Demonetization

On Nov. 8, Prime Minister Narendra Modi announced that 500 and 1,000 rupee notes (1,000 rupees is about $15) were no longer legal tender; people were given 50 days to deposit them in bank accounts or exchange them for new notes at banks and post offices — when only half of Indian adults have bank accounts. Beyond a fairly low threshold (under $4,000), people will be required to explain the source of their cash holdings.

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.

The goal is to eradicate black money, counter tax evasion and destroy counterfeit currency. In most large economies, cash is around 5 percent of GDP; in India it is 12 to 14 percent. Fewer than one-third of Indians have access to financial institutions. While most banks are concentrated in cities, most Indians live in villages. Forcing businesses to use banks and digital payments will help to bring them inside the tax net. Only 5 percent of Indian workers pay income tax, just 15 percent of the economy is inside the tax net and India's tax to GDP ratio at 17 percent is 5 points lower than comparable countries. Because of high property taxes, for example, buyers collude with sellers to understate the sale value and split the tax difference. This explains why the policy is an attack on the Indian way of doing business: Much of India's cash-based consumer transactions have ground to a halt.

As per former Finance Minister P. Chidambaram :"In practice it amounts more to demonization of cash than demonetization of currency. It is shockingly callous in its indifference to the distributional consequences. The ATM networks have been hit by total chaos, while the central bank struggles to print replacement currency. Almost 50 deaths have been reported among people forming long lines at banks".

Consumer goods sales are reported to have dropped by one-third. Trucks are at a standstill. Farmers have difficulty buying seeds and fertilizer and selling crops and perishable produce. The fishing industry is close to collapse. Few villages have ATMs and having to trek into cities and wait in line for hours means the loss of daily wages — as it does for the rickshaw drivers, street vendors, domestic workers and daily laborers in the cities. The construction industry has been badly hit with significant wage implications for its casual workforce.

While the poor keep their money in cash, the rich park illicit wealth in Indian and overseas real estate, shell companies, shares, gold and overseas bank accounts. Only 5 to 6 percent of India's illicit wealth is estimated to be held in cash components. Demonetization attacks the stock without touching the flow of black money. Cumulative illicit outflows from developing to developed countries increased from $369 billion in 2000 to $1.26 trillion in 2008. In the 10-year period from 2004 to 2013, the developing world as a whole lost $7.8 trillion. India has experienced the third-highest illicit capital outflow ($83 billion in 2013) after China ($259 billion) and Russia ($120 billion). Yet India's tax authorities have been among the least aggressive in going after names leaked in the Panama Papers in April.

The move also confuses the black with the informal economy by conflating cash with black money. Demonetization has the potential to permanently damage the latter, which comprises 45 percent of GDP and 80 percent of the workforce. Its main motor is the desire to escape the crushing burden of state taxes, regulations and bureaucracy. India's formal and informal economies are not quarantined from each other, but form a seamless value chain. For example, almost one-third of the working capital of small businesses comes from the black economy. Can that lost capital be replenished with fresh credit?

The policy also highlights several pathologies of India's governance. It buttresses the power of economically illiterate politicians and heavy-handed bureaucrats to control a large economy. Few citizens have encountered the tax inspector as a paragon of efficiency and probity. Forcing people to stand in line for unending hours and answer humiliating questions is an attack on property rights that puts restrictions on the people's ability to earn, access and use money.

A better solution would have been to shift the balance of economic decision-making away from the state to firms and consumers; simplify, rationalize and reduce taxes; cut regulations and curtail officials' discretionary powers; eliminate loopholes; and widen the tax net.

A major cause for the persistence of poverty and the 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 the thickets of red tape. Shock therapy without institutional transformation enlarges government while minimizing governance; more government equals more corruption. Demonetization cements the Indian government's reputation for capricious and arbitrary economic actions.

Politically, the decision has reinforced Modi's image as a strong and decisive leader prepared to take bold and tough decisions in the country's interests. It could denude political rivals of substantial cash assets for fighting the forthcoming elections in Uttar Pradesh, India's most populous state.

On the political downside, it has hit the lavish expenditure wedding season. The ruling party's main political base includes wholesale and retail traders who deal largely in cash. Their businesses have been gutted. How many marginal small businesses will survive the loss of a week's or fortnight's sales and income?

Foreign tourists were caught unawares and most simply do not have the time or patience to stand in line for long hours for minor sums of money. A substantial proportion of the 25-million-strong Indian diaspora is likely to have $100 to $300 in the high-denomination rupees as convenient small change on arrival in India. For these groups the shock therapy amounts to a minor inconvenience rather than a major hardship. But several million mildly irritated people among a country's most likely overseas goodwill ambassadors is not to be disregarded.

Disruptive technology can unleash creative forces through destructive impact on an industry that exists in a stable equilibrium of vested interests. Will the world's fastest growing big economy show similar resilience and regeneration from deep shock therapy, or will demonetization cure the disease but kill the patient? By withdrawing 86 percent of circulating currency when 70 to 80 percent of transactions are cash-based, has the Indian government burned down its economic house in order to eradicate the pest of corruption?

Union Government introduces Taxation Laws (Second Amendment) Bill, 2016

Evasion of taxes deprives the nation of critical resources which could enable the Government to undertake anti-poverty and development programmes. It also puts a disproportionate burden on the honest taxpayers who have to bear the brunt of higher taxes to make up for the revenue leakage. As a step forward to curb black money, bank notes of existing series of denomination of the value of Rs.500 and Rs.1000 [Specified Bank Notes(SBN)] have been recently withdrawn the Reserve Bank of India.

Concerns have been raised that some of the existing provisions of the Income-tax Act, 1961 (the Act) can possibly be used for concealing black money. The Taxation Laws (Second Amendment) Bill, 2016 ('the Bill') has been introduced in the Parliament to amend the provisions of the Act to ensure that defaulting assesses are subjected to tax at a higher rate and stringent penalty provision.

Further, in the wake of declaring specified bank notes "as not legal tender", there have been suggestions from experts that instead of allowing people to find illegal ways of converting their black money into black again, the Government should give them an opportunity to pay taxes with heavy penalty and allow them to come clean so that not only the Government gets additional revenue for undertaking activities for the welfare of the poor but also the remaining part of the declared income legitimately comes into the formal economy.

In this backdrop, an alternative Scheme namely, 'Taxation and Investment Regime for Pradhan Mantri Garib Kalyan Yojana, 2016' (PMGKY) has been proposed in the Bill. The declarant under this regime shall be required to pay tax @ 30% of the undisclosed income, and penalty @10% of the undisclosed income. Further, a surcharge to be called 'Pradhan Mantri Garib Kalyan Cess' @33% of tax is also proposed to be levied. In addition to tax, surcharge and penalty (totalling to approximately 50%), the declarant shall have to deposit 25% of undisclosed income in a Deposit Scheme to be notified by the RBI under the 'Pradhan Mantri Garib Kalyan Deposit Scheme, 2016'. This amount is proposed to be utilised for the schemes of irrigation, housing, toilets, infrastructure, primary education, primary health, livelihood, etc., so that there is justice and equality.

An overview of the amendments proposed in the Bill are placed below;

Overview of Amendments Proposed

PARTICULARS	EXISTING PROVISIONS	PROPOSED PROVISIONS
General provision for penalty	**PENALTY (Section 270A)** Under-reporting - @50% of tax Misreporting - @200% of tax (Under-reporting/ Misreporting income is normally difference between returned income and assessed income)	No changes proposed
Provisions for taxation & penalty of unexplained credit, investment, cash and other assets	**TAX (Section 115BBE)** Flat rate of tax @30% + surcharge + cess (No expense, deductions, set-off is allowed)	**TAX (Section 115BBE)** Flat rate of tax @60% + surcharge @25% of tax (i.e. 15% of such income). So total incidence of tax is 75% approx. (No expense, deductions, set-off is allowed) **PENALTY (Section 271AAC)** If Assessing Officer determines income referred to in section 115BBE, penalty @10% of tax payable in addition to tax (including surcharge) of 75%.
Penalty for search seizure cases	**Penalty (271AAB)** (i) 10% of income, if admitted, returned and taxes are paid (ii) 20% of income, if not admitted but returned and taxes are paid (iii) 60% of income in any other case	**Penalty (271AAB)** (i) 30% of income, if admitted, returned and taxes are paid (ii) 60% of income in any other case
Taxation and Investment Regime for Pradhan Mantri Garib Kalyan Yojana, 2016' (PMGKY)	New Taxation and Investment Regime	Undisclosed income in the form of cash & bank deposit can be declared: **(A) Tax, Surcharge, Penalty payable** Tax @30% of income declared Surcharge @33% of tax Penalty @10% of income declared Total @50% of income (approx.) **(B) Deposit** 25% of declared income to be deposited in interest free Deposit Scheme for four years.