**(November 27 2016**

**“Primer of Corruption and Black Money” by S L Rao**

**People who evade taxes could use the money saved  to pay for consumption; keep it in cash; if possible in ‘benami’ bank accounts in other names; invest it in gold and jewellery where it will not earn a return except through capital appreciation; invest it in real estate which has a black and white components but poor return except from capital appreciation;  send it abroad to safe tax havens to be kept in banks; or use it in production and generate more unaccounted money. On November 8 2016 India only stopped the then Rupees 500 and 1000 notes from being legal tender; there was no demonetization.**

**Apart from tax evasion, other sources for creation of unaccounted money are bribes and corruption, received in India or abroad.**

**India has been plagued by increasing amounts of “black” money and assets since the 1960s. People were avoiding paying the high income and wealth taxes, escaping import restrictions and high import duties, or earning from criminal activities.**

**Over the ages, India developed an informal banking system. It was based on trust and had little paper work. To send money from one place to another, the hawalidar in the first location took the cash and asked his counterpart in the other location was told to hand over the cash to the designated person.  Hawala is grounded firmly on trust between all parties concerned. Today it is an illegal banking system. It enables the transfer of money without its physical movement.**

**In modern times, with high rates and different forms of taxation (income, wealth, excise and customs duties, sales taxes, state entry taxes, town entry taxes), each tax provides opportunities for tax collectors to negotiate commissions for themselves for enabling tax evasion, creating black money.  Hawala is a way to transfer money that is earned illegally. It is unaccounted or “black” money.**

**In India, the black economy is an impotent part of the whole economic system. Black money might be held as cash, real estate, high value electronic items, gold, jewellery and also be part of the production process, and invested in plant and materials. It is an integral part of the Indian economy. It generates incomes and wealth, and is held in the domestic economy as well as overseas.**

**A sophisticated system exists all over the country to convert black money into overseas holdings in banks where it might be kept liquid or invested in real estate or businesses. Participants are not only shady underworld characters but also legitimate members of the financial system. The cash is converted at an agreed rate of exchange and a receipt given for the agreed holdings abroad.  The black cash is recycled into the domestic system.**

**To enable illegal foreign holdings to come back as white money in India, government officials devised double taxation agreements with some small nations, mainly Mauritius. Any investment from there to India (of havala money converted into their currency) was not subject to Indian capital gains tax out of Mauritius and others where capital gains tax. It was the Mauritius tax which was zero. Such foreign investments mainly in the stock markets became white. A money laundry was created for black money.**

**When held as cash it has been in high value notes, till recently of values Rupees Five Hundred and One Thousand, the larger proportion being Rs 1000 notes. A good part is cash for daily transactions and some is cash acquired through corruption and tax evasion. Their sudden devaluation to zero value was   without warning. The desire to put it back into bank accounts or exchange it for legal currency caught was suddenly made difficult.**

**The black money holders safeguarded a proportion by using Jan Dhan accounts and other small holders of bank accounts, for a fee. But a good part of the black money would have lost value altogether because the holder would not want to disclose the illegal ways in which it was acquired. This adds to government income since it  no longer has to honour those notes. The fake notes (principally from Pakistan) in circulation will have no value anyway since no bank will touch the fake notes.**

**No doubt that there has been   disruption of economic activity. Legitimate activity in trader, agriculture, business, and cottage and small scale industries (all paying wages in cash) was curtailed by shortage of legal cash. The black production activity would have been halted.**

**In a society that is much more cash based than many others, a shortage of cash in lower value notes ( Rs 100 and 500 or less)  prevents transactions unless credit and credit cards can replace them immediately. This could not happen. Further, the withdrawal as legal tender of Rs 500 and 1000 notes might have temporarily halted corruption. But the ‘demonetization’ is only one of the many steps required to be taken. By itself this sudden withdrawal of a substantial amount of legal tender would have adverse effect for some time.**

**India unlike many other countries, uses much more cash in its transactions than plastic or bank online transfers. It is also an economy which until about 30 years ago, had confiscatory levels of taxation. The marginal rate of income tax was 98%. If you were also subject to wealth tax, you had to sell assets to pay taxes!**

**Up to the 1980s many imports were banned and what was allowed was also subjected to very high rates of import duties. This resulted in large generation of corrupt black money.**

**Before 1991 the economy was tightly controlled by government with many procedures and rules that required many applications for licenses and permits, to start a new business or factory, its location, where it would get its machinery from, what would be the capacity of the plant, where the technology would be sourced from, what would be the royalty to be paid, and so on. These applications to different government departments were then subjected to many formalities with complex rules. In the process, bureaucrats who had mastered these complicities, were in great demand. Many made extra income by easing the path for applicants. Since a license or permit enabled the earning of large profits, politicians and bureaucrats were the intermediaries who benefited from this corruption and bribery.**

**Withdrawing from legal circulation of high value currency is a small step to prevent black money and corruption. Double taxation agreements with Mauritius and others have been revised so that their investments will be subject in three years to Indian capital gains tax, closing the money laundries. Some black money was taxed in an amnesty scheme. A move to reduced use in cash and more plastic and bank transfers will begin but take time to have effect. Changes in “doing business” in India might reduce government corruption. However, these procedures and rules were created by the bureaucracy. It would not be surprising if some of them were created to enable illegal earnings for people in government. A concerted drive to a less cash using economy over the years will help. The change in defence procurement from imports to local manufacture must also be commended. Laws must be made much more stringent so that illegal earnings are punished severely.**

**‘Demonetization’ is a small and short-term step for cleansing the Indian economy. Many more things must be done. Indeed, some have been. We must look forward to a cleaner society.**

**(1237)**