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DEMONETIZATION AND PARALLEL ECONOMY

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ABSTRACT

Demonetization is a radical monetary step in which a currency unit's status as a legal tender is declared invalid. This is usually done whenever there is a change of national currency, replacing the old unit with a new one. Prime Minister Narendra Modi's sudden announcement to demonetize Rs 500 and Rs 1,000 notes in circulation, though welcomed by people across the country, has left many in the lurch. Despite facing the opposition's ire, the Prime Minister, in an impassioned plea on Sunday, urged the people to support the move while asking them to bear the "pain for 50 days" to help him deliver the "India of your dreams". The surprise move by the govt. is a disaster for people who have accumulated lakhs and crores of unaccounted cash under their pillows and mattresses. By moving Rs 500 and 1000 notes out of the circulation govt. wants to clamp down on the parallel economy which runs side by side to the main economy or structured economy. The present paper is aimed at to study the impact of demonetization on parallel economy.

KEYWORDS

demonetization, parallel economy, structured economy.

INTRODUCTION

The Government of India announced that the Rs 500 and Rs. 1000 denominated currency notes will cease to be legal tender. Since our govt. is replacing the old Rs. 500 notes with newer ones and doing away with Rs.1000 notes, it would be more appropriate to call the move as 'scrapping' or 'phasing out' of certain currency notes.

The move was targeted towards:

1. Eliminating fake currency;
2. Inflicting losses on those with black money;
3. Disrupting terror and criminal activities.

Later, new objectives were tracked on:

4. Enabling growth in bank credit,
5. Turning India into a cashless economy.

It is going to be one of the economic events of our time. Its impact is felt by every Indian citizen. It affects the economy through the liquidity side.

A study by the National Investigation Agency and the Indian Statistical Institute, in 2016, estimated that fake Indian currency notes in circulation have a face value of Rs 400 crores. This is an incidence of fake currency of 0.022%. The scale of counterfeiting of the Indian rupee is not out of line with what is seen in other countries, and the procedures adopted worldwide to address this include investigative actions against counterfeiters, phased replacement of old series of notes with new notes that have better security features, etc. De-monetization is generally not seen as a tool for dealing with counterfeiting. We must also not forget that the counterfeiters will now get to work on the new 500/2000 rupee notes. When talking about international level, such a step was taken when the European Monetary Union nations decided to adopt Euro as their currency. However, the old currencies were allowed to convert into Euros for a period of time in order to ensure a smooth transition through demonetization. Zimbabwe, Fiji, Singapore and Philippines were other countries to have opted for currency demonetization.

HISTORY OF DEMONETIZATION

The term demonetization is already experienced by the Indian economy. Periodic experiences are cited as under:

1946: In Jan. 1946, Rs 1,000, Rs 5,000, and Rs 10,000 notes were taken out of circulation. The highest denomination note ever printed by the Reserve Bank of India was the Rs 10,000 note in 1938. However, all these three notes were reintroduced in a fresh avatar eight years later in 1954 before the Morarji Desai government demonetized these notes in 1978.

1977: The Wanchoo committee a direct tax inquiry committee, (set up in 1970s), suggested demonetization as a measure to unearth and counter the spread of black money. But this recommendation sparked black money hoarders to act fast and rid themselves of high denominations before the government was able to clamp down on them. Rs 1,000, Rs 5,000 and Rs 10,000 notes became illegal for the second time in Jan. 1978.

But these two phases of demonetization did not have a big impact on the country as less than 5 percent of population in India had access to such notes and most banks never had such currency notes. In the recent, it is the banning of the 500 and 1000 denomination currency notes as a legal tender. The government's move to discontinue high denomination notes is expected to make it difficult for hoarders to amass large sums of wealth, the suddenness of the move is likely to impact businesses of all sizes in the short term, experts said. Undoubtedly the common public and bankers are facing hardship with the latest round of demonetization. But this move will ensure that more transactions move from cash to digital modes and come under the purview of tax authorities in the long term.

It was decided to curb the illegal use of high denomination currency for corrupt deals in the country. More than 85 percent of currency in circulation has been rendered illegal. Demonetization surely would hamper the current economy in the prevailing situation and will also have impact on India's growth in the forth coming years and to have the positive long lasting effects.

WHAT IS PARALLEL ECONOMY

Economy consists of economic system of a country or other area, the labor, capital and land resources, and the economic agents participating in the production, exchange, distribution, and consumption of goods and services of that area. All kind of professions, occupations, economic agents or economic activities, contribute to the economy. Consumption, saving and investment are its core components and determinants.

Parallel economy means functioning of an unsanctioned sector in the economy whose objectives run parallel and in contradiction with the objectives of official or sanctioned or legitimate sector in the same economy (Rajaram, 2006, 577). This is variously referred to as unaccounted economy, illegal economy, subterranean economy, or unsanctioned economy, shadow economy and underground economy.

It is an economic activity that is neither taxed nor monitored by a government, contrasted with a formal economy. So it is not included in that government's Gross National Product (GNP). Black money is the currency of parallel economy.

According to the D. K. Rangnekar (as cited by Datta & Sundharam, 2004, 376). "If the 'Parallel economy poses a serious threat to stability and growth of the official economy, surely it stems from the fact that the magnitude of 'black-money' is large and rigged deals are growing in volume and complexity at an alarming rate. Apart from the wide ramifications of the 'parallel economy, one might also be alive to the fact that 'black incomes' are accentuating the inequalities in income and wealth and breeding a new class of 'black' rich in a society which is already harshly stratified."

Illegal economy is tax-evaded economy. It is possible to convert illegal economy or black money into white money and vice versa. The parallel economy has political, commercial, legal, industrial, social and ethical aspects. The objectives of the legitimate and illegitimate sectors running under parallel economy have wide confrontation. D.R.Pendse (as cited by Lekhi, 2003, 191) argued that there are two possible sources of black money. Firstly, it may originate from illegitimate source of income arising out of illegal gratification such as payment of 'Selami or Pagri' or income from smuggling, bribery etc. Secondly, it may originate from legitimate and legal sources of income but concealed from tax authorities out of tax evasion.

OBJECTIVES

Main objectives that are lying behind this paper are:

1. To analyze the causes of parallel economy.
2. To study the impact of parallel economy on the India's structured economy.
3. To analyze the impact of demonetization as a major initiative of Indian government to tackle this problem.

CAUSES OF GENERATION OF BLACK ECONOMY

1. Controls and licensing system give birth to black money in India.
2. Inflation: The increase in prices of commodities like crude oil etc. in international market causes a rise in the prices of commodities due to the increment in duties and taxes imposed by the government, which ultimately leads to buy things with unaccounted money.
3. Inappropriate tax structure: High rates of tax and ineffective enforcement of tax laws results in tax evasion as a growing tendency among the tax payers.
4. Funding of political parties with the help of black money.
5. Making money through shortcuts not out of extension of the business activities.
6. Agricultural income: The reluctance to bring the agricultural income in the realm of income tax has also contributed to creation of black money.
7. Privatization: Privatization has opened up a new area to the private sector as well as to ministers and bureaucrats for making black money.
8. Other factors: Generation of black money in a country like India also results from different activities like smuggling, property deals, Bribery, kickbacks, concealment of income by professionals, artists etc this way an enormous amount of black income results in enhancement of black money.

IMPACT OF PARALLEL ECONOMY ON THE INDIA'S STRUCTURED ECONOMY

Parallel economy is a new threat for the Indian economy. In India, this economy is expanding very rapidly. Generation of black income and thereby establishment of shadow economy has been creating the following serious impacts on the social and economic system of the country.

1. Underestimation of GDP: In India as an enormous volume of income is diverted to this unaccounted sector resulting in growing continuation of parallel economy which is not included in GDP.
2. Strengthening of the parallel economy.
3. Loss of revenue to the state exchequer as a result of tax evasion.
4. Diversion of resources to purchase real estate & luxury housing.
5. Transfer of funds from India to foreign countries through clandestine channels.
6. Inequalities in income and wealth.
7. Increase in real savings.
8. Virtues like hardwork and honesty are underestimated.
9. The existence of parallel economy has totally distorted and disrupted the planning of the economy.
10. It deals with the portion of the income that is earned from legal and illegal activities which cannot be accounted for by the standard measurement procedures used in computation of national income account.
11. Inflation.
12. Immensely complex tax system requiring inordinate taxpayer time, paper work and expenses.
13. Smaller share of national output for direct consumption by wage earners.
14. One of the more serious consequences of parallel economy is difficult to quantify namely the lack of public confidence in the system of taxation and general administration and the ability of the government to operate efficiently and fairly.

IMPACT OF DEMONETIZATION ON PARALLEL ECONOMY

The move is a "decisive blow" to the black economy. As we have faced two unsuccessful rounds of demonetization earlier but the present action has better chance of success as it proceeds logically. First, people across India were given an Identity card (Aadhar), then Jan-Dhan bank accounts were opened and people across India can transfer money using SMS today. This time there are better mechanisms that people can switch to.

Another argument is that, people can deposit the money now and withdraw cash five months later for black money transactions. Of course they can. But there are various laws that track the cash withdrawer. These guidelines were framed for Prevention of Money Laundering Act. As per RBI rules, under that every withdrawal needs a PAN card reference. Further, every branch manager is required to file detailed statement of weekly/monthly cash transactions. The cost-benefit for legitimate fellows becomes high. Tax authorities can easily monitor them.

It appears from the logical approach followed by the government that this is merely the beginning of effort against black money. I suspect these two mechanisms will be taken care of in subsequent actions. The most fundamental answer is that black money is not a pool but a chain. Breaking the chain or making it costly cause inconvenience to the poor who did not have access to bank systems. But with Jan-Dhan accounts, poor have ready access to banking channels (though not credit). So if you are law-abiding citizen then you can sail through mostly unscathed no matter how poor/rich you are.

BODY BLOW TO FAKE CURRENCY RACKETS

The move will also reduce the flow of fake currency in Indian markets as data shows that most of the counterfeit currency in circulation exists in high-denomination notes of Rs 500 and Rs 1000.

According to the Reserve Bank of India's annual report published in 2016, more than 2.61 lakh counterfeit notes in the denomination of Rs 500 were detected by banks in the year 2015-2016 while another 1.43 lakh fake notes of Rs 1000 were detected.

CONCLUSION

The demonetization undertaken by the government is a large shock to the economy. It is like a surgical strike on the parallel economy. The impact of the shock in the medium term is a function of how much of the currency will be replaced at the end of the replacement process and the extent to which currency in circulation is extinguished. While it has been argued that the cash that would be extinguished would be "black money" and hence, should be rightfully extinguished to set right the refractive incentive structure in the economy, this argument is based on impressions rather than on facts. While the facts are not available to anybody, it would be foolhardy to argue that this is the only possibility. As argued above, it is possible that these cash balances were used as a medium of exchange. In other

words, while the cash was mediating in legitimate economic activity, if this currency is extinguished there would be a contraction of economic activity in the economy and that is a cost that needs to be monitored in while assessing the impact of the demonetization on the parallel economy and its agents. It is likely that there would be a spurt in the banking deposits. While interpreting the phenomenon, however, one has to keep in mind that a large part of their deposits were earlier used for transactional purposes. Black money is a wider societal ill and demonetization is but one step in the war against black money. The biggest mission of demonetization is described as fighting black money. India's economy historically holds a big parallel economy where unreported income is the norm. It sends a strong message about the government's anti-corruption drive and would improve India's reformist stance by clamping down on the parallel economy. The parallel economy will surely collapse. Demonetization is a fight against corruption. Dishonest will have to suffer, absolutely that is the right thing and also provides a boost to government's financial inclusion drive pushing more households towards efficient banking and payment infrastructure.

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