Demonetisation and India Inc*

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In Finance Minister Arun Jaitley's pre-Budget meeting with members of India's Chambers of Commerce and Industry and other special category capitalists like exporters, the latter reportedly told him that while demonetisation is a welcome move, the government must "offset the immediate downturn that industry will go through". This was accompanied by a range of demands varying from reduced corporate taxes to special export incentives and accelerated privatisation. In sum, India Inc had its own ideas of how the short term pain of demonetisation could be converted into long term gains for itself, though the policies recommended to ensure the realization of long term gains had little to do with the abolition of the black economy, the end of corruption and counterfeiting that the government claims motivates the initiative.

On the surface, this stance of India Inc seems to flow from its ostensibly limited dependence on the cash economy, especially when compared with 'unorganised' industry and the informal economy. What the demonetization exercise did and continues to do is flush out old currency from the system and limit access to new currency. To that end it requires holders of cash amounting for 86 per cent of the value of currency in circulation to exchange a small proportion of these notes for new ones or deposit them in their bank accounts to be replaced through a gradual process, since withdrawal of currency from these accounts is subject to stringent ceilings. The implication of this is that the measure would hit hardest those who need cash for transactions or who use it as a store of value to hold wealth that they have not declared in order to evade taxes or prevent detection of illegal earnings. The pain suffered by the former is seen to be the small sacrifice needed to force holders of unaccounted wealth to reveal their 'black' assets and suffer the penalty that would be imposed.

The argument that the hit to be taken by large industry would be limited is based on the presumption that its need for cash is limited, since most of its transactions are settled through cheques, bank transfers or electronic payments systems, rather than payments in cash. This 'independence' from cash is seen as having increased in recent times when banks have modernised their operations, embraced the internet and introduced the technological ingredients needed for a largely cashless economy. The conclusion is that corporate India would only be affected indirectly by the demonetisation initiative, inasmuch as the latter is resulting in a liquidity crunch and a contraction of demand. Since that is seen as a short term constraint lasting till such time that the demand for new currency is met by supply from the mints, large industry has limited cause for concern. Demands such as those made at the pre-Budget meeting overstate the difficulties faced and losses suffered by corporate India.

There is some truth in this when seen in relative terms. Agriculturists, petty producers and informal sector workers are likely to be hit the hardest during what is for them an excessively prolonged 'short-term'. But declaring the world of corporate India as largely cashless is an exaggeration. Even if we restrict the discussion to industry there are certain features of the "organised" sector that are ignored by those who argue that industrial India is substantially cash-independent. The first is that the registered manufacturing sector consists of many units that are medium and small enterprises, which while registered under the Factories Act, straddle the thin line between the informal and formal economy. These units range from those manufacturing cycles or lathes in Punjab, to those engaged in producing knitwear for export in Tirupur. It is now clear that a substantial part of transactions undertaken by these units, to buy inputs, pay workers, and distribute goods, is in cash. Not surprisingly, their functioning has been adversely affected by the demonetisation exercise. Both depressed demand and difficulties in obtaining inputs have been reported from different parts of the country. Moreover, the currency shortage and the consequent rationing of legal tender have made it difficult for employers to meet cash payments. In many areas this has led to workers losing their jobs, however temporary they may have been.

A second feature of the industrial sector is that the organised and unorganised sections of it are not separated from and independent of each other. Rather, the organised sector is increasingly outsourcing a range of tasks earlier undertaken in-house to units in the informal sector, to reduce costs and circumvent labour legislation. Profits are inflated by this ability to operate simultaneously in organised and unorganised forms. It is to be expected that in some of these transactions too there is an important role for cash, so that the operations of the organised sector can take a direct hit from the demonetisation. In sum, even the more 'modern' industrial, segment of the economy, which is seen as near-cashless, is bound to be affected adversely.

The third is that some of the "dynamic" industrial sectors (like garments) that drive exports, or that both contribute to exports as well as satisfy the desires of the rich and middle classes (like gems and jewellery) are ones in which manufacture and/or sale are based on cash transactions.

However, even in the industrial sector the effects of demonetisation are likely to be distributed regressively. Small and medium units, which dominate India's industrial landscape, are clearly more dependent on cash transactions for their day-to-day operations than the large firms that dominate many product markets and deliver India's leading brands. But neither is the overall industrial economy relatively cash-free, nor are the operations of India's leading firm cashless in character. So the longer the currency shortage lasts (and it would last for much longer than the government claims), the greater would be the damage inflicted on the industrial sector in India.

All this leaves out the impact of the hit that black money held in currency form would take. To the extent that black wealth takes the currency form (it does, though by no means to the extent the government claims it does), corporate and industrial India would be an important target of the government 's monetisation drive. The 'black economy' constructed with unreported receipts that have evaded taxes is not a seamy underside operating parallel to the world of the registered and/or corporatized, 'formal' sector. It is an integral part of the larger economy in which 'black' and 'white' segments seamlessly engage with each other. In that economy the formal industrial sector is required to engage in and profits from 'black' transactions. Moreover, there are enough alleged, investigated and confirmed instances of black wealth in the form of real and financial assets besides cash in the hands of leading business persons, which establish that India Inc thrives on unreported transactions and the money, wealth and corruption associated with that.

This discussion has some implications. It suggests that the extent of India's cash economy is not determined by the cashless payment and transactions options that are open to agents. So to exhort Indians to go cashless is not the best way to deal with the currency shortage. In the first instance, the return to normalcy would be defined by the pace at which new currency to replace the old can be issued. In the longer run, structural features and processes that create the space for cash transactions need to be addressed. Further, it is clear that there is an assumption of a strong link between the degree of prevalence of a cash economy in a particular segment of the economy and its importance as a source of black incomes and location for black money and wealth.

It is in this background that three kinds of evidence must be read. The first is that close to a month after the demonetisation was announced, less than two-thirds of the Rs. 14 lakh crore in circulation in the form of notes of Rs. 500 and Rs. 2000 denomination had been deposited with the banking system, and more than Rs. 5 lakh crore still remains in the system waiting to be converted into legal tender. Second, that there has been a surge of deposits in unlikely accounts including Jan Dhan Yojana accounts, pointing to an effort to find ways of converting old notes without breaching the Rs. 2.5 lakh barrier which triggers special scrutiny. And, third is that after a period when the rush was for conversion or deposit of old notes, the banking system is seeing a rush of withdrawals, creating suspicion that this is for exchange for old notes at a premium, by those who can find ways of replacing the old with the new without attracting attention. Paying that premium (rumoured to be around 30 per cent) would be a far better option than revealing the black income and paying a much high tax and penalty and inviting prosecution. All this corroborates the view that demonetisation per se cannot even fully unearth unaccounted or black money, let alone get rid of it.

It is also true that to the extent that business is not affected by the measures announced by the government, the latter are unlikely to be effective in shutting down the black economy. Meanwhile, it is becoming clear that a section of corporate India is looking to find illegal ways of protecting a part of its tax-evaded gains. Not surprisingly, official and unofficial spokespersons of India Inc have not only demanded benefits in return for the 'pain' they are suffering, but cautioned against harassment by tax authorities of law abiding citizens and a return to the 'inspector Raj' that reportedly prevailed before the era of liberalisation.

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