

INDIA'S POST-DEMONETIZATION POLICY AGENDA

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Indian Prime Minister Narendra Modi announced in November 2016 that denominations of 500 and 1,000 Indian rupees would cease to be legal tender with immediate effect and that the Indian public had fifty days to deposit the old notes into their bank accounts, removing the notes from circulation. This demonetization was a drastic decision because these notes constituted 86 percent of the cash in circulation in India, a high cash economy. Given the mammoth scale and extraordinary nature of the exercise, it is almost an obligation on the government's part to reap a wide range of economic benefits from it and not just treat it as an exercise in raising tax revenues.

The Challenges After Demonetization

- Just as India needs to record and regulate economic activity, it also needs to facilitate and enable more formal activity. That is the breakout opportunity that the currency note withdrawal affords the government.
- Even by the standards of other developing countries, India's informal economy is large, and its economic consequences—mostly negative—are substantial. Shrinking the informal economy is essential to India's ambitions to achieve sustainable high growth.
- Because of the informal economy's pervasive nature, both financial and nonfinancial measures are necessary, with the latter involving efforts to lower the cost of undertaking economic activities.
- India needs a multi-pronged approach to address the twin challenges of limiting black money creation and encouraging formality.

What India Can Do

- Reforms to the largest sources of black money creation—real estate and political corruption—would curb that phenomenon. These policies will require long-term engagement.
- To increase the size of the formal sector requires measures to expand the tax base, enhance tax compliance, digitize transactions, lower the cost of doing business, and eliminate policy distortions and facilitate financial inclusion of small enterprises. Some of these policies can be pursued quickly; some will require expanding existing legislation.
- Merely making economic activity in the informal sector untenable and having it disappear without transferring it to the formal sector is harmful to the economy as well as to society at large.
- Eliminating regulatory distortions in the labor market should be on the medium-term reform agenda, though some of these distortions can be addressed expeditiously.
- Finally, the government may have to respond opportunistically on politically sensitive issues like agriculture income tax and campaign finance.

ABOUT THE AUTHORS

V. Anantha Nageswaran graduated with a master's degree in management (MBA) from the Indian Institute of Management, Ahmedabad in 1985. He obtained a doctoral degree in finance from the University of Massachusetts in 1994 for his work on the empirical behavior of exchange rates.

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