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Arthakranti Plan: Noble Intentions but Muddled Thinking

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1. Introduction

The systemic changes that Arthakranti proposes are definitely well intended but whether they will produce desired results or not is a big question. This is because the reasoning behind the proposals shows a lack of understanding and knowledge of economics in general and that of institutions and reform in particular. They argue that abolishing black economy will solve many problems which have held back India's growth till now.

1.1. Black Economy

As a starter, emergence of black economy is much more complex phenomenon than what is assumed by the Arthakranti. If we take the black economy to consist of informal as well as the illegal economy, then various suggestions to curb this economy may affect these two sectors differently. There is also some evidence that black economy in general may emerge as a correction to some real rigidities or policy distortions in the economy and trying to curb it may amount to treating the symptom but worsening the disease. To see the point, smaller firms, many of which are in the informal sector emerged in India because of restrictions on size of firms or workers get hired but do not show up on the roster because its costly to employ someone legally. Having said this in what follows I comment on some of the specific proposals from the Arthakranti plan and demonstrate how at best they constitute loose thinking.

However, before I embark on analyzing the proposals, a word about how policies are chosen in practice. Policy choice in reality is often guided more by political and social considerations than by theory. To illustrate the point, economic logic shows that one way to reduce the incidence or burden of tax on the consumer is to have a value added tax (VAT). We have been trying to implement it for quite some time. However, there is a lot of resistance from various groups to this tax system. Manufacturers and sellers do not like it because the current system has a good amount of ambiguity that allows them to overprice and under report to some extent. With VAT this room for maneuverability is no more available. So a policy which looks ideal from theoretical perspective may not be chosen in reality or may be implemented at a slower pace because policies are determined by politics and special interest groups. So to just say that a policy should be implemented because it makes sense may be naive.[1]

[1]See Dixit and Londregan (1998) for an interesting model of fiscal federalism and the redistributive policies as an example of the literature looking at the political economy of government policy.

2. Proposals

2.1. Abolishing all the indirect taxes and having only one transaction tax

Let us now consider a specific proposal. The plan suggests that all indirect taxes at different levels should be abolished and the only tax levied should be the income tax or one uniform tax on banking transactions. Economic theory tells us that a single direct tax like the income tax works if only if all the consumers are identical or at the very least ability of individuals to be taxed is perfectly observable.[2] To the extent this is not the case, optimal tax policy will have both income and commodity taxes. Now you do not need to be an economist to see that the above two assumptions are rarely satisfied in the real world.

What actually might work, at least in the short run, are policies like posting prices separately from taxes instead of the maximum retail price inclusive of taxes. However, there is some grain to the argument of harmonization of taxes across jurisdictions from the point of reducing fiscal barriers to mobility of commodities and services.

2.2. 100 vs.1000- Which is better?

Now, consider their reasoning for reducing the denomination of currency notes. Decline in the maximum denomination will supposedly reduce the problem of inflation, unemployment and the black economy. How do we know this? Look at the developed countries. They have lower maximum denomination than that of India. US, UK and Japan have 100 units as biggest denomination as against of 1000 units for India. The ratio of per capita GDP to this maximum denomination is around 400 in US, Japan and UK and 23 in India. What do we understand form these differences? Is there any reason to believe that a high value of such ratio signifies lower black economy as Arthakranti would have us believe or does it point to something else?

For the uninitiated this ratio is similar to what economists call income velocity of money. Velocity of money tells you how much a unit of money circulates to support the income generated. In the above calculations the unit of money is the maximum denomination of currency notes. To start with in as much as you are using different denominators the ratios are not comparable[3]. Secondly, the variation in these ratios comes from denominations as well as per capita incomes and that should tell us something. Would it surprise you if I said that countries with high per capita incomes have sophisticated payment systems and use much less cash than those with lower per capita incomes? At least it would not surprise me. In general we would expect that developed countries have higher velocity of money than the developing ones, other things re-

[2] See Salanié (2003) for a good review of taxation theories.

[3] There is also this issue of which currency note is most in circulation. For example in US even though the maximum denomination is $100, the currency note that circulates the most is $20. The average ATM withdrawal is not more than $20.

maining same[4]. The point is that the difference in velocity points to institutional and economic differences and there is no reason to believe that per se a lower velocity would imply higher black economy, though it does signify presence of a substantial cash based economy.

2.3. Scrap all above 50!

Can we say that a cash based economy automatically implies a large black economy? One would be tempted to believe so but the relation is not that obvious. Moreover, even if we take it be true, there is still the question of whether reduction in maximum denomination of notes help reduce cash based economy and inflation. My answer is a qualified no. Qualification being which direction the causality goes. Do we use higher denominations of currency notes in response to rising prices or the other way round?[5]

But without getting into this issue lets engage in a thought exercise. Suppose the government tomorrow declares that all the notes above Rs.50 are illegal to use. What will happen next? If the government does not add to the money supply for every confiscated note of higher denomination there will certainly be reduction in money supply. This will translate into less money in all our pockets and so we will spend less. Producers and manufacturers of goods and services will find they cannot sell enough at the current prices and hence will reduce the prices to induce consumers to buy their goods. This will reduce all the prices, thereby reducing inflation.

What are the problems with this scenario? No doubt that people with substantial cash in high denominations will suddenly find their wealth has vanished but not all of them contribute to the black economy. So will all of us support this policy? No. There will be substantial social and political cost to this action. Moreover, for this action of the government to be effective it has to come as a surprise. Even if there is inkling that government might do this, all the black money in high denominations will get converted in Rs. 50 multiples and the scrapping of high denominations will have little or no effect on inflation. The same will hold true if currency compression is done in stages.

There have been cases in Latin America where they scrapped the complete money supply and replaced it by a different currency to control inflation. Such measures work only when there is a clear evidence that inflation is a monetary phenomenon. Theory and evidence tells us that this is true only at substantially high levels and growth of money supply and in the long run[6]. It would be incredibly naive to believe that is the case in India. The question of what if the

[4]Velocity of money is affected by changes in technology and institutions and therefore will change over time. Even in developed economies velocity has undergone tremendous changes over the last couple of centuries. Generally, any innovation in the payment systems that reduces the necessity of actual currency notes would increase the velocity, as less number of currency notes support higher number of transactions.

[5]I thank Shalini Mitra for pointing this out.

[6]A switch to a relatively stable currency like the US dollar is also a possibility in such situations as demonstrated

producers do not cut the prices enough opens a different black box altogether.

2.4. No cash transactions above Rs. 2000

Law says whenever you buy something you have to pay a tax. What do you do? You do not take a receipt and evade the tax. So if government disallows cash transactions above Rs. 2000, what will you do? You find a variety of ways to get away from this requirement too! The point is that even if this proposal is the one that makes most sense, to get people to adhere to it will require some checks and balances. Economic theory says people respond to incentives. So if a law gets the incentive structure right it will be followed. To implement the proposal in practice we will have to make violations costly and minimize on monitoring costs. How do we do this? Well thats where economics of law comes in picture. We also have to think if Rs. 2000 is valid limit for cash transactions.

3. Why does cash based economy emerge?

At this point it might pay to think why does cash based economy flourish in the first place? Will reducing maximum denomination of currency notes transform a cash based economy to a non cash one? To answer these questions we have to first understand that the cost of adopting an electronic payment system is an economic decision. This means that a vendor will engage into a cost benefit analysis before he switches to such a system. Now we all have faced this constraint at some or other point right? You walk into a shop and buy something and present your card for payment. The person behind the counter says she can accept a card only above certain purchase value. This happens even in the US and thus, you could have cash based transactions even in a relatively sophisticated economy.

Notwithstanding this, more generally it should be that the more organized the economy is the cheaper it is to shift to non cash systems of payment. So as long as we have smaller shops, street vendors, and roadside carts selling stuff which we spend most of our money on, there will always be a cash based economy and this will lead to some black economy in terms of unreported income.

Why do we have more number of smaller shops instead of Walmarts and Stop & Shops? One of the answers according to me is that along with being price sensitive many of our consumers are liquidity constrained. Smaller and decentralized shops provide easier access to credit purchases to liquidity constrained consumers and hence even if a cheaper alternative is available it will not be chosen if it means paying cash up front. Thus, if organization of commerce affects the kinds of payment systems we will have, it is the level of economic development that

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recently by Zimbabwe.

affects the way commerce will be organized. Our level of per capita incomes is just not enough to sustain the scale of economic organization that makes adoption of non-cash based payment systems attractive on a wider scale.

4. Summing it up

A lot of the changes in the way the commerce is organized in the developed economies has been a result of increasing income levels, even though there might be some causation other way round as well. Hence, to say that we should do what the developed countries do and we will be developed like them definitely implies a very restricted view of how institutions emerge and evolve. Changing laws or enacting new ones does not automatically mean that they will be followed. There has to be an incentive system in place to make people respond in the desired manner. Any meaningful policy making exercise has to take this into account. India would definitely be a superpower someday, but getting there will unfortunately take much more than just scrapping currency or changing the tax system.

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