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# *Emerging issues in Political Economy of India-Demonetization*

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## Abstract

The Indian demonetizations of November 2016 came at an entirely new scale to those of January 1946 and January 1978. This time around, the Narendra Modi government's measures applied to 86.4% of the banknotes and coins in circulation, the equivalent to 11% of GDP. Much analysis has been undertaken on the demonetization. This has largely been critical because of its disastrous consequences on local populations and the most deprived among them. Our paper adopts a different angle: it argues that demonetization has had a key impact on the digitalization of payments. We use data from the Reserve Bank of India from 2014 to 2020 to show that the demonetization period brought about a decline in Automatic Teller Machines (ATM) withdrawals. It equally boosted the adoption of digital means of payments, via Point of Sale Terminals (POS) and mobile banking. Since October 2016, the number of POS transactions has risen almost threefold, while the number of ATM transactions has decreased by almost one-fifth. The current government's rhetoric is to promote digitalization as a means of both formalizing the economy and protecting the poor. Its claim is unfortunately highly debatable.

## Introduction:

Consider the sequence of events in its demonetization saga. In November the government made a high-risk, high-stakes economic intervention in the world's largest democracy, with an objective to reduce corruption. Overnight, 86% of cash in circulation was voided. In a country almost 90% cash reliant, chaos ensued. As I said at the time, it was a case study in poor policy and even poorer execution. The country emerged with few obvious scars. Although the impact on corruption remains to be seen, Prime Minister Narendra Modi's government was rewarded with victory in midterm state-level elections, seen as a referendum on its unprecedented action. India's demonetization experiment has generated some important thinking about cash, corruption, data, and the digital economy. Let's consider some new takeaways:

### Demonetization Is Not the Best Tool to Root Out Corruption

The original reason given for the drastic demonetization action was to expose the so-called "black" market, fueled by money that is illegally gained and undeclared for tax purposes. The existence of this parallel economy is a substantial drag on the Indian economy: According to recently released data, only about 1% of Indians paid taxes on their earnings in 2013. When the policy change was announced, people were given until December 30, 2016, to return 500- and 1,000-rupee notes to banks, or else risk losing the value of them.

It would have been better to demonetize less-commonly-used large-denomination bank notes (Larry Summers wrote about the idea here). India invalidated the 500-rupee and 1,000-rupee banknotes (worth approximately $7.50 and $15, respectively), which represented 86% of all currency in use. These widely used currencies affected a very large swath of people, from all parts of the socioeconomic spectrum, including the poor.

Besides, when corrupt people need places to park their ill-gotten gains, cash normally is not at the top of their list. Only a tiny proportion of undeclared wealth is held in cash. In an analysis of income-tax probes, the highest level of illegal money detection in India was found to be in 2015–2016, and the cash component was only about 6%. The remaining was invested in business, stocks, real estate, jewelry, or “benami” assets, which are bought in someone else’s name.

Some legal experts have argued that demonetization violates the law. They say the sudden extinguishing of the public debt owed by the government to the holder of the bank note results in the government taking an individual’s “movable property” away without easy access to a replacement or compensation. Public policy for rooting out corruption calls for a systemic approach, with carrots and sticks to motivate cultural, institutional, and behavioral change in the long term. Silver bullets, such as drastic demonetization, don’t work.

**Innovation and Creativity Emerged Around Digital Payments**

The unqualified winners of the demonetization period were the mobile wallet players, with the market leader, Paytm, claiming 170 million users, with a traffic increase of 435%, and a 250% increase in overall transactions and transaction value. Arguably, the surge in business for mobile wallets was natural, at least for the 17% of the population that owned a smartphone in early 2016. Here, the government’s innovative capacity shone through. The government-backed payment app, BHIM, facilitated electronic transfers between bank accounts; users could enter their unique, 12-digit Aadhaar ID number to make payments. The easy-to-use system works on an ordinary flip phone — no internet-enabled smartphone required. In other words, it was an inclusive solution, and, if the service continues to improve, it stands a chance of scaling up to India’s large market. Plus, there are plans to mandate digital payments at gas stations, hospitals, and universities, with cash transactions over $4,500 banned altogether. Indian Railways will no longer levy a service charge on tickets booked online, and the government is removing duties on point-of-sale devices and fingerprint readers. Putting aside the policy missteps, these moves are a shot in the arm to the ecosystem around digital payments and consumer-and-context-friendly technology.

Official estimates from India’s Central Statistics Office (CSO) on GDP growth have shown that the economy grew at 7% in the quarter ending December 2016. This was exactly what was predicted in the CSO’s advance estimate, before demonetization. That means demonetization had no impact whatsoever on the economy, which is surprising, given the widely reported experiences of the closings of small factories and businesses, workers losing their wages, and projects being postponed. There are several problems with the CSO’s

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figures. First, there is a lag between the time when estimates are made and when actual data comes in. Much of this estimation is done on the basis of models relying on past data, which is much less reliable when an event such as demonetization occurs. Second, the informal sector plays a disproportionate role in the country's economy; by one estimate it produces 45% of the output and employs 94% of the workforce. It is the sector on which it is hard to get reliable direct data. The informal sector is also primarily cash-reliant and bore the brunt of demonetization.

Finally, India does not have reliable national retail sales data, so statisticians have to use production figures to estimate consumer spending. To compound the estimation challenges, these production figures include data only for listed companies, thereby underrepresenting the unregistered companies and informal manufacturing producers — the ones that are directly affected by the cash ban. Consider some additional data for the last quarter of 2016. Commercial vehicle output, rail freight, service tax receipts, and home appliance sales showed a slowdown, causing some economists to set the GDP growth forecast at 6.4% instead of 7%.

The fast-moving consumer goods industry reported around 1%–2% reduction in volumes. Hindustan Unilever Ltd (HUL) and Nestlé, two of the biggest names in the industry, reported drastic declines in profits and revenues. HUL experienced a 4% decline in sales volumes, according to BW Disrupt.

- Tractor sales to farmers flush with cash after a healthy rainy season were weaker: Volume rose only 18% in October–December, down from 28% gain the prior quarter, reports Nikkei Asian Review.
- Passenger car sales grew 1% on the year for October–December, down from 18% growth a quarter earlier. Maruti, India's largest car manufacturer, had a 3.5% increase in car sale volumes, down from 18.4% growth in the previous quarter, according to a recap on Scroll.in.
- In the case of two-wheelers (think scooters), sales declined 22%in December 2016, compared to the prior December, marking the highest monthly contraction since 1997, as reported on Business Standard.

The official economy-wide data struggled to reflect the reality on the ground precisely because cash transactions are fragmented and defy accurate data capture.

**The Rise of the "Big Narrative" Continues**

Ultimately, the public did not judge the Modi government's actions on the basis of arcane issues, such as the percentage of money deposited in banks, what percent of illegal assets are held in cash, or the intricacies of how GDP growth is calculated. Every person living in India had to experience some form of dislocation or inconvenience. Despite that, the message that carried the greatest weight was that the government was acting, and acting decisively, on behalf of ordinary people to fight corruption. As for those questioning the wisdom of the policy, the prime minister's comments at an election rally in the state of Uttar Pradesh said it all: "On the one hand are those [critics of the note ban], who talk of what people at Harvard say, and on the other is a poor man's son, who through his hard work is trying to improve the economy."

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

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economy is without precedent, so no one can predict the long-term structural impact and the full range of intended, pernicious and perverse consequences. 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. 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. 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?

**Conclusion**

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?

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