

Mr. Modi can still salvage a terrible decision

When people start losing faith in the currency, it marks the start of the nation's decline...Thomas Jefferson

Mr. Modi's decision to demonetize the currency was a bold move. But it was not the right move. And while we can applaud the need to be bold and to think out-of-the-box, many big bang decisions, if improperly conceived, can boomerang in a big way. This decision will have major repercussions for the economy and is a huge over reach by the government.

This ill-conceived plan has no basis in either proven economic principles or historical precedent. There is virtual unanimity among economists that demonetization, except in rare cases of hyperinflation, is really counterproductive. In the annals of economic history, demonetization as a tool to curb either corruption or black money, is unheard of. No developed country has ever used demonetization as a tool to either fight corruption or eradicate black money. In fact, in the US there is a law against demonetization.

Mr. Modi cites three reasons for this draconian step:

- (1) Counterfeit money being used by terrorists
- (2) Corruption
- (3) Black money

We can all agree that both counterfeit currency, and the terrorism it possibly funds, are a threat to the country and all measures should be used to defeat this menace. But could this objective not be achieved by coming up with new currency that is difficult to counterfeit? The issue of counterfeit currencies has been around since the advent of fiat money. And no currency is more at risk of being counterfeited than the US Dollar because of its universal appeal as a stable measure of value. The US has countered this, not by demonetizing the currency, but by making it difficult to print counterfeit currency. India could have done likewise.

It is understandable that Mr. Modi feels the need to attack the issue of counterfeit currency quickly. Maybe the insurgency in Kashmir, and its dubious sources of funding, had something to do with his desire to make a clean and quick break from the old currency. Thankfully, I am not an expert on printing counterfeit currency, and don't want to delve into an area outside my expertise. I wish, however, that someone had weighed the risks from counterfeiting and the need to eliminate it immediately, against the huge negative economic impact of this decision.

Let's, however, focus on the other issues of corruption and black money that this demonetization is designed to address. Tax evasion and corruption are criminal issues that are best handled by the criminal justice system and not by debasing the currency. Surely there are other more prudent ways to address both corruption and black money without the unintended economic consequences of demonetization.

Corruption stems from the ability of someone in a position of authority and power to extract rent from those requiring benefits that such authority can bestow. So, essentially, the vast majority of corruption happens in transactions which involve the government. Transactions between private parties are based on market forces, and rarely involve bribery. Corruption is essentially a government phenomenon which Mr. Modi could have addressed more effectively had he looked at the institution he heads. In fact, in a speech three days ago, he acknowledged that corruption was deeply entrenched in the system, and that the vast majority of it involved politicians, engineers, and bureaucrats.

Having come to that realization, how then did he reach the conclusion that somehow changing the currency would curb corruption when the agents of corruption; politicians, engineers, bureaucrats remain unchanged. The only thing that has changed is the currency that will be used for bribes. One only has to look at the declared wealth of candidates running for elections to know that a vast amount of corruption is political. Almost every candidate running for political office has personal wealth in crores. In a country where 90% of the people make less than Rs.10,000 a month, it is surprising that such vast amounts of wealth do not raise red flags.

So, if Mr. Modi is serious about addressing corruption, he should investigate, convict and incarcerate these powerful people that have amassed such huge wealth illegally. It is inconceivable that Mr. Modi does not comprehend that corruption will only be effectively addressed by reducing the size, scope, and power of the government, developing a strong criminal justice system, and applying laws fairly and equally to all citizens. The US has relatively lower levels of corruption because everyone is treated equally in the eyes of the law and there is strict punishment for corrupt behavior. Even a person running for the President of United States was not spared, and had her emails as Secretary of State scrutinized for corrupt behavior. That's how you fight corruption: make the law work effectively and equally for everyone, and change behavior by using strong penal action and putting the fear of God in those who engage in corrupt practices.

That, of course, would have been hard to do because everyone in politics has dirt on their hands. Mr. Modi did neither the brave or the correct thing to fight corruption: instead he chose to manipulate the currency to somehow hope it would end corruption. Mrs. Gandhi demonetized the currency in 1971, as did Morarji Desai in 1977, and we all know what has happened to corruption since. Corruption in India is systemic will come down only when a strong message is sent that such behavior would entail huge fines and substantial jail time. And that requires setting an

example by sending a few powerful people to jail. You start at the head of the beast, and the rest of the body withers away.

The other issue is that of black money. It is doubtful that Mr. Modi sought advice from economists on this, because they would have told him of the potential for a massive economic slow down that such demonetization would cause. Did Mr. Modi, or his advisers ever consider other, more effective and less draconian, ways to address the issue of black money? Did they ever try to understand the root cause of this black money and develop strategies to address that?

Black money has both a stock component and a flow component. By demonetizing the currency Mr. Modi has effectively removed more than half the capital from the economy without addressing the root cause of black money. As for the flow component, new black money is being created as we read this article. A new cycle of black money, using shining new Rs. 2000 bills, started on midnight November 8th, and will start to flourish again unabated unless the root cause of black money is addressed.

The problem, I believe, is in how most people perceive the notion of black money. Somehow, the impression most have is that black money is evil money that people print in their backyard. Black money is real money made by real people using real labour. It is not stolen money; it is money hard working people earn, but on which the government has not gotten its pound of flesh in taxes.

Could it be that people don't pay taxes because they see how inefficiently the government uses their hard earned tax money, how that money is openly stolen by politicians in one scam or another, or how generously politicians use that money to buy favor with voters. Mr. Kejriwal, who is the Chief Minister of Delhi, just announced a Rs. 1 crore award to a person who committed suicide in another state. What entitles him to use tax payer money to score political points, and shouldn't tax payers be weary of paying taxes into such a system? The CM of Panjab spent almost Rs. 40 crores of taxpayer money on fuel expenses last year. Shouldn't a hard working person be entitled to question why he should be paying for Mr. Badal to blow that much money in fuel?

Yes, there are people who don't pay taxes. In fact, more than 97% of the people in India do not pay any income tax. And there could be several reasons for that: inefficient use of tax payer money by the government, very high tax rates, unnecessarily burdening one class of earners, ineffective and complex tax policy, poor enforcement, and also outright tax avoidance and fraud. But is demonetization going to address all these issues--clearly not. There was little or no black money eighty years ago. Why? Because tax rates were low and people were happy to pay a reasonable share of their hard earned money in taxes to support the nation's development. Now with over 50 different taxes and cesses, the average person ends up paying more than 50% of his income in taxes to a government that cannot even provide decent public service.

Black money start to rear its ugly head ever since tax rates went up to meet the insatiable demands of increasingly bigger governments. There is a direct correlation between tax rates and black money; the higher the tax rates the greater the incentive to evade taxes.

A simpler tax code, with low tax rates, coupled with heavy penalties and jail times for tax evasion, would do more to curb black money than destroying a nation's currency.

The root of many problems in India is the massive size of the government and the gross misuse of tax payer money by a bloated and ineffective government machinery. The government is the largest employer in the country and almost 10% of the annual budget is spent on government salaries and pensions. And all this money comes from the taxpayer. When Mr.Modi came to power he promised “ smaller government, bigger governance”. But he has not delivered on his promise of a small government. There are more than 80 Cabinet and State Ministers in his government--in contrast the entire US economy, which is roughly 8 times larger than the Indian economy, runs with only 14 Ministers (they are called Secretaries). Whatever happened to Mr. Modi's promise of a small government? Each of these Ministries sucks up hundreds of crores of tax payer money each year. The red lights and security details that you see around Ministers does not come for free. When the CM of Haryana travels with an entourage of 20 cars, an ambulance, a fire engine, and two trucks full of policemen, guess who foots the bill for all this--the taxpayer. And when citizens, observing this blatant wastage of their hard earned money, refuse to pay into this inept and wasteful system they are accused of having black money. Isn't it strange that it is not a crime for governments to steal and misuse taxpayer money, but it is a crime for a hard working citizen to not pay into such a corrupt system.

How will demonetization cure black money especially when it does absolutely nothing to mitigate the biggest reasons for why most people refuse to pay taxes: high tax rates, complex tax laws, and government wastage and theft. If Mr. Modi wants to increase tax compliance he needs to first show that his government can act as a prudent guardian of taxpayer money. He should demonstrate this prudence by reducing the size of this bloated government and bureaucracy, show visible evidence of belt tightening and reduced wastage and theft, and do what governments are elected to do, provide efficient public services. So, before resorting to draconian measures like destroying a currency Mr. Modi should put his own house in order.

Let's take a numerical example to illustrate how demonetization will adversely affect the economy, employment, wages, and living standards. Assume I make Rs. 100 and my tax obligation on that is Rs. 30. For whatever reason I do not pay that tax and instead keep the entire Rs. 100 in cash. The black money component is only Rs. 30 (my unpaid tax obligation), but by demonetizing the currency the entire Rs. 100 is effectively lost. In other words the baby has been thrown out with the bathwater.

Money is the life blood of an economy, and whether it is black or white, money is money. When you destroy black money you also destroy real money. A growing economy like India needs large amounts of capital to sustain that growth. Let's

further assume that I use the Rs. 100 to get a haircut; the barber in turn uses that Rs. 100 to buy his groceries; the grocer in turn uses that Rs. 100 to have a wedding party for his daughter and employ waiters and other labour; they in turn use that money to buy their groceries and so on. In economics this is called the multiplier effect. The larger the multiplier, that is, the more times one rupee changes hands, the higher the economic growth and greater the wealth creation.

Now if the hundred rupees that I have in cash suddenly ceases to become legal tender I will not get a haircut, and then the barber will not go to the grocer, the grocer does not have a party and the poor labour will not get hired. In essence demonetization has made worthless the entire Rs. 100 when the black money component of it was only Rs. 30. And the multiplier effect of that on GDP is substantial. So instead of devising other more prudent ways to get their Rs. 30, the government has effectively destroyed the entire Rs. 100. Not very clever you will agree.

Irrespective of whether money is black or white its use adds to economic growth. And in a country like India where more than half the economy is powered by black money suddenly taking such a huge amount of capital out of the system will destroy the economy, hurt business sentiment, increase bad loans and put a weak banking system under further pressure, and create massive unemployment.

Thomas Jefferson once said: “ When people start losing faith in the currency , it marks the start of the nation’s decline.” One only look has to look at history and countries like Germany (1941), Argentina, Nigeria, Chile, Zimbabwe, and many others that have resorted to demonetization with drastic effects. There is little doubt that the unintended consequences of this poorly conceived decision will shake the Indian economy without achieving any of the goals it was intended for.

Given that the fox is already in the hen house and the damage already done, can Mr. Modi still somehow salvage the situation and possibly make a positive out of a huge negative. Possibly, but he has to put hubris in his back pocket, and surround himself and listen to smart people who know more about these things than he or his bureaucrats.

There are two things Mr. Modi must do immediately.

Firstly, he must announce that the tax immunity that expired on September 31st will be extended to December 31st. This will bring huge amounts into the government treasury that otherwise would be destroyed. In the example I presented above nobody won: I lost Rs. 100 and the government did not get the Rs. 30 in taxes. It was a classic lose-lose outcome; the worst of all possible scenarios. Why destroy Rs. 100 in capital for Rs. 30 in unpaid taxes? Why not extend the immunity offer and collect Rs. 40 (taxes and fines), and release the other Rs. 60 back into the economy. That would be a win-win outcome. The treasury benefits, I as the taxpayer benefit, and the economy benefits. And given that the system has already been substantially

jolted by this sudden demonetization, compliance to this immunity offer can surely be expected to be very high.

Secondly, Mr. Modi should come up with a big bang tax reform that will actually transform the Indian economy. He should declare an end to all taxation the way it exists today, and replace all existing taxes (with the exception of import duties) with a simple 15% tax on consumption. This would entail a simple extension to the GST process already underway, which unfortunately applies only to indirect taxes but not to direct taxes. A simple 15% tax on consumption (with offsetting direct benefits to the poor as compensation) would greatly simplify tax policy, increase compliance, get rid of black money, broaden the tax base, increase tax revenue, and provide a huge boost to the economy. It would be a game changer for India. But it has to be one rate across all sectors, not this hodge podge of multiple rates the government has proposed for the current GST.

So Mr. Modi, while your demonetization decision was a terrible mistake and will hurt the economy, it is still possible to convert a bad outcome into a win-win. With power also comes the responsibility to use it wisely, and the accountability for the decisions you make. That accountability will be at the ballot box in 2019, and unless you act wisely to fix this terrible mistake, there is a good chance that you could be a one term Prime Minister.

Sanjiv Bhatia, PhD
Managing Director, Center for Environmental & Economic Policy