently being issued.

When the government announced demonetization, it also justified the measure as a way to curb terrorism financing that relies on counterfeit rupee notes, as well as to dampen inflation. Both these justifications are flawed. Catching fake notes already in circulation neither helps trap the terrorists who minted them nor prevents more such money from being injected into the economy. It simply inconveniences the people who use it as legal tender, the vast majority of whom had no hand in its creation.

There also is no evidence that black money actually is more inflationary than white money; nor in theory should it be. Black money is just money held by people instead of the government. It's an excessive money supply that tends to create inflation; whether that money is white or black makes little difference.

Demonetization may have been well-intentioned, but it was a major mistake. The government should reverse it. It could at least declare that 500 rupee notes, which many poorer people frequently use, are legal again.

And if the government really does want to limit the amount of black money in circulation, it would do better to move India toward becoming a more cashless society. About 53 percent of adult Indians have a bank account, but many signed up at the government's initiative and so quite a few of the accounts are dormant. On the other hand, more than one billion people in India have a cellphone, and this could be tapped to encourage more active banking, in the form of mobile banking.

India's push to issue a unique I.D. number to all Indians based on their biometric information is a major step in the right direction. More than one billion people have already been registered, according to the government, potentially enabling them to use an app to collect pensions, for example.

Tackling corruption also goes beyond currency, cash or even banking. It requires changing institutions and mind-sets, and carefully crafting policies that acknowledge the complexity of economic and social life. The government could start by increasing penalties for tax evasion and amending India's outdated anti-graft laws.

In a country like India, where the illegal economy is so intimately intertwined with the mainstream economy, one inept government intervention against shadow activities can do a lot of harm to the vast majority, who are just trying to make a legitimate living.