Demonetization as a Means of Fighting "Black Money"*

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So many lies are being spread by the government which is currently busy wrecking the Indian economy in the manner of a bull in a china shop, so many spurious economic arguments are being trotted out by it, that one has to be extremely vigilant not to be swept away by this tide of unreason. In the current article, and the two subsequent ones to follow, I propose to examine some of the more persistent assertions that are being made by government spokesmen.

The most persistent assertion of course is that demonetization is a measure against "black money". In an earlier article (People's Democracy Nov.13) I had pointed out that the term "black money" was a misnomer, that it was not a "stock" but a "flow", that it refers not to stacks of currency notes hidden in pillowcases, but to a whole set of undeclared activities, some illegal, others legal but undeclared nonetheless in order to avoid payment of taxes. These activities, like all others, are carried out with the help of money, in this case largely in the form of currency, i.e. the flow of such activities requires a stock of currency; but disabling a part of this stock would not terminate these activities as long they remained profitable.

Let me illustrate this point with some figures. The maximum amount of currency which the government hopes to disable in the "black economy" through its demonetization move is reportedly Rs. 3.5 lakh crores. Indeed a former governor of the Reserve Bank of India, D.Subbarao, a supporter of the demonetization move, has also mentioned this as the maximum amount that can be rendered worthless in the "black economy". The size of the "black economy" however, according to a World Bank study, is close to a quarter of the "white economy", i.e. roughly around 35 lakh crores. Others would put the figure much higher, which would actually strengthen the argument that follows, but let us accept this lower figure. Now, the share of profits in the "black economy", again on a conservative basis, would be half of the total income generated, i.e. 17.5 lakh crores. The magnitude of the disabled stock of currency therefore would amount to no more than 20 percent of the annual flow of profits in the "black economy". Were it all to be offset via a reduction of profits, then the profit rate in this economy would merely fall from, say 25 percent (again to take deliberately an extremely conservative figure) to 20 percent. To imagine that this minor dip would constitute a blow against the "black economy" is absurd.

But the question may be raised: even if such disabling of cash would be a small matter relative to this sector's profits, which would not discourage "black activities", nonetheless cash would be required for carrying on these activities as before; would not the sheer loss of this cash therefore create problems for the operations of the "black economy"? And indeed herein lies the rub.

As long as "black activities" remain profitable, which they would despite the once-and-for-all dip in the profit rate just mentioned, this loss of cash owing to demonetization (and let us assume, for argument's sake, that that there is such a loss as anticipated by the government), would only mean, that for carrying on these activities, the "black economy" would now demand fresh cash. This would raise the interest rate, unless the Reserve bank of India increases the supply of currency to make good exactly what has been lost by the “black economy”. Such a rise in the interest rate would simply suck out cash from the “white economy” to finance the working of the “black economy”; and this sucking out can only be at the expense of the petty, “informal” sector which is both extremely cash-dependent, and is so precariously placed that it is vulnerable to a jack-up in interest rates.

In short, demonetization, far from being an attack on the “black economy”, would in effect turn out to be an attack on the vulnerable “informal” segment of the “white economy”. And this is so because of the immanent logic of the system, which the government, on a charitable interpretation, does not understand. The more profitable activities invariably pull resources, including cash for working capital and other needs, from the less profitable, more vulnerable ones; these, in an economy like India, consist of the petty production and petty trade sector, or the “informal economy”. Even Adam Smith and David Ricardo, classical political economists, long before Marx, had made the point that capital always flows from the less profitable to the more profitable activities; and this is true for money capital as well, including that portion of it which takes the form of cash.

Of course, the Reserve bank of India may not allow this to happen, and may step in to augment the supply of cash to the economy, to make good what has been “lost” to the “black economy” through demonetization. But in such a case, while the petty production and petty trade sector would have been prevented from going under, the “black economy” would have obtained the cash it requires for carrying on its activities, without having to pay, even temporarily, a higher interest rate.

The vacuity of the demonetization drive as a weapon against “black money” should be obvious from this. As long as “black activities” remain profitable, they would be carried on; but, given the interconnected nature of the entire economy, the interpenetration of “white” and “black” economies, any measure such as demonetization, that does not directly attack “black activities” via reducing their attractiveness form the point of view of their operators, necessarily impinges only on the vulnerable segment of the “white economy”, viz. the “informal sector”. Since this sector accounts for 45 percent of the (“white”) economy’s output and around 80 percent of employment, such anti-“black economy” measures amount therefore to cutting off one’s nose to spite one’s face.

It may be pointed out, against what I have been arguing, that for making good its “loss” owing to demonetization, through acquiring fresh cash, the “black economy” would have to incur fresh liabilities, on which there would be a fresh interest burden. In other words, the once-and-for-all loss of cash through demonetization would still leave a trail of additional interest payment obligations in the “black economy” even if this economy continues to function exactly as it was doing earlier. But, if this once-and-for-all loss itself is trivial relative to profitability, as we have seen, then the legacy of interest payment obligation that this loss would leave behind would be even more trivial, indeed too trivial even to merit notice.

To say all this is not to diminish the significance of “black money”; it is to suggest that demonetization is the wrong weapon for fighting “black money”. Of course there are two issues here which should be distinguished. The first is that the impression created by the government, and by persons like Baba Ramdev who these days don the mantle of “economics experts”, that the central problem of the Indian economy relates to “black money”, is absurd. Their idea is to suggest that it is not capitalism, but the violation of laws under capitalism such as what the “black economy” entails, that is to be blamed for the economic misery of the masses.

This view is wrong for two reasons. The first reason is that the very distinction between “white capitalism” and “black capitalism” is a tenuous one. Capitalism necessarily entails seeking profits and if there are profits to be made in certain activities, then those activities are undertaken by capitalists. If those activities are illegal, then they constitute “black activities”; but they are nonetheless undertaken as long as their profitability is large enough to outweigh the risks associated with undertaking them. A “black economy” in short is merely the designation for certain activities under capitalism. There can be no capitalist economy, there is no capitalist economy, in the world, which does not have a “black economy”: drug-running for instance is a major problem in the United States. (Of course a “black economy” would not immediately disappear even under socialism, but that is because even a socialist economy would take a long time to cast off the shell of capitalism from which it emerges; but since profit-seeking is not the raison d’etre under socialism, such legacies inherited from capitalism would tend to disappear gradually over time).

The second reason is that even if we assume that there was no “black economy” in the country, the immanent tendencies of capitalism, to produce wealth at one pole and misery at another which Karl Marx had written about (and no “black economy” had figured in his analysis), would nonetheless operate, as indeed they are operating before our very eyes in this era of neo-liberal capitalism. Reams have been written on how this process is being enacted in India today, even without invoking the “black economy”, and the point need not be laboured further.

But the second issue, with which we are dealing here, concerns the method of combating “black money” even under the present system. And demonetization as a method, it is already very clear, instead of combating “black money” has the effect of decimating petty production and petty trade sector (the so-called “informal sector”), and thereby carrying further the process of “primitive accumulation of capital”.

The obvious immediate way to combat “black money” is by making “black activities” unattractive, by investigating transgressions of law honestly, rigorously and meticulously, and handing out exemplary punishment to wrong-doers. Making the lives of honest people especially the poor even more miserable, punishing them collectively on the argument that some criminals may be lurking among them, represents an abandonment of reason on the part of the government that is quite astounding.

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