

An Insight into Demonetization in India of 2016

Anindita Neogi

Assistant Professor of Economics, Ranaghat College
aneogi580[at]gmail.com

Abstract: *Money is the heart of the financial system of every economy. Demonetization was not in our serious consideration before 8th November, 2016. Money in circulation help financial system to function smoothly like blood help heart in its normal functions. On 8th November, 2016, the sudden declaration by the Central Government of withdrawal of currency notes of the denomination of Rs.500 and Rs.1000 shacked the Indian economy. As the volume of demonetized currencies was 86 percent of the total currency in circulation the Indian economy was forced to face a great challenge. It is expected that prudent financial decisions must be based on factual information and adequate relevant knowledge of the decision maker. Objectives behind demonetization are always positive. But the achievements will depend on the efficiency of the decision makers. The above - mentioned demonetization was announced with the objectives of arresting black money, checking counterfeit currencies, raising tax revenue, digitization of financial transactions, reducing criminal funding etc. This paper is an effort to find out some of the important consequences of demonetization of 2016.*

Keywords: Demonetization, Black Money, Tax, Inflation, Employment

1. Introduction

Money is the heart of the financial system of every economy. The rhythm of heart is disturbed by the irregular supply of blood into the heart which in turn influence the normal activities of the body. Generally, we do not try to realize the importance of the functions of our heart until it gives us ailment. Likewise, demonetization was not in our serious consideration before 8th November, 2016. Though, India observed demonetization both before and after independence. Money in circulation help financial system to function smoothly like blood help heart in its normal functions. On 8th November, 2016, the sudden declaration by the Central Government of withdrawal of currency notes of the denomination of Rs.500 and Rs.1000 shacked the Indian economy. As the volume of demonetized currencies was 86 percent of the total currency in circulation the Indian economy was forced to face a great challenge. It is expected that prudent financial decisions must be based on factual information and adequate relevant knowledge of the decision maker. Objectives behind demonetization are always positive. But the achievements will depend on the efficiency of the decision makers. The above - mentioned demonetization was announced with the objectives of arresting black money, checking counterfeit currencies, raising tax revenue, digitization of financial transactions, reducing criminal funding etc. This paper is an effort to find out some of the important consequences of demonetization of 2016.

2. Literature Review

Khatik, S. K, in his paper "A study on Pre - and - Post Analysis of Demonetization Period: Issues and Challenges" concluded that though demonetization affect economy in the initial stage, it will have positive impact on the economy in the long run. In his opinion black money does not mean cash so, withdrawal of money will not influence black money. His study reveals that only 1% of the total black wealth is in the form of cash. Therefore, demonetization will not affect black income generation. Kushwaha, Himanshu, Kumar, Ashwani, Abbas Zainab. (2018), in their paper "Impact of Demonetization on Indian Economy: A critical Study"

mentioned that the sudden decision of demonetization by the Central Government was considered as surgical strike against the undeclared money. According to them the move may be towards cashless economy and demonetization is followed by liquidity crunch which affected small business, agriculture and transportation. However, they concluded that it will bring benefit in the long run through digitization of financial transactions. Ganesan, G and Gajendranayagam, B in their writing in "Impact of Demonetization on Indian Economy" mentioned that as per t - test analysis the positive effect of demonetization between pre and post demonetization period showed no significant difference in short run but their regression analysis confirmed that there is a positive effect in the long run. They observed that agriculture and its related industry face a cash shortage problem and the real estate sector also faces negative impact in the short run with the expectation of positive impact in the long run. Kumar and Kumar in their paper "Demonetization and Complete Financial Inclusion" studied the effect of demonetization in India on money supply, consumption, bank deposits etc. They found that demonetization mostly impacted negatively on different sectors of the economy in the short run. However, they opined that the situation may turn in to favourable position through the suitable policies of the Government.

3. Research Methodology

The study is based on the secondary information published in various report of RBI, many research papers, Publications, Journals and newspapers etc. Also, various related websites have been referred.

Defining Demonetization

Wikipedia defines monetization as a process of converting something into money. In banking, the term refers to the process of converting or establishing something into legal tender. While it usually refers to the coining of currency or the printing of banknotes by the Central Bank. This legal tender is officially termed as coin or banknotes that must be accepted if offered as payment in financial transactions. Legal tender is backed or supported by the Central Bank of the country. Until the backing or support of a currency is

withdrawn by the Central Bank the currency exists as legal tender valid for transactions. When backing of a currency is withdrawn by the Central Bank the currency is termed as demonetized currency and it turns into a mere material. Demonetized currency is not accepted in any financial transactions. Demonetization is a process of terminating the status of a currency as legal tender. In strict sense demonetization process may be described as a situation when government wants to exchange one or more old currencies with one or more new currencies. What will happen with common people who hold old currencies? Government asks people just go to your bank or post office, deposit the old currencies and get them exchanged with the new one. This will not affect the people who have earned the currencies and declared the sources of income to government. But it will create problem to them who hold undeclared income and avoided tax on this income. When this undeclared income is deposited in a bank, the depositor will be caught by the government and high rate of taxes and penalties will be imposed on them. Holder of illegal income in the form of old currencies will not deposit the money to his bank. Their currencies will have no value and they have to destroy it.

Necessity of Demonetization

Demonetization involves huge cost to the government as it involves discarding of one or more existing currencies and the same time issue of one or more new currencies. To attain some economic benefits government decides to demonetize one or more of its currencies. It is obvious that the success will depend on the competence of the decision maker. When government cannot match the official finance in circulation with the actual finance circulating in the economy it may resort to demonetize one or more currency in circulation. In other words, when a parallel economy is found to exist in the economy the government may opt for demonetization. The main issues for which demonetization is resorted to are as follows:

Control of black money: Black money is that portion of earnings which are not exposed to the government and on which taxes are not paid by the earners. It directly affects the tax collection of the government and therefore developmental activities of the government are hampered. When government decides to demonetize one or more of its currencies the holders of the currencies are bound to deposit the currency in any of their bank account, otherwise the currencies will have no value.

Checking of counterfeit currencies: Counterfeit currencies are also a serious problem to the government. Generally, high value currencies are forged and penetrated in the economy mixing with legal tender. Demonetization can directly hit the counterfeit currencies leading the holder of counterfeit currencies to destroy it. In this way the markets become free from counterfeit notes.

Cashless transactions: One of the significant objectives of demonetization is digitization. In digitization cashless transactions are made by people through online portal. Absence of liquid cash due to demonetization has led people making online transactions. Government can easily track the

transactions made online if needed. Cashless transactions increase white money in the economy.

Increase Tax collection: Demonetization helps increase unaccounted money to go through the main channels which in turn increase the tax revenue of the Government. Untaxed money passing through the main channels are easily identified by the Government. Higher tax rates and penalties are imposed on the holder of unaccounted money.

Curb inflation: Inflation is a situation where prices of goods and services are increased depending on the supply of money in the economy. Reserve Bank of India considers Wholesale Price Index (WPI) and Consumer Price Index (CPI) to measure inflation. Demonetization reduces money supply in the hands of people. People have to cut down on spending. Demand is decreased and inflation is checked. Thus, demonetization directly impact on inflation.

Reduce terror funding: Terrorists usually use cash for their illegal activities. Demonetization largely affect terrorism activities leading cash crisis for them. They mostly depend on black money and counterfeit notes. Sudden demonetization helps to reduce terrorism activities.

Significant areas impacted

Impact on circulation of banknotes and cost involved

Table 1: Banknotes in circulation, Rupees Crore

Banknotes	2014 – 15	2015 – 16	2016 – 17	2014 – 15	2015 – 16	2016 – 17
	%					
₹2	854	853	853	0.06	0.05	0.07
₹ 5	3702	3680	3645	0.26	0.22	0.28
₹ 10	30304	32015	36929	2.12	1.95	2.82
₹ 20	8699	9847	20315	0.61	0.60	1.55
₹ 50	17436	19450	35564	1.22	1.18	2.71
₹ 100	150265	157783	252801	10.52	9.61	19.29
₹ 500	656391	785375	294098	45.94	47.84	22.45
₹ 1000	561245	632568	8925	39.28	38.53	0.68
₹ 2000	-	-	657063	-	-	50.15
Total	1428896	1641571	1310193	100	100	100

Source: RBI Annual Reports

Table 1 shows that demonetization of 2016 has largely decreased the cash circulation in the economy because the demonetized currencies were not considered as a part of legal tender. People were allowed to deposit the old notes into their bank accounts up to a certain period. In this way bank deposits were increased and on the other hand money supply in the market were contracted. Annual Report 2016 - 17 of RBI revealed that 15.44 billion Rupees composed of Rs.500 and Rs.1000 notes were out of circulation. Out of this amount about 99% or 15.3 billion Rupees were deposited in to banks. This indicates that Rs.8900 Crore of Rs.1000 notes were lost. In between 2016 and 2017 RBI took the policy of enhancing the supply of small notes to mitigate the shortage of money supply after demonetization of 2016. For this, supply of notes of Rs.10, Rs.20, Rs.50 and Rs.100 were increased at the rates of 15.35%, 106.3%, 82.84% and 60.22% respectively. The new currency notes of Rs.2000 were distributed to the tune of Rs.6570.63 billion representing 50.15% of the total circulation. The new note of

Rs.500 were issued representing the second highest circulation of 22.44%. The existing 100 - rupee notes were augmented to 29.29% of total circulation by printing new notes.

The Annual Report of RBI for 2016 - 17 showed that expenditure incurred for printing of bank notes was Rs.79.65 billion as compared to Rs.34.21 billion incurred in 2015 - 16. The expenditure incurred was mainly related to the supply of notes of 29, 043 million pieces during the year which was 37% higher than the total supply during the previous year (21, 195 million pieces). Supply of higher denomination notes in the year 2016 - 17 was 13, 702 million pieces as compared to 5, 268 million pieces supplied in 2015 - 16, higher by 160%. The report also disclosed that in the wake of withdrawal of bank notes there was an increase in the number of remittances in our remonetisation efforts resulting in higher freight and forwarding expenses. For quick supply of notes across the country by air resulted the increased freight charges. RBI had to reimburse the cost of finished banknotes, work - in - progress, raw materials, etc. as the printing presses had to discontinue printing of Rs.500 and Rs.000 denomination banknotes which were ceased in November, 2016.

Impact on direct tax base

Table 2 shows the collection of direct taxes from the year 2012 - 13 to 2017/18. It is clear from the table that direct tax collection increased over the years. For the year 2013 - 14 total tax collection was increased and it was 14.24 % higher than the previous year. After that the rate of increase in tax collection was decreased up to 2015 - 16 and it was 6.63 % in 2015 - 16. It is obvious that the positive impact of demonetization of 2016 reflected on tax collection of the Government from the year 2016 - 17. The year 2016 - 17 recorded an increase of 14.53 % in tax collection over the year 2015 - 16. The trend also observed in the following year in which tax collection increased by 18.03 %.

Table 2: Total Direct Tax Collection

Year	Total Direct Tax Collection (Rs. In Crore)	% Changed (Year to Year)
2012 - 13	558989	-
2013 - 14	638596	14.24
2014 - 15	695792	8.96
2015 - 16	741945	6.63
2016 - 17	849713	14.53
2017 - 18	1002741	18.03

Source: CBDT

Impact on widening tax base

Demonetization of high value currency in November, 2016 contributed in widening of taxpayers' base and increase in household savings. Table 3 shows that the number of new taxpayers added in the 2014 - 15 was 3.1 billion and for the year 2015 - 16 it was 3.6 billion. But the year 2016 - 17 recorded a robust increase in the number of new taxpayers added. A large portion of the figure 9.1 billion is obviously the result of demonetization in 2016. The year 2017 - 18 also maintained the growth and the figure reached to 12.8 billion. The demonetization drive forced people to deposit their holdings of high value demonetized notes into their bank account. In this way a large people were caught under income tax net. 11.78 percent IT return file increased in 2014

- 15 over the year 2013 - 14. The same percentage increase declined in 2015 - 16 and 2016 - 17 and the figure reached to 9.9 percent and 7.30 percent respectively. But the year 2017 - 18 showed a remarkable 24.7 percent increase in IT return filed. This increase must be attributed to the impact of demonetization in 2016 and the administrative steps taken by the income tax department.

Table 3: New Taxpayers added

Year	Increase in IT Returns Filed (%)	New Tax Payers Added (Billion)
2014 - 15	11.78	3.1
2015 - 16	9.9	3.6
2016 - 17	7.30	9.1
2017 - 18	24.7	12.8

CBDT Statistics 2018

Impact on job market

Demonetization of 2016 significantly impacted on job market. It is very clear that cash driven sectors like agriculture and unorganised sectors are mostly affected by the decision of demonetization. As per the report of Labour Bureau's Sixth Annual Employment - Unemployment Survey, the unemployment rate increased to a 4 - year high when Government demonetized old currency in November, 2016. Report of the National Sample Survey Organisation revealed that in 2017 - 18 India's unemployment rate had reached to a 45 - year high of 6.1%. Between 2016 and 2018, according to the State of Working India 2019 report, as many as five million Indian men lost their jobs. In addition, the report notes that women are worse affected by the employment scenario than men.

Impact on black money

Another objective of the Government was to hit black money in the country. As per report of the RBI almost entire portion of money (more than 99%) which was invalidated came back to the banking system. Out of the Rs.15.41 lakh crore worth of money invalidated, notes worth Rs.15.31 lakh crore have been returned. In February, 2019, the then Finance Minister announced that only Rs.1.3 lakh crore black money has been recovered through anti - black money measures including demonetization. The Government had originally expected that at least Rs.3 - 4 lakh crore black money will get extinguished outside the banking system due to demonetization process. So, demonetization objective of the Government against black money was not up to expectation.

Impact on fake note

Fake notes or counterfeit currency was the other target of the demonetization of 2016. In 2016, 6.32 lakh pieces of fake notes were seized across the country. According to RBI between 2017 - 2020 a total of 18.87 lakh pieces of fake notes of various denominations have been seized. During 2019 - 20 out of the total fake currency detected in the banking sector, 4.6% were detected at the RBI and the balance 95.4 % were detected in other banks. Maximum fake currency seized after demonetization was in the Rs.100 denominations, 2.4 lakh pieces in 2017 - 18, 2.2 lakh pieces in 2018 - 19 and 1.7 lakh pieces in 2019 - 20. Compared to the previous year, there was an increase of 144.6 percent, 28.7 percent, 151.2 percent and 37.5 percent in counterfeit

notes detected in the denominations of Rs10, Rs.50, Rs.200 and Rs.500 (Mahatma Gandhi New Series) respectively.

4. Conclusion

Demonetization of 2016 removed high value currency of Rs.1000 and Rs.500 from our economy. As a result, 85 percent of the currency in circulation were withdrawn. Cash intensive sectors like small sectors, agricultural sectors and agriculture allied industry were largely affected by the impact of demonetization. Unorganised sectors occupy a large part in Indian economy. They suffered a huge loss. Though a large number of people are not acquainted with digitization, the objective of digitization showed to some extent a positive impact after demonetization. The demonetization is a right step to clean and regularise the economy. It should be implemented with proper planning to get optimum result.

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