IS DEMONETIZATION THE SILVER BULLET TO END CORRUPTION AND BLACK MONEY? : LESSONS LEARNT FROM INDIAN EXPERIENCE

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ABSTRACT

Prime Minister of India, on 08 November 2016, took a major decision to demonetize ₹ 500 and ₹ 1000 notes (bills), removing them as legal tender. This has resulted in 86% of all currency in circulation being taken out of the Indian monetary system. According to Indian Prime Minister, demonetization was resorted to eliminate black money and corruption. It was expected that nearly ₹ 5 Trillion ($70 Billion) of black money will not come back into the system. However, ₹ 15.28 trillion (US $ 239 billion) or 99% of these notes were deposited into banks. This proves that demonetization has not succeeded in eliminating black money. Demonetization's ability to fight corruption is also limited.

Keywords: ***Black Money, Corruption, Demonetization, Legal tender***

INTRODUCTION

On November 08, 2016, Prime Minister of India announced that ₹ 500 and ₹ 1000 notes in circulation would no longer be legal tender after midnight. This demonetization announcement has caught everyone by surprise. According to the Prime Minister, the main objective of demonetization was to remove black money from the monetary system and other objectives included eliminating corruption, combating terrorism, and rooting out fake currency. ₹ 500 (US$7.50) and ₹ 1000 (US$15) notes constituted 86% of the total currency in circulation in the country. Taking out 86% of currency notes from the monetary system had a profound effect on the country as a whole and caused a great deal of suffering to the people of India. However people of India at large appears to have supported the demonetization. This paper is a study of the effect of demonetization on corruption and black money. The paper is structured as follows. The second section describes the methodology. The third section explains corruption in India. The fourth section covers black money. The fifth section discusses demonetization in India. The sixth section brings out the lessons learnt and the seventh section concludes the paper.

RESEARCH METHODOLOGY

This paper uses a mixed modes research approach using both quantitative and qualitative data. Demonetization in India is a very recent event and understandably there is no published research on this topic in academic journals. Hence this paper makes use of the data available from various newspapers, magazines, Internet and other media.

CORRUPTION

Robert Klitgaard's (1995) equation summarizes the corruption framework effectively as "**Corruption = Monopoly + Discretion – Transparency (in governance)".** Corruption in the world has existed for centuries. Corruption is all about abusing public office and power vested in public officials for personal pecuniary gain. World over corruption has started receiving attention starting from 1990s. A number of eminent researchers have studied this phenomenon 1990-2000 including Rose-Ackerman (1999), Olson (1993). Corruption exists both in both developing and developed countries. In this context, Kitzgaard (1998) observed "while there are bribe–takers in the former, there are bribe-givers in the later".

Corruption and bribes have been considered pretty common in India throughout its history, though in the recent past it appears they have reached unprecedented levels. Indian political parties, police and judiciary have been ranked as the first, second and third corrupt institutions respectively in India (Xu, 2014). According to a 2012 Hindustan Times youth survey conducted across India targeting educated, young people in the age group of 18 to 25, at least 42% of young Indians have paid a bribe, 39.3% said that they will not be ashamed of paying bribe, 39.4% felt that Indians are more tolerant of Corruption and 42.6% reported that nobody has ever stopped them from paying a bribe (Hindustan

Times, 2012). Corruption is a complex and distinct phenomenon. Transparency International (TI), the corruption watchdog of the world defines corruption as 'misuse of entrusted power for private gain' (TI, 2008). Corruption according to UNDP is principally a governance issue, reflection of institutional failure or lack of capacity on the part of government 'to manage society by means of a framework of social, judicial, political and economic checks and balances' (UNDP, 2006).

Corruption is common whenever big government infiltrates all facets of economic life, as well the political and business systems. Golden (2000) argues that "widespread unabated political corruption and patronage system depends on extent to which businesses are willing to pay bribes as part of the cost of doing business with the public sector, or the extent to which politicians have an incentive to seek additional illegal financial resources or the extent to which politicians enjoy a large collective incumbency advantage and do not fear exposure by a credible political rival". According to the Transparency International's Global Corruption Barometer for 2007 political parties and the legislative branch – meaning parliament and congress – are perceived by people around the world to be the institutions most tainted by corruption (TI, 2007). Corruption in a country can be classified into three levels. The first one is petty bureaucratic corruption that takes place at the lowest level like in government offices. The second level is administrative corruption, involving senior administrative officials of the government and the third or highest level is at the political level, what is known as 'grand larceny' (Pathak and Prasad, 2006). Table below is a compilation of Transparency International's Corruption Perception Index (CPI) for India from 1995 to 2016. The CPI score is on a scale of 1 to 10, where a high score is an indication of low levels of corruption and low score is an indication of high levels of corruption in a country. With regards to the rank, the higher the rank, the higher the corruption. A cursory look at these figures indicates that corruption is a major problem in India.

CPI SCORE AND TRANSPARENCY INTERNATIONAL RANK OF INDIA 1995 - 2017

Year	CPI Score	Rank/ Number of countries
1995	2.78	No Rank
1996	2.76	46/54
1997	2.75	45/52
1998	2.9	66/85
1999	2.9	72/99
2000	2.8	69/70
2001	2.7	71/91
2002	2.7	71/102
2003	2.8	83/133
2004	2.8	90/145
2005	2.9	88/158
2006	3.3	70/163
2007	3.5	72/179
2008	3.5	85/180
2009	3.4	84/180
2010	3.3	87/ 178
2011	3.1	95/180
2012	36	94/174
2013	36	94/174
2014	38	85/174
2015	38	76/167
2016	40	79/176

Source: Compiled from Transparency International CPI reports from 1995-2016.

During the last two decades the nature of corruption in India has changed. From 1950 to 1980s the petty corruption and administrative corruption were more prominent, but starting from 1980s, the political corruption has become the more predominant. During the last decade, starting from 2000 till 2012 India has witnessed unprecedented political corruption both in quantity and number of cases. The present government came to power with the promise of ending corruption. Though there was no major corruption scandal in the last three years, surprisingly, the CPI of transparency International shows that the corruption is increasing in India, though marginally.

BLACK MONEY

Black Money refers to the unaccounted money which is generated through black market, corruption or organized crime, on which taxes have not been paid. Black money can be generated through both legal and illegal activities. India is predominantly rural and a cash economy where 90% of commercial transactions take place in cash. The wages of millions of workers in both urban and rural areas are paid in cash. Similarly most purchases and sales of all items are carried out in cash. Even in e-commerce the most popular mode of transactions is Cash on Delivery. These cash transactions provide lot of scope for generating black money.

Black money in India gets generated in a number of ways. Most shopkeepers do not maintain any records of sales and do not pay taxes on complete volume of sales. They sell at a higher price and record transactions at a lower price, resulting in generation of black money. The wages are paid in cash and most employers inflate these payments. Employees are out of the tax net. Real estate market is notorious for generating black money. Only 50to 60% of the transaction is reflected in white or clean, tax paid money. Rest is paid in cash from black money. This is done to show the sale prices at lower value and avoid tax on property transfer. In construction, manufacturing sectors costs are inflated using fake bills. Many professionals like doctors do not report their income and never provide invoices and receipts to patients and lawyers to their clients. Organized crime, prostitution, smuggling generate a great deal of black money. Promoters of public companies generate black money through the practice of transfer pricing, which involves under-invoicing exports and over-invoicing imports through countries such as Singapore. Many companies show profits in one business but show losses in other businesses and avoid paying taxes.

Corruption generates tremendous amounts of black money as this income is never reported for obvious reasons. Corruption in India is endemic and it is not an exaggeration to say that there is no public organization without corruption, only the degree varies. Political corruption has emerged as the biggest source of black money in recent years. Some researchers like Vaidayanathan attribute the rise in the number of visits by ministers to Switzerland and other tax heavens as an indicator to this phenomena.

The high income tax rates in India since independence till late 1980s have contributed to generation of black money. India was one of the highly taxed nations in the world. For example during 1970 -71, the effective tax rate was unbelievable 93.5 %, during 1985-86 was 50%. In 1991 as part of economic liberalization, highest tax rate was made 40%. In 1997-98 this tax rate was further brought down to 10, 20 and 30 % respectively. Later budgets increased the threshold limits for tax exemption and ceiling on individual slabs. The 2010 budget made 20% tax applicable to income above ₹ 500,000 and 30% for income above ₹ 800,000 (India Today, 2011).

ESTIMATE OF BLACK MONEY IN INDIA

Ser #	Year From	Amount	Source/ Committee	Remarks
1	1953-54	₹ 600 crore	Prof Kaldor	
	1961-62	₹ 1150 crore	Rangrekar	
		₹ 2,350 crore	Rangrekar	
	1965-66	₹ 1000 crore	Wanchoo committee	
	1967-68	₹ 3,034	Gupta	(Economic and Political Weekly, January 16, 1982:73)
	1969-70	₹ 1400 Crore	Wanchoo committee	
	1969-70	₹ 3,080 crore	Rangrekar	
	1978-79	₹ 40, 867 crore	Gupta	
	1996	4,00,000 crore	The Hindustan Times	
	2017	₹ 70,00, 000 crores	Dr R Vaidyanathan	

According to Gupta's estimate black money constituted 9.5 % of GNP in 1967-68, swelled to 49% in 1978-79. In 1985 the planning commission estimated that ₹ 50,000 crore black money was being generated each year. Arun

Kumar (1999) in his book on black money in India estimated black economy equivalent to 40% of GDP out of which 32% is generated through legal sectors and 8% through illegal sectors like prostitution (Mandal, n.d). Schneider (2006) estimated black money in India to be between 23 to 26% of GDP. According to Vaidyanathan (2017) Indian black money deposits in Swiss banks are estimated to be US $1.4 trillion (₹ 70, 00,000 Crore), which is 40% more than entire Indian budget of 2007-08. He estimated the size of black money to be 20% of the 2016-17 GDP. People with black money are always on the lookout for opportunities to convert their black money into white money. They do this using a number of ways. Buying real estate, investing in benami (nonexistent) persons names, sending it abroad mostly to off shore tax heavens, depositing in Swiss banks, money laundering through havala (illegal Money transfer) operations, to name some. In the past Indians used to take the black money out through havala channels and use to park in foreign banks. But as the interests rates have become very low, the current practice is to bring the clean money as foreign Direct investment (FDI), through a financial intermediary from Tax heavens and enjoy the benefits.

DEMONETIZATION

Demonetization is the process of rendering the exiting currency useless by removing it from being legal tender. Many countries in the past tried demonetization for various reasons like eliminating black money from their monetary systems. Many of them failed but a few have succeeded. Examples of countries that tried demonetization and failed include Ghana, Myanmar, Soviet Union, Zimbabwe and Zaire. During 1982, Ghana demonetized their Cedi 50 with the aim of controlling black money, but failed (Jain, 2017; Neha, 2016). However, demonetization has succeeded in some other countries like Australia, EU and US (Spellerstep, 2016).
Indian Government also tried demonetization on two other occasions in the past. In 1946, the colonial government demonetized ₹ 500, ₹ 1000 and other higher denomination notes with the intention of penalizing the merchants, who tried to evade taxes by concealing profits made from supplying goods for war effort. In 1978, the Janata party government in power demonetized ₹ 1000, ₹ 5000 and ₹ 10,000 notes introduced in 1954, for curbing counterfeit notes and black money. But the move failed to achieve the desired result (Sankaran, 2016). On November 8, 2016, at 8.20 PM, Prime Minister of India, Narendra Modi announced that all ₹ 500 and ₹ 1000 notes in circulation will no longer be legal tender from midnight. According to him, the objectives of this 'demonetization' were to eliminate black money, curb corruption, fight terrorism and stop fake currency notes 'that were coming from enemies across the border'. He said that demonetization will render higher denomination notes horded by 'anti-national and anti-social elements' worthless pieces of paper from midnight.

According to RBI bulletin of November 04, 2016, the total currency in circulation in India was estimated to be ₹ 17.97 trillion ($260 billion). ₹ 500 ($7.50) and ₹ 1000 ($15) notes comprised of 86% of all currency notes in circulation are worth ₹ 15.45 trillion ($217 Billion) (Waghmare, 2016). ₹ 500 notes accounted for 47.8% in value and ₹ 1000 notes another 38.6 % (RBI, 2016). This decision to demonetize ₹ 500 and ₹ 1000 notes was believed to have been made in May 2016. Printing of new ₹ 2000 and ₹ 500 notes also started at the same time. To ensure that no inconvenience is caused to honest people holding ₹ 500 and ₹ 1000 notes, Prime Minister allowed depositing them in any bank, without any upper limit. This facility was made available for 50 days starting from November 10, 2016 to December 30, 2016. To prepare for this task ahead the banks and ATMs remained closed for a day on November 09, 2017. However, in order to prevent abuse of this facility and also to detect black money, persons depositing more than ₹ 250,000 ($3650.00) were required to prove that they have paid taxes on the amount deposited. Failure to do so rendered them liable to a fine of 200% on the tax owed to the government and also possible prosecution (Aleem, 2016). It was hoped that people with black money will not be depositing their money in banks due to the fear of prosecution and penalties.

The government's plan was to issue a new series of ₹ 500 ($7.50) and ₹ 2000 ($30) notes with additional security features, to replace the demonetized notes. The new notes were brought into circulation from November 10, 2016. However as it was not possible to replace all old notes in one go, the replacement was planned over the next two months. In the meantime some curbs were imposed on withdrawal of money from banks. A person with a bank account could only withdraw a maximum of ₹ 10,000 ($150) per day, and ₹ 20,000 ($300) per week. These limits were to be reviewed periodically and increased as the supply of new currency notes increased. A provision was also made for people without a bank account, to exchange their old notes to the tune of ₹ 4,000 ($60) from any bank or post office. Restrictions were placed on ATM withdrawals also and cardholders could withdraw ₹ 2000 ($30) per day only. However some exceptions were allowed for using demonetized notes. Demonetized notes were accepted at government hospitals and pharmacies to avoid hardship to patients. Old notes were also accepted for 72 hours at railway ticket booking counters, gas stations of public sector companies, consumer cooperatives, milk booths, crematoria and burial grounds. Arriving international travelers could exchange up to ₹ 5,000 ($75) at international airports (Chakraborty, 2016).

Demonetization has caught every one unaware and resulted in great inconvenience to people. Ordinary people who saved their money in cash in demonetized notes had to deposit them in banks. Many rural and poor urban people did not have bank accounts. Initial limit on withdrawals from banks and ATMs added to the problems of public. Long queues were witnessed in front of the banks. Many banks were caught unprepared for this huge task. The erratic supply of new notes compounded the problem. ATM machines ran out of cash. Fights erupted between customers and bank employees and between people standing in queues. Though estimates vary, by the end of 50 days on December 30, 2016, Forbes put the number of people died due to demonetization and its after effects at 100 (Worstall, 2016) . In rural areas framers could not get money for buying seeds. They were not able to sell their farm produce.

No doubt rich people were caught unaware, but the effect was also harsh on poor people and rural India. The micro business like milk vendors and tea vendors, vegetable vendors, small restaurants and small shop keepers were most hit. Smaller businesses like these reported 50% decline in sales over night. Many of them had no bank account. They used to keep their savings in cash mostly in ₹ 500 notes. As most rural folks and urban poor did not have bank accounts, it had become very difficult to carry on with their daily lives. Cab drivers, small shop owners refused to accept ₹ 500 and ₹ 2000 notes because they did not have the change in smaller denomination notes. The poor, both from rural and urban India bore the brunt of this step. Many daily wage laborers lost their livelihood as the employers did not have the cash to pay them. Small and Medium Enterprises (SMEs) in India contribute 8% to the GDP, while employing nearly 80 million people. Lack of banking infrastructure in rural areas added to the problem.Slowly the situation has improved with increased supply of new notes but that has taken much longer than expected 50 days. Indians bore all those difficulties and majority supported the decision hoping for elimination of black money.

Many people believe that demonetization has not been able to eliminate black money as expected. The total volume of ₹ 500 and ₹ 1000 notes in circulation was ₹ 15.4 trillion ($240 billion). According to reports ₹ 14.97 trillion (US $ 220 billion) out of ₹ 15.4 trillion ($240 billion) or 97% of the demonetized ₹ 500 and ₹ 1000 notes have been deposited in the banks as on 30 December 2016. This bellied the hopes of the government that ₹ 5 trillion ($70 billion) of black money will not be deposited in the banks and hence will not come back into the monetary system. Complete data was not available and RBI and Finance minister said that it is likely to take time before they can provide accurate data. Hence it may be quite a while before the true picture emerges. (Singh, S. & Pradhan, 2017; Express Web Desk 2017).

LESSONS LEARNT : BLACK MONEY

However it is not difficult to see why demonetization has not made an effective impact on black money. According to analysts, only 6% of the illegal money is in the form of cash. A major part of it is stashed away in tax heavens like Panama, Swiss banks. According to a report 'The drivers and dynamics of Illicit Financial flows from India 1948-2008', by Kar (2010), chief Economist at Global Financial integrity, India lost $213 billion during this period due to illicit outflows. The report found that on the average $22.7 to $27.3 billion was leaving India per year between 2002 and 2007. This report also says that the money illegally stashed abroad by Indians represents 72% of the underground economy and 50 % of the Indian GDP.

The second form of black money is believed to be in the form of stable international currencies like US dollars and British pounds. Many Indians with black money have been accumulating US dollars, Euros and other currencies from local markets. According to some estimates, these two, money sent abroad and accumulated in international currencies account for 85% of all black money in India. The third form is the vast amount of unaccounted money invested in real estate. In India 95% of all real estate deals have a black money component. If one takes into account all the above facts, less than 6% of the black money is in the form of cash (Singh, 2016). On the other hand, introduction of ₹ 2000 note has also become an issue of debate. It is a fact that higher denomination notes help people who hoard money. If the aim of demonetization is to fight black money generation, many question the wisdom of government in printing new ₹ 2000 notes. Government's explanation that expected future inflation as the reason for issuing ₹ 2000 notes does not appear to be very convincing in the backdrop of demonetization. Hence it can be safely assumed that demonetization did not succeed in eliminating black money. Some people argue that in fact it helped black money hoarders to convert their money into white. That may not be true as Income Tax department is scrutinizing all the large suspicious cash deposits. They have already issued notices to concerned people.

CORRUPTION

It is an irony that demonetization, which was to eliminate corruption has given birth to some new forms of corruption. After demonetization, some enterprising Indians have tried to convert their black money into white money using the following 13 different ways. First is donations to temples. As the government declared that no questions will be asked about the money donated to temples, many cases were reported where people deposited old currency with temple management. The arrangement was that some unscrupulous elements in temple management would convert old notes into new notes and get a 20% commission for their services. A sting operation by ABP news brought this to public attention. The second way was by depositing the old notes back dated in co-operative banks in rural areas where transactions are carried out and recorded manually. Third is using other poor people to deposit the money in their accounts, as the government said that deposits up to ₹ 300,000 ($4500) in any account would not be questioned. The fourth one was giving interest free loans to poor people in old currency and asking them to deposit in their bank accounts. The fifth one is using Jan Dhan accounts, a scheme launched by the government to encourage poor people to open bank accounts, where deposits up to ₹ 100,000 ($1500) are asked no questions. The sixth scheme was by mafia buying old notes by paying 15% to 80 % of value in ₹ 100 notes. The seventh is employers paying advance salaries for 3 to 8 months, but less than 2.5 lakh to avoid detection, and keeping employees debit cards with them. The eighth is booking expensive AC Ist class train tickets in old currency and cancelling them later to get refund in new currency, as it only involves paying a small cancellation fee. The ninth is using professional money laundering firms, some of them run by chartered accountants. The tenth is buying gold on back dated transactions. The eleventh one is using farmers to convert demonetized notes by paying a commission, as agricultural income is not taxed. The twelfth is making contributions to political parties as this is not questioned and trying to get political favors and the last is depositing them in the bank and be prepared to face consequences (Vij, 2016; Khan & Sharif, 2016).

Further there were widespread reports of bankers involving in corrupt practices by helping the corrupt people move their money. 27 senior officers from public sector banks were suspended for irregularities committed by them. Hordes of new cash in ₹ 2000 notes were recovered from businessmen from different parts of the country and investigations reveled collusion between bank officials and these corrupt players. Axis bank has been accused of violating the RBI guidelines. It came to light that ₹ 100 crore ($15.3 million) was found deposited in 40 fake accounts. Income tax department initiated an investigation into these irregularities. 50 officers from private, public sector banks and RBI have been found conspiring with money launders (Harlankar, 2016).

Demonetization has proved that fighting corruption with only one measure like demonetization is not practical. Corruption in India is endemic and prevalent at all levels of the society. Unless a serious and holistic approach is taken with effective legal and enforcement mechanisms it is difficult to eliminate or even reduce corruption. This clearly proves that demonetization is not a silver bullet to reduce or end corruption.

CONCLUSION

Demonetization in India can be considered a bold experiment considering the fact that 86% of the currency notes in circulation have been taken out from monetary system in a country that is predominantly a cash based economy. Demonetization has received the support of common man fed up with rampant corruption and black money.

However in the final analysis, demonetization has proved that it is not the silver bullet to end corruption and black money.

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