

Demonetization – Priceless Opportunity for Fundamental Change

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It is impossible to make an accurate estimate of unaccounted money in circulation as high denomination currency. A rational analysis shows that the over Rs 14 lakh crore high denomination currency is in three forms. A significant part – about Rs 4 lakh crore – would be in the currency chests of Banks as the Cash Reserve Ratio, which is 4% of the total bank deposits by law. Another large chunk is with the over 90% informal or unorganized workers in agriculture, small business, daily wage earners and with households and businesses for day-to-day legitimate cash expenditure. It is the balance amount – probably about 30-40% which is ‘unaccounted’.

But all this is not immoral, or corrupt accumulation of unearned wealth. A large chunk of this unaccounted money is a result of cash transactions in real estate. A genuine middle class Indian who has legitimate, accounted income and pays his taxes is often forced to convert his accounted money into cash to buy a small plot of land or flat. It is no secret that a majority of property sales have 50% or more of cash component. Often the citizens who do not want to deal in cash lose in the market, because buyer will not pay the full value by cheque, or the seller is not willing to receive all money by cheque. Added to that are the habitual corruption at the time of registration of sale deed, and the high stamp duties (for buyer) and capital gains tax (for seller) on these large, once-in-a-life transactions.

The rest of the money – probably about 20% - is result of deliberate tax evasion on undeclared income, and corruption. By treating all cash as immoral or untaxed or product of corruption, we will make it impossible to reduce cash economy or ensure willing compliance of tax laws.

It is reasonable to assume that only about Rs 2.5 lakh – 3 lakh crore of high value currency in circulation is the product of undeclared income or corruption. Many economists believe that this is only 3 – 5% of the actual undeclared wealth which is stored in foreign accounts, property or other assets like jewellery. Some estimates suggest that about 20-25% of GDP currently is converted into unaccounted wealth, amounting to about Rs 25 lakh or 30 lakh crore accumulation every year. Not all of it is stored; much of it goes into conspicuous consumption, luxury goods etc generating downstream economic activity.

Demonetization therefore will not unearth or suppress significant black money in currency form. It will at best make it necessary to convert currency into one time bank deposits. It is a necessary first step to pave way for non-cash economy, and if other necessary measures quickly follow, for willing compliance of tax laws and stopping further generation of unaccounted money, it can transform our economy and society.

The government machinery clearly failed to anticipate the problems in such a massive exercise. Adequate new currency was not ready in time for exchanging the old

currency, leading to shortages, rationing and chaos. New currency notes are different in size making calibration of ATMs difficult and advance planning is inadequate forcing change of rules and guidelines almost on daily basis. These are all avoidable administrative lapses causing great hardship to ordinary people, particularly unorganized workers, farmers and small businesses.

All this real and immediate pain can be justified if other necessary steps are quickly taken to end the scourges of black money, corruption and vote buying, and citizens are made to feel good about paying taxes. Excessive empowerment of tax officials letting loose Inspection Raj and overregulation in license-permit Raj created black money and corruption in the first place. Therefore relying on these methods will be a recipe for disaster.

What then are the practical, rational, effective steps that will radically transform the way citizens look at tax laws, the public servants behave, and government acts? Here are the five doable things along with this massive exercise of demonetization touching the life of almost every citizen.

Service Delivery

1. Taxation without commensurate services is only legal plunder. Our tax rates are comparable to most countries at 30% of top rate. But services people get in return are appallingly bad. Our infrastructure, water, sanitation, storm water drainage, education and healthcare are among the most unreliable and sub-standard in civilized world. On top of this, for almost all basic, paid services citizens are entitled to, people are forced to pay a bribe to avoid delays, repeated visits, harassment, humiliation or denial of services. In most cases, a ration card, birth certificate, income or caste certificate, land records, registration of a sale deed, water connection or power connection cannot be obtained without a bribe.

Immediate enactment and effective enforcement of a Public Service Delivery law which guarantees services in a fixed time, and compensation is paid for every day's delay will improve citizen satisfaction, give fair returns for taxes paid, and enhance trust between people and government. Considering that it is the poor and middle classes who suffer most from poor service delivery, this step will improve lives for the bulk of the people at no additional cost and will reduce the ubiquitous, day-to-day petty, extortionary corruption.

Tax Rates

2. Considering the appallingly poor quality of basic services provided by government, our tax rates are high. Now that unaccounted money is going to reach the banks, government can safely reduce tax rates in a revenue-neutral manner. Taxation without services cannot be tolerated in a democratic society, and it soon degenerates into legal plunder and extraction under duress. The best way to raise tax, GDP ratio and ensure willing compliance is to reestablish the link between taxes and services. Three measures are vital to ensure willing tax compliance of citizens:

- a) An immediate reduction of top rate of income tax in a revenue neutral manner – by say 5%.
- b) Fair tax assessment, and non-discretionary application of tax laws so that harassment and corruption of tax officials are a thing of the past.
- c) Devolution of resources to local governments – especially in urban areas – where citizens see where their money is going, along with encouragement to raise local taxes based on services and accountability institutions to prevent abuse.

Real Estate Reform

- 3. Real estate reform is long overdue. Many honest farmers and salaried middle classes are forced to deal in cash transactions without any benefit to them. Three simple steps by union and states together will eliminate black money in real estate in a revenue-neutral manner.
 - a) Increase basic valuation of land and property to reflect 75% - 80% of current market price
 - b) Reduce stamp duty in a revenue neutral manner, so that buyers can show real value and pay fair duties and government does not lost revenue.
 - c) Reduce capital gains tax from 20% to 10%, which will be revenue neutral as the actual market value will be reflected in the registered sale price. When long term capital gains are not taxed in stock market, it makes no sense to tax 20% of capital gains on urban housing when most often replacement cost is high, urban land values keep rising, and most people invest life's savings in a house or urban property.

Collusive Corruption

- 4. Once small corruption is reduced by service guarantees and localized, accountable exercise of power, the grand, collusive corruption needs to be confronted. In grand corruption, both bribe giver and bribe taker collude to defraud the public, undermine competition, cause loss to exchequer, appropriate natural resources, provide low quality public good and services or damage the environment. If this collusive corruption is not addressed swiftly and sternly, corruption will shift from cash to assets, and deposits in foreign accounts will soon become the habitual medium of corruption. Three practical steps are needed to address grand, collusive corruption.
 - a) Withdraw the unwise amendments proposed in anti-corruption law – they make 3-year prison term mandatory for ordinary citizens compelled to pay bribes for services they are entitled to, and give protection to all bribe takers at all levels from even police investigation into corruption without prior government approval. Instead, grant full immunity to citizens who are forced to pay a bribe for what is their due, and give protection to those public servants who are subjected to vexatious investigations – those related to policy advice and policy formulation at government level, or bona fide decisions taken in compliance with government policy.
 - b) Compulsory retirement of at least 1000 senior officials with known record of immense corruption and misgovernance. Everybody in the system – the

politicians, bureaucrats, media and businessmen – know who are corrupt, but remain silent. Government has power to retire them after 50 years of age or 25 years of service without assigning any reason. But for this step to be truly effective, government should identify the worst offenders without fear, favour or prejudice, and must be utterly fair, and objective in its decisions. Otherwise, it will only lead to more damage than good.

- c) Bring in a law to curb corruption similar to SAFEMA, 1976 intended to curb smuggling and foreign exchange manipulation, and upheld by the Supreme Court in 1988. The SC suggested that such a law should be enacted to curb corruption. In this law, there should be three key provisions – confiscation of all property, including benami properties; mandatory jail term of 15 years or more; and reversal of burden of proof once there is prima facie evidence.

5. Systemic political reform to end vote buying

All these steps listed above will help a great deal in curbing black money and corruption. But they cannot be sustained for long unless we stop vote-buying and vast, illegitimate expenditure in elections.

In a cycle of 5 years, nearly Rs.100,000 crore (one trillion or one lakh crore) is spent illegitimately in elections at national, state and local levels. Such a system cannot be sustained without a ten-fold returns to those who are elected to office. That means political corruption of the order of Rs. 10,00,000 cr (ten trillion). Such volumes are necessary to cover the risk of failure (only some are elected after spending vast sums), expenditure in next election, maintenance of party machinery in the constituency between elections, lavish life styles for political functionaries and the profit and assets they seek in return for a life time of political activity. This political corruption is mediated by contracts, licenses, natural resource allocation, interference in rule of law, and most of all transfers, postings and key placements. In return, much of the vast machine of bureaucracy that has paid for transfers, posting and placements and the entrepreneurs who bribed to get licenses, favours, loans or natural resources, have to either indulge in corruption for returns on investment, or suppress revenue and evade taxes to make a profit in a business venture. Through all these routes, the actual generation of unaccounted money linked to illegitimate political expenditure and vote-buying runs into Rs.100 trillion in a cycle of five years. Clearly, the nature of our politics and elections is at the root of generation of unaccounted wealth and ubiquitous corruption.

What can be done to end vote buying in a poor country with asymmetry of power and no notion of citizenship, particularly when most of the country is mired in vote buying and politics as business? Moral persuasion and Election Commission diktats are of little value when the candidate and voter are sucked into the vicious cycle of money for votes, and there is no link between vote and public good. Therefore we need the following three systemic reforms to alter the incentives for candidates, parties and voters. Politics in its essence is the pursuit of power. Politicians and parties are not evil by nature; they only do whatever it takes to acquire and retain power. If the political

culture and perverse incentives operate in a manner that vote buying, corruption and misgovernance constitute a necessary vicious cycle to pursue power, they succumb to it. If it is possible to acquire and retain power by ethical means, and if the risks of vast vote buying are greater and rewards are fewer, they will change their approach to politics and pursue power through socially desirable methods.

Proportional Representation in States

- a) The requirement of marginal vote in the winner-take-all first-past-the-post system is at the root of vote buying in a poor country with our historical and political background. In the quest for winning votes, most major contenders for power – candidate and parties – are forced to spend lavishly and buy votes. Vast, unaccounted expenditure has become the necessary entry fee for serious electoral competition; but it does not guarantee victory. Thus while money does not guarantee political success, it had become a huge entry barrier, has distorted political competition and incentives in politics, has attracted wrong kind of people and repelled most of the public-spirited citizens, and created a system of corruption, bad governance, cynicism and under-performance.

If we allocate seats in proportion of the share of votes of a party in a state, then marginal vote is not vital; winner does not take all; there is no desperation to buy votes; ethical groups and parties will have voice; consensus becomes necessary in governance; representation is available to all views; and ethical politics and entry of truly public-spirited citizens become assets, not liabilities for parties.

There are various models of such Proportional Representation (PR). But simple, state-based models with a reasonable threshold of vote requirement to prevent excessive fragmentation, and multi-member constituencies to continue link between people and their representative will work best in Indian conditions.

Such a PR system is technically easy to introduce – it only requires a change in law. However, it is unlikely to materialize at the national level now, when a major party has a clear majority, and is a beneficiary of FPTP system. Nevertheless, if there is political consensus at the national level, PR can be introduced in States. Real politics and governance challenges are in states. As seen in the UK, there is no need to have the same FPTP model at national and state levels. In the UK, while the House of Commons is elected on FPTP model, regional parliaments in Scotland, Northern Ireland and Wales are elected through PR. So are members of European Parliament elected so far (until Brexit becomes a reality). Similarly London city mayor is elected directly by all people.

Therefore PR model for state assembly elections is a viable, practical reform which will transform nature of politics and governance in states. As the real governance touching citizens is at state and local levels, it will be transformative in nature. And it can be achieved by a simple law of parliament as the Constitution provides space for multi-member constituencies.

Direct Election in States

- b) Now that there is a vigorous debate about simultaneous elections to Lok Sabha and State Assemblies, the best way to accomplish that goal is election of the head of government in states by the people in a direct election, with clear separation of powers, fixed tenure, term limitations, and the freedom to appoint the cabinet from outside the Assembly. In a large, aggregate election in the whole state, the risks of vast investment in vote buying are too high, and rewards are too low. Therefore leaders and parties will depend on the personality, character, record and credibility of the candidate, and the agenda, rather than on vote-buying. At the same time, as the legislative majority is no longer necessary for the survival and functioning of the executive, the profit making opportunity of the legislator diminishes substantially (he can no longer pressurize government for transfers, contracts and other favours). Therefore, the risk of high investment in vote-buying becomes unsustainable, as the rewards are few. The whole system will go into a virtuous cycle, and black money and corruption will decline significantly.

Accountable, Empowered Local Governments

- c) Well-designed, accountable local governments are where people can see the links between their vote and personal outcomes (very similar to residents' welfare associations – RWAs), and between taxes and services. Also in empowered local governments authority can be fused with accountability, and there will be clear lines of accountability and no alibis for non-performance or failure. If we allow the local governments to be the real third tier of governments with clear separation of functions listed in the Seventh Schedule, and with a definite share of devolution on par with states through Finance Commission, our democracy will undergo radical transformation and vote buying, black money and corruption will be reduced substantially. We also need strong, independent, empowered local ombudsman, so that the pervasive culture of corruption and mis-governance does not destroy local governments before a virtuous cycle can be established.

All these five fundamental reforms – service delivery, tax rates and administration, real estate, grand collusive corruption and electoral system – are achievable and within reach. The demonetization is a difficult, massive operation. Now that the government has taken this major initiative, the people are very receptive to all these major reforms. All we need are clarity of purpose, a sense of strategy and deep insights into how free societies operate. If these steps are proposed by the government, and the first four easy, popular steps are implemented quickly, the conditions for the major political reform with popular will and broad consensus would be created. Time is of the essence. If this priceless opportunity is squandered by inaction or arbitrary action, we may not recapture the momentum for positive change for a long time.

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