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EXECUTIVE BRIEFINGS
POLITICS & ECONOMY: DEMONETISATION

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Gain for Pain

With a tax-to-GDP ratio languishing around a puny 16%, India's resource base is not nearly enough to fund its development needs. It is somewhat below emerging market and substantially lower than OECD averages of 21% and 34% respectively. It is in fact over 6-7 percentage points less than comparable countries. With the primary intent of correcting this imbalance, the Modi administration risked demonetising 86% of the currency in circulation. Understandably, there have been damaging consequences in the short term, hammering consumption and consequently economic output, but in the longer term the benefits may far outweigh these. Ultimately, the Government hopes that cash as a percentage of retail transactions will reduce. Estimates vary, but many economists believe this is as high as 80-90%. Scandinavian countries on the other hand have moved completely digital. Cash as a percentage of GDP hovers around 12% in India compared to half as much in comparable countries. Logically, the hoarding of cash or its use in transactions enables tax evasion. It would seem logical therefore, that the ultimate rationale behind the demonetisation move simply cannot be faulted.

Whilst it is early days yet, some figures on tax collections provide reasons for cheer. For instance, in November total tax collections, which include both direct and indirect, jumped by 54% against 2.8% last year. This is the highest monthly increase in nearly a decade. Corporation tax collections surged by 164%, income tax 41% and other taxes (mainly securities transaction tax and certain indirect taxes in Union Territories collected by the Centre) by a remarkable 530%. If this substantiates the hypothesis that more people are now in the tax net, then the long term implications are game changing. Clearly, we need to wait for further data to be available and should have a better fix by the end of this fiscal year. What basically happened over the last six weeks is that a large volume of transactions, for instance those that were previously within the ambit of the informal economy, surrendered themselves into the mainstream. When GST finally happens – markets expect some delay – the absorption of the informal economy within the tax net will become easier. The demonetisation shock may therefore have created the right motivation for individuals and businesses to become compliant.

The second important benefit is a switch to more efficient digital mechanisms for transactions. For instance, the volume of credit card transactions spiked from an average of 76 million a month to 97.6 million in November. Debit card purchases doubled from 120 million transactions a month to 235 million while mobile wallet transactions increased from 61 million a month to 138 million in November. Digital money is cheap, easy to move and possible to trace. Cash on the other hand is cumbersome and comes with huge costs to the economic system. According to a paper on the subject by Tufts University, this is a whopping Rs 21,000 crores per annum. This includes the printing of money, its transportation, insurance costs, agency fees, ATM costs, etc.

The demonetisation move, despite common perceptions, is really not an 'elite versus deprived' story. Nor is it about nationalism. It is wrong to make it out as so. The arguments really ought to be based on cold economic logic and facts. Going forward, if the Government succeeds in increasing the share of digital transactions by both encouraging citizens to switch and providing the backbone infrastructure that enables it, the demonetisation episode would have been worth the pain. Perhaps, most importantly, should the tax to GDP ratio over the next 3-5 years move upwards from 16% to say, 23% then arguably a lasting benefit of epic proportions would have been delivered. It is early days yet, but the odds instinctively appear to be in favour of the move.