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Has Demonetisation Impaired Policy Credibility?

In order to execute policies effectively, governments need to ensure that a policy initiative is predicated on realistic assumptions borne out by past experience, existing institutions and the structure of the economy; that it is internally consistent and cognisant of the interests and expected behaviour of different stakeholders; that the policy instruments and outcomes are measurable and directly related to desired outcomes; and that a clear framework is in place to assess outcomes and provide feedback to policymakers. This insights discusses these principles in the context of demonetisation and finds it lacking in internal consistency. It goes against the thrust of policy initiatives undertaken by the government thus far, that provided a clear indication of the direction in which the government wished to direct the economy. Demonetisation may have impaired credibility of future policy initiatives.

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Introduction

Above all, an investor seeks a predictable environment that will enable her to plan for the long term with confidence. A predictable environment entails macroeconomic stability with a low inflation rate, a sustainable fiscal balance, and a policy framework and tax regime that is stable and predictable over time.

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A credible policy calls for consistent and uniform policy implementation across all levels of bureaucracy enabling stakeholders to clearly discern the rules and regulations governing economic activities, over time, and across sectors. On either count, India hasn't fared well. There have been improvements, some of them significant, for attracting foreign direct investment and towards easing conditions for doing business. However, despite reforms over the past several years and promises of a stable and business friendly environment, the investment scenario continues to be fraught with uncertainties. The minimum alternative tax regime, lack of congruence between what the ministries profess and facilitating actions at the grassroots, and continuing lack of coordination between reforms carried out by the government and what transpires at the operational levels in lower echelons of the government, are holding back India from reaching the inflexion point at which it could attract urgently-needed large-scale investment projects. Investment into India has risen, however most of the investment flows are in the form of portfolio flows, or 'hot money', which do not directly increase production and create jobs.

The demonetisation of Rs 500 (S$11) and Rs 1000 (S$22) announced on November 8, sought to eliminate the parallel economy, and implicitly broaden the tax base. This note contends that the radical monetary policy initiative has not lent credibility to the government's reform agenda, nor is it consistent with the government's own reforms carried out in the past. It has impaired the credibility of well-regarded institutions such as the Reserve Bank of India, the fiscal authorities, and the government itself. There is however much that the government can still do to contain the fallout from demonetisation.

Consequences of Lack of Policy Credibility

Credibility is important at the national level as well as for individual sectors. Research has highlighted the adverse consequences of policy changes and the lack of consistency in policy on investment[2]. Uncertainty about the long term induces investors to shift to short-term risky projects. Conversely, a stable predictable environment induces investors to embark on projects with long gestation periods, e.g. in the infrastructure sector. A cross-country study[3] of 12

[2] "Policy Uncertainty and Corporate Investment" Huseyin Gulen and Mihai Ion. Review of Financial Studies, 2016; "Economic policy uncertainty and firm-level investment" W Kang, K Lee, RA Ratti. Journal of Macroeconomics, 2014, and a number of other studies focus on the impact of policy uncertainty and inconsistency on investment.

[3] "Measuring Economic Policy Uncertainty" Scott R. Baker, Nicholas Bloom, and Steven J. Davis. NBER Working Paper No. 21633; October 2015 Journal of Economic Literature (JEL).

economies, including India and the United States, drawing upon media reports as a proxy for policy changes found that increase in policy uncertainty triggered falls in investment, output and employment. It specifically reduced investment and employment in policy-sensitive sectors such as infrastructure, healthcare and construction.

Events such as Brexit or the election of Mr Trump as President of the United States on a protectionist mandate that may spell radical changes in rules governing trade and investment, heighten policy uncertainty and impair credibility of policy regimes. I adapt Howlett and Ramesh (1995[4]), Hill and Varone (2016)[5] to conceptualise the policy decision-making process, running the gamut for identification of the problem policy-makers seek to address to policy formulation, implementation and eventual monitoring and feedback to demonetisation (Table 1).

Why is Demonetisation Suboptimal

As the table indicates, demonetisation lacked a coherent, internally consistent and credible framework. For an effective policy, the policy instrument should have a focused, predictable, measurable, response. Taking a large proportion of currency comprising widely used currency bills out of circulation, without a clear assessment of the likely impact and the costs it imposes on different segments of the population, does not meet these requirements.

The embedded assumption of demonetisation, that cash held by individuals in excess of ‘reasonable’ needs is primarily ‘black’ money, contradicts the Indian reality of a cash-based economy, with nearly half the GDP generated in the informal sector where activities are legitimate, though not sanctioned legally.

Cash is integral to the Indian household’s portfolio. In the absence of a safety net, cash is widely held among the population, especially amongst the low and middle income class. As is the case in China, the high savings rate is also a reflection of the need to hold substantial precautionary savings. While banks today have extensive reach across the country, banking activities, e.g. deposits and loans, continue to be confined to a small percentage of the population. Precautionary savings levels, in the form of cash and precious metals, are high. In a setting

4 “Studying Public Policy: Policy Cycles and Policy Subsystems” M Howlett and M Ramesh, Oxford University Press, 1995.

5 “The Public Policy Process” M Hill and F Varone, Routledge, 2016.

where risk aversion is high and banking is yet to catch on at the mass level, large cash holdings may be socially undesirable, as they takes resources that could have been deployed productively elsewhere, out of circulation. , However, holding cash in such a scenario is privately optimal. Demonetisation risks further undermining the weak social compact[6] between the state and the citizen.

Table 1: Stages of the policy cycle

Stages in policy cycle	Phases of applied problem solving	Assessment
The problem	Problem recognition: prevalence of black money, counterfeit currency, also used to finance 'terrorist activities'	*Corruption has been at the forefront of public debates, and a major election plank of Mr Modi's government. *At best, demonetisation addresses the problem of 'flow' of black money. *No articulation of strategy to stem future generation of black money. *No clear rationale on how demonetisation would eliminate black money, and how obvious measures to convert black money into legitimate cash would be negated.
The evidence	Marshalling viewpoints of stakeholders: prevalence of corruption and tax evasion; counterfeit currency	*Estimates of black money are extremely difficult to obtain. The most widely quoted number was from a World Bank study in 2011. *The White Paper on Black Money, GOI, 2012, indicated that approximately 6% of black money was held as cash.
Assessment of alternatives	Choice of solution;	*The root causes of black money: widespread tax evasion; narrow tax base; a large informal sector –

6 "Ascending India and Its State Capacity: Extraction, Violence, and Legitimacy" Sumit Ganguly and William Thompson, Yale University Press, 2017

	how interests of different stakeholders are addressed	due to onerous labour and product market regulations is not addressed. *The role of the RBI in finalising the strategy is not clear. *How decision-makers decide what to do—or not do—about an issue. *Does the policy-maker take into account institutional structures, the structure of the economy, institutional idiosyncrasies.
	Stamping out ‘generators’ of black money	*Rationalising administrative controls; streamlining / eliminating bureaucracy. *Political funding.
	Broadening the tax base	*Streamlining tax administration. *Taxing agricultural income. *Increase incentives for formalising.
Policy formulation	Design of instruments	*The debate on how the strategy was finalised is yet to be released in the public domain. *What were the alternative policies considered; the research that informed the decision; how the interests of the various stakeholders were assessed?
Policy implementation	Institutions / agencies that facilitate execution of policy	*This was amongst the weakest links – extremely slow replacement of cash, and the inability of the banking system to honour what had been promised, caused considerable disruption to cash-based business (98% of all transactions).

Monitoring / Feedback		*While policy revisions and fine-tuning are inevitable in response to unpredictable and evasive behaviour, the frequent revisions and, at times, reversals of policy measures, resulted in considerable confusion and uncertainty about the future course of policy.
Policy evaluation	Monitoring results	*Volume of black money retrieved, taken out of circulation. *The final data is yet to be released, but estimates suggest that a proportion of outstanding demonetised currency far greater than expected was deposited into the banking system.

Demonetisation militates against Fukuyama's construct of 'trust'[7] among citizens and between public authorities and citizens, an essential attribute for the development of large firms. Despite liberalisation since 1991, and accelerated reforms since 2014, it remains a fragile compact, reflected in an industrial structure dominated by small and tiny enterprises.

If the state is seen as an appropriator of legitimate wealth, it risks portfolio switching behaviour at the household level away from cash into other assets that serve as a store of value and, for those in the middle classes and below, a search for an asset that can be used for precautionary savings.

The state's administrative capabilities have been called into serious question by the slow production of new currency notes. This has imposed considerable damage on legitimate economic activity conducted with cash, especially that in the informal sector.

From a stakeholder perspective, anecdotal evidence suggests demonetisation may well have imposed a high cost on those engaged in legitimate economic activities. About 6% of income evading taxes is held as cash[8], the remaining 94% is not affected by demonetisation. Of the 6%, a significant amount has been converted into other assets or deposited back into the

[7] ()"Trust: The Social Virtues and The Creation of Prosperity" Francis Fukuyama , The Free Press, 1995.
[8] White Paper on Black Money, Ministry of Finance, Government of India, 2012

banking system. The tax authorities are likely to have seized a small proportion of the 6%. The most significant impact has been on the cash-dominated informal sector. The poor have been disproportionately hurt by the logistics and time spent in converting their small cash holdings.

Real estate and consumer luxuries are the two sectors where demonetisation has had the most significant beneficial impact, by curbing expenditures with unaccounted income. Transparency and recording values at market prices in the real estate sector should, after a transitional period, result in rationalisation of real estate prices, bringing housing within the reach of a wider section of the population.

Demonetisation at best can tap the existing stock of black money. Without comprehensive reform it doesn't impact generation of black money. It is questionable if it is even desirable to stamp out a large part of what is defined 'black money', as 83% of the work force finds gainful work that is legitimate economic activity, but not legally recognised. The large size of the informal sector is due to the high costs of doing business and the absence of employment opportunities.

Where has Policy Credibility been impaired?

The credibility of the Reserve Bank of India (RBI) as the arbiter of an independent monetary policy has been dented. Since its inception in 1935, the RBI has maintained its independence and credibility. The Governor's testimony before a parliamentary panel hasn't yielded clear insights into the extent to which, if at all, the RBI was instrumental in initiating demonetisation. It has had to issue frequent clarifications, revisions and even reversals of earlier announcements in some instances within 24 hours of the original announcement. This has raised questions about whether RBI's autonomy and its ability to credibly execute monetary policy in the future has been impaired. Some of these issues may be clarified when the minutes of the RBI board's meetings are placed in the public domain.

While precise estimates on the amount of cash turned in still are not available, preliminary estimates so far suggest it could be as high as 97%. This negates the hope of erasing large part of the stock of black money and hopes of a fiscal bounty for the government. India's tax authorities will now embark upon the arduous task of deciding upon how to proceed with the hundreds of thousands of Jan Dhan accounts that have been inundated with cash between November 8 and December 30, 2016. Much depends on follow up policies. There are serious concerns that the tax authorities may be asked to make up for revenue shortfalls. The usual mechanics is that regional tax commissioners are asked to meet targets. These are then passed down to junior staff at the operational level. Meeting targets has a bearing on performance appraisal. Under the circumstances, with unprecedented levels of cash transformed into deposits, and the challenge of accounting for those, this opens avenues for discretionary assessment and bilateral negotiation of tax liabilities, in other words rent-seeking. The concern is that the state could turn predatory, raising the risk of inducing more evasive behaviour in the future. Punitive punishments rarely work, their effects can be seldom be sustained. However, it is noteworthy that the revenue department will draw upon data analytics to identify anomalous deposits, and then accordingly target individuals for further inquiry. If executed well, this could help widen the tax base.

Consequences of Policy Impairment

From the investors perspective, India with its growing economy, large workforce, and nascent markets, offers tremendous promise – albeit, in the long run. Despite liberalisation over the 25 years, it continues to be amongst the most intensively regulated economies. There is no clear rationale underlying the appropriateness of demonetisation as an instrument for checking the parallel economy. Prior experience, theoretical predictions, and received wisdom all suggest that demonetisation is an inappropriate tool, the costs are far greater than any benefits. It runs the risk to triggering undesirable portfolio switching behaviour on the part of households. India is a cash based economy, with substantial volume of cash holdings on the part of individuals. On the part of those holding cash, demonetisation may induce a switch into other assets, such as gold, or increase precautionary holdings of smaller currency notes, notwithstanding the inconvenience and the costs of doing so.

Investors have an option value of 'waiting to invest'. In colloquial terms, in an environment where the course of future policy measures is uncertain, it is generally prudent for investors to wait for clarity. But options do expire and investors do have choices of other economies seeking to attract investments.

Policy Implications

The dislocation offers an opportunity to shore up a tax administration that is lacking in coverage. The huge trove of data available can be deployed to buttress the tax administration and widen the tax base. Some of the obvious reforms include bringing agricultural income under the purview of the tax authorities, accelerating the ongoing agenda of easing conditions for doing business, with the state stepping in as a partner and a facilitator, rather than a suspicious monitor. Under-reporting of income among professionals and others who are self-employed is pervasive. A carrot-and-stick policy to induce self-reporting would be useful. The use of data analytics, digitisation of data, which is already under review. For the government it will help to shore up the tax administration regime.

The consequences of demonetisation were predictable. RBI Governors in 1946 and 1978 had opposed demonetisation, which in those days would have impounded a much smaller fraction of outstanding currency, held by a tiny percentage of the population. Experience suggests that the best policy regimes are those with fewer rules with transparency in their implementation, and enforced strictly. That lends clarity to investors, savers, and the bureaucracy.

Policymakers have to work in an environment fraught with uncertainties in the macro environment, in the behavioural response to rules and regulations, in the uncertain impact on incentive structures. An assessment of alternatives, prior research, detailed monitoring and follow-up policies, and drawing upon ongoing and past experience is vital for enhancing prospects for policy effectiveness[9].

The Lucas and Sargent[10] contention, albeit in the context of inflation, bears relevance. A credible government policy – one that makes itself understood and believed – will cause people to quickly adjust their expectations. The key to that credibility is policy. If government commits to a clear policy, then its motives are understood and its actions and statements are believed. After a stable period since January 2015, the policy uncertainty index[11] was at its highest level in December 2016. Demonetisation unfortunately, has left too many loose corners.

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9 "Learning Within the State: a research agenda" Luke Jordanú, Sébastien Turban and Laurence Wilse-Samson, The World Bank, 2013.

10 Sargent, Thomas J. (1982) "End of four big inflations" in NBER book *Inflation: Causes and Effects* Robert E. Hall, editor. University of Chicago Press

11 http://www.policyuncertainty.com/india_monthly.html. The index is based on "Measuring Economic Policy Uncertainty" by Scott Baker, Nicholas Bloom and Steven J. Davis