

Demonetisation is not the way to tackle corruption

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*Drawing on India's previous experiences of demonetisation and contemporary data, **Swati Dhingra** and **Amartya Menon** argue the benefits seem few and far between. They write that if the government is serious about tackling corruption, it should prioritise taxing the super-rich and changing the tax system to minimise arbitrary action by corrupt tax officials.*



The Indian government's decision on 8 November to dismiss the use of the two largest denomination currency notes overnight has taken the entire nation by surprise. Prime Minister Narendra Modi's decision to demonetise Rs. 500 and Rs. 1000 notes has been accompanied by very clear intentions – fight corruption, terrorism and rid the economy of black money. While the move has been called [brave](#) in many quarters, it has received vocal [criticism](#) in others. History tells us that demonetisation as a tool to fight black money simply isn't effective enough to justify its costs.



On two separate occasions in the past, India has demonetised high value currency notes. In 1946, Rs. 1000 and Rs. 10,000 banknotes were withdrawn from circulation, only to be reintroduced eight years later in 1954, along with a new Rs. 5000 note. Then again in 1978, the Janata Dal coalition party demonetised these same notes. IG Patel, RBI governor at the time, was quick to point out the inefficiency of the method, stressing that most graft money was unlikely to be held in the form of cash. In his [autobiography](#) he writes,

“Most people who accept illegal gratifications or are otherwise the recipients of black money do not keep their ill-gotten earnings in the form of currency for long. The idea that black money or wealth is held in the form of notes tucked away in suitcases or pillow cases is naïve.”

Most often, black money can be traced back to two activities – tax evasion and corruption. In both instances, the money is usually used to fund further transactions, most of which are legal. As a consequence, the move is only likely to scratch the surface, affecting petty corruption while leaving super-rich, tax evading individuals and businesses largely untouched.

Demonetisation as an instrument has no impact on money that is held abroad. According to the Hindu, drawing on [data](#) released in 2014 by the Swiss National Bank, Indian money held in Swiss bank accounts amounted to CHF 1.78 billion, translating to approximately Rs. 12,300 crores. It is likely that this number understates the actual amount, because the estimate does not take into consideration Indian money deposited in Swiss accounts via other countries. PM Modi's move fails to do anything about this money being held abroad by India's elite.



Image: Rs. 500 & Rs. 1000 notes. Credit: [Aschevogel](#) CC BY-NC-ND 2.0

It's tempting to argue that the demonetisation would bring vast volumes of black money back into circulation. But the reality is that very little of this money is recovered by the government and injected back into the economy. A 2012 Central Board of Direct Taxes [report](#) describes the last two episodes of demonetisations as a “catastrophic failure” in channeling black money back into the real economy. Less than 15% of high currency notes were exchanged and 85% of the currency did not surface because individuals were wary of possible penalties.

While the benefits seem few and far between, the costs of demonetising, both in the short and long run are significantly high. Unlike past moves of its kind, this time, the devalued currency notes are not of a sufficiently high magnitude, meaning that they are widely used by a large fraction of the population. The Rs. 500 and Rs. 1000 notes constitute [85%](#) of India's cash economy, which overnight was rendered useless. As a result, the entire Indian subcontinent will have to exchange their currency for notes of lower denomination, a logistical nightmare. In urban areas, this is already evident from the [long queues](#) outside both banks and ATMs. In rural India, accessing new currency in adequate quantities is much harder because of lower bank and [ATM penetration](#). The problem is exacerbated by the fact that the bulk of the population does not have debit or credit cards. According to an RBI [report](#), as of October 2015, there are 638 million debit and credit cards in circulation in a country of 1.3 billion people.

Prime Minister Modi has appealed to the masses to bear with the minor inconveniences caused in the short term. But these are not just teething troubles and the government seems to have grossly underestimated the incapacitating effect of demonetisation. Demonetisations tend to reduce economic activity because they get rid of the medium of exchange on which ordinary people rely. This was the unintended [consequence](#) of demonetisation implemented by the Burmese military junta in the late 1980s. The policy measure brought the economy to a near standstill; business transactions were significantly affected, consumption fell and the tourism industry experienced a slump.

Similar stories are being heard in rural India where economic activity is [slowing](#) down for want of cash. The best way forward now is to extend the use and exchange of the dismissed currency notes, so that the economy gets some breathing room while the mess is sorted out. And if the government really is serious about tackling corruption, it should prioritise taxing the super-rich and changing the tax system to minimise arbitrary action by corrupt tax officials.

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