A STUDY OF DEMONETIZATION OF CURRENCY AND ITS IMPACT ON TAXATION IN INDIA

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Abstract

On November 8, 2016 Prime Minister Narendra Modi announced the cancellation of the legal tender of Rs500 and Rs1,000 notes with effect from 9 November. The first visible impact of demonetisation on government tax revenue was an increased tax base. As per the publically available data, India had only 55.9 million individual tax payers at the end of 2015-16. In 2016-17, the government added 9.1 million new taxpayers, which represented an 80% increase over the typical yearly increase. At the same time, it was revealed in May 2017, that number of people who had filed income tax returns also got increased by 9.5 million. Due to demonetisation, the tax collection has witnessed a double digit growth. As far as the indirect taxes are concerned, the excise duty got increased by 43.5%, service tax by 25.7% and custom duties by 5.6%. At the same time India’s direct tax collection in the fiscal year 2017-18 stood at about Rs 10.03 lakh crore. In this research paper, researcher has tried to analyse the overall impact of demonetisation on direct tax as well as indirect tax as per data available from finance ministry latest report.

Key Words : demonetisation, legal tender, tax base, direct tax, indirect tax..

Introduction

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 crore. 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. Demonetisation 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, while India will likely never do a demonetisation again.

The analysis presented in the Finance Ministry's White Paper on Black Money, 2012, shows (on page 47) that, on an average, the amount of cash seized during raids by income tax authorities is 4.88 percent of total undisclosed income admitted in those cases. This data is from more than 23 thousand warrants executed. Even if this decision inflicted a 100% loss upon holders of unaccounted cash, this would imply a loss of 4.88% of their total unaccounted wealth, which is not much of a shock for those with such wealth. If, as is more likely, the demonetisation has imposed a 40% loss upon holders of unaccounted wealth (who suffer a 40% discount when laundering the money), this implies a loss of about 2% of unaccounted wealth.

Here are eight countries that tried demonetization before India...

- Nigeria.
- Ghana.
- Pakistan.
In terms of value, the annual report of Reserve Bank of India (RBI) of 31 March 2016 stated that total bank notes in circulation valued to ₹16.42 lakh crore (US$240 billion) of which nearly 86% (around ₹14.18 lakh crore (US$210 billion)) was ₹500 and ₹1000 banknotes.

India’s History With Demonetisation: From 1946 To 2016

The first currency ban:
In 1946, the currency note of Rs 1,000 and Rs 10,000 were removed from circulation. The ban really did not have much impact, as the currency of such higher denomination was not accessible to the common people. However, both the notes were reintroduced in 1954 with an additional introduction of Rs 5,000 currency. Rs 500 and Rs 1000 notes were introduce in 1934 and after four years in 1938, Rs 10,000 notes were introduce.

The second currency ban:
That came in 1978; the then Prime Minister of India Morarji Desai announced the currency ban taking Rs 1000, Rs 5000 and Rs 10,000 out of circulation. The sole aim of the ban was to curb black money generation in the country.

Objectives behind Demonetisation
* Flushing out black money
* Eliminate Fake Indian Currency Notes (FICN)
* Strike at the root of financing of terrorism and left wing extremism
* Convert non-formal economy into a formal economy to expand tax base and employment
* Give a big boost to digitalization of payments to make India a less cash economy

Literature Review
Annamalai, S. and Muthu R. Iiakkuvan (2008), In their article “Retail transaction: Futurebright for plastic money” projected the growth of debit and credit cards in the retail transactions. They also mentioned the growth factors, which lead to the popularity, important constraints faced by banks and summarized with bright future and scope of plastic money.

Alvares, Cliford (2009), in their reports, “The problem regarding fake currency in India” said that the country's battle against fake currency is not getting easier and many fakes ground detected. It is also stated that counterfeiters find it hard to have restricted printing facilities which made it easier to discover fakes.

Ashish Das, and Rakhi Agarwal (2010), in their article, “Cashless Payment System in India - A Roadmap” said that cash as a mode of payment is an expensive proposition for the Government. The country needs to move away from a cash-based economy towards a cashless (electronic) payment system. This will help in reducing currency management cost, track transactions, check tax avoidance/fraud etc., enhance financial inclusion and integrate the parallel economy with the mainstream.

Jain, P. M (2006), In their article “E-payments and e-banking” opined that payments will be able to check black money. Taking full advantage of technology, quick payments and remittances will ensure optimal use of available funds for banks, financial institutions, business houses and common citizen of India. He also pointed out the need for e-payments and modes of e-payments and communication networks.

Research Methodology
This paper is based on secondary data collected from various sources like journals, magazines, websites and newspapers and economic survey etc.

**Objective**
- To analyse impact of demonetization on direct tax.
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- To study overall impact of Demonetisation on Indian Economy.

**Data Analysis**
On November 8, 2016, currency notes of denominations of 1000 and 500 (specified bank notes or SBNs), valued at 15.4 trillion and constituting 86.9 per cent of the value of total notes in circulation were demonetised. According to the Central Board of Direct Taxes, there has been a substantial increase of 25 per cent in the number of Income Tax Returns (ITRs) filed in the current fiscal year. The increase is attributed to the initiative of demonetisation and Operation Clean Money.

**Operation clean money:**
The Income Tax Department launched ‘Operation Clean Money’ (OCM) on 31st January, 2017 to analyse the data of the persons who deposited large sums of cash and whose returns of income were not in sync with such deposits.

**Phase 1:**
In the first phase of OCM, **18 lakh suspect cases** were identified through use of data analytics where cash transactions did not appear to be in line with the tax profile of depositors.
- Online verification in these cases was enabled and done in a record time of 4 weeks.
- The success of the first phase was also attributable to the massive taxpayers’ awareness and media campaigns on Operation Clean Money launched by the Department.
- The scale of the Operation may be gauged from the fact that **response of 9.72 lakh persons in respect of 13.33 lakh accounts involving cash deposits of around Rs.2.89 lakh crore**, as per pre-defined parameters on sources of the cash deposits was captured by the Income Tax Department within a short span of 3-4 weeks. Online queries were raised in more than 35000 cases and online verification was completed in more than 7800 cases.

**Phase 2:**
The Operation Clean money has since moved into the next phase that includes enforcement actions in high risk cases, taxpayer engagement through a dedicated website in medium risk cases and close monitoring in low risk cases. The high, medium and low risk cases have been identified through use of advanced data analytics, including integration of data sources, relationship clustering and fund tracking. The exercise has also unearthed large number of persons and clusters having suspect transactions. These include **about 14,000 properties of more than Rs.1 crore each** where persons have not even filed Income Tax Returns.

The Government of India launched a concerted drive against black money with Demonetisation being an important step in that direction. Among the main objectives of Demonetisation was the flushing out of black money and also conversion of the non-formal economy into a formal economy to expand the tax base. The impact of Demonetisation on black money, widening of tax base and Direct Tax Collections is summed up hereunder:

**Impact On Black Money**
- Transactions of more than 3 lakh registered companies are under the radar of suspicion while one lakh companies were struck off the list.
• The government has already identified more than 37000 shell companies which were engaged in hiding black money and hawala transactions.
• Around 163 companies which were listed on the exchange platforms were suspended from trading, pending submission of proof documents.
• The Income-tax Directorates of Investigation have identified more than 400 benami transactions up to 23 May, 2017 and the market value of properties under attachment is more than Rs 600 crore.

Impact Of Demonitisation On Direct Tax
The effect of Demonetization is also clearly visible in the growth in Direct Tax Collections. The provisional figures of Direct Tax collections up to December, 2017 show that net collections are at **Rs. 6.56 lakh crore** which is **18.2%** higher than the net collections for the corresponding period of last year. The net Direct Tax collections represent **67%** of the total Budget Estimates of Direct Taxes for Financial Year (F.Y.) 2017-18 (Rs. 9.8 lakh crore). Gross collections (before adjusting for refunds) have increased by **12.6%** to **Rs. 7.68 lakh crore** during April to December, 2017. Refunds amounting to **Rs.1.12 lakh crore** have been issued during April to December, 2017.

An amount of **Rs. 3.18 lakh crore** has been received as Advance Tax up to December, 2017 reflecting a growth of **12.7%** over the Advance Tax payments of the corresponding period of last year. The growth in Corporate Income Tax (CIT) Advance Tax is **10.9%** and that in Personal Income Tax (PIT) Advance Tax is **21.6%**. India managed a second consecutive year of strong growth in its direct tax collections in FY18. Net collections (gross mop ups minus refunds) increased by 17.1% in the just concluded fiscal year, to 9.95 lakh crore. This was after a 14.6% increase in the mop ups in FY17. In FY15 and FY16, India’s direct tax kitty witnessed growth of just 8.9% and 6.9%.

Impact On Widening Of Tax-Base
According to I-T department, the number of returns filed as on August 5,2017 stands at 2,82,92,955 as against 2,26,97,843 filed during the corresponding period of 2016-2017, registering an increase of 24.7 per cent compared to growth rate of 9.9 per cent in the previous year. The total number of all returns (electronic + paper) filed during the entire Financial Year 2016-17 was 5.43 crore which is 17.3% more than the returns filed during FY 2015-16. For FY 2016-17, 1.26 crore new taxpayers (return filers + non-filers making tax payments) were added to the tax base (till 30.06.2017).

As per the annual report of the ministry of finance for 2015-2016, the latest annual report which is publicly available: The definition of "Tax base" has undergone change. Tax base as on 1st April of the financial year is now taken as number of persons who have either filed Income Tax Returns (ITRs), or in whose case tax has reportedly been paid or deducted, in any of the three consecutive financial years, previous to the reference year. Table 1 shows us the taxbase for the last three financial years.

<table>
<thead>
<tr>
<th>Financial Year</th>
<th>Tax-base at the end of the financial year</th>
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<tbody>
<tr>
<td>2014-15</td>
<td>6.91 crore</td>
</tr>
<tr>
<td>2015-16</td>
<td>7.46 crore</td>
</tr>
<tr>
<td>2016-17</td>
<td>8.26 crore</td>
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</tbody>
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Source: [http://164.100.47.190/loksabhaquestions/annex/12/AU3444.pdf](http://164.100.47.190/loksabhaquestions/annex/12/AU3444.pdf)
In 2016-2017, the tax base grew by 10.7 per cent in comparison to 2015-2016. In 2015-2016, the tax base had grown by 8 per cent in comparison to 2014-2015. In May 2017, that number of people who had filed income tax returns also got increased by 9.5 million. Hence, the tax base has increased at faster pace, due to demonetization.

Direct tax collection has surged dramatically post 2016, following the Income Declaration Scheme and demonetisation, according to a report by Crisil. Direct tax collection surged even as GDP growth slowed down in FY17 and FY18. According to Crisil, the income tax growth increased from 8.2% in FY16 to 26.8% in FY17 and 21.0% in FY18. The corporate tax growth in the corresponding years were 5.7%, 7.0% and 16.3% respectively.

As per figure 1, Tax buoyancy in FY18 was 1.9 as compared to 1.3 in FY17 & 0.6 in FY18. Tax buoyancy is an indicator to measure efficiency and responsiveness of revenue mobilization in response to growth in the Gross domestic product or National income. A tax is said to be buoyant if the tax revenues increase more than proportionately in response to a rise in national income or output. A tax is buoyant when revenues increase by more than, say, 1 per cent for a 1 per cent increase in GDP.

![Figure 1: Improvement in direct tax collections](image1)

Source: Crisil

![Figure 2: Corporation Tax + Income Tax as a proportion of GDP](image2)

Source: Author calculations on data from Centre for Monitoring Indian Economy and www.indiabudget.nic.in
Figure 2 explains the total corporation tax plus the income tax collected as a proportion of the GDP, over the last few years. Here we can see that in 2016-17, total corporation tax plus the income tax collected as a proportion of the GDP was 5.58% as compared to 5.41% in 2015-16.

From figure 3, we find out that the income tax to GDP ratio in 2016-2017 has seen a jump of 23 basis points to 2.33 per cent in comparison to 2015-2016. Demonetisation cost India at least 100 basis points of economic growth.

**Impact Of Demonetisation On Indirect Taxes**

As per the data, during November 2016, net indirect tax (with ARM) declined by 13.9% as compared to October, 2016. The figures for indirect tax collections (Central Excise, Service Tax and Customs) up to November 2016 show that net revenue collections are at Rs 5.52 lakh crore, which is 26.2% more than the net collections for the corresponding period last year. Till November 2016, 71.1% of the Budget Estimates of indirect taxes for Financial Year 2016-17 has been achieved. Excise duty and service tax collection growth slowed in November, reflecting to some extent the impact of demonetization on economic activity in the country.

According to indirect tax data released by the Central Board of Excise and Customs, excise duty collections grew by 32% in November as against 41% in October and 36% in September, reflecting the slowdown in manufacturing activity.
Growth in service tax collections decelerated to 13% in November, as against more than 60% in October.

**Goods And Service Tax (GST)**

GST is a comprehensive indirect tax levy on manufacture, sale and consumption of goods as well as services at the national level. It has replace all indirect taxes levied on goods and services by states and Central. The Goods and Service Tax Act was passed in the Parliament on 29th March 2017. The Act came into effect on 1st July 2017; Goods & Services Tax Law in India is a comprehensive, multi-stage, destination-based tax that is levied on every value addition. GST is one indirect tax for the entire country.

Collections from the levy of the Goods and Services Tax (GST) stood at a provisional 7.41-lakh crore for the year ended March 31. The GST regime was rolled out on July 1, 2017, and therefore the total tax mop-up pertains to the nine-month period from July 2017 to March 2018. According to the Finance Ministry, the total GST revenue collected between August 2017 and March 2018 was 7.19-lakh crore. For (these) eight months, the average monthly collection has been 89,885 crore. These collections include 1.19-lakh crore of Central GST, 1.72-lakh crore of State GST and 3.66-lakh crore of Integrated GST. The Integrated GST collections include the 1.73-lakh crore tax on imports and 62,021 crore of cess.

**Findings Of The Study**

The argument about whether demonetisation was good or bad for the economy refuses to die down even a year after the event. In the last sixteen months, there has been a lot of premature analysis on India’s tax compliance metrics based on sporadic data points cited by the Finance Minister and tax officials. But with the deadline for FY17 return filings ending on March 31, official data on direct tax collections for FY17 and FY18 is available. This makes an objective analysis possible on what demonetisation did to India’s tax base. Here are some important points worth to be remembered to have a clear picture of demonetisation’ impact on taxation.

- As we know that in 2016-17, the jump in income tax came about because of the two income tax amnesty schemes were run by the government. If we were to leave these schemes out, the income tax to GDP ratio would have been more or less the same as earlier years. The government won't have access to these amnesty schemes during the current financial year and it will impact its tax collections.
• From figure 2 we can see that as far as corporation tax plus income tax as a proportion of GDP is concerned, the income tax department is just about trying to play catch up. This ratio was much higher up until 2013-2014, without any demonetisation being carried out.

• In the case of service tax, the data includes very small businesses as the annual revenue threshold for them is Rs10 lakh.

• While manufacturers with an annual revenue threshold of less than Rs1.5 crore are exempt from levy of excise, the impact of demonetization on very small manufacturers may not be captured by the excise collection data.

• In fiscal year FY14 (under the UPA government), direct tax collections rose 14.3% without any demonetisation of currency.

Conclusion
According to the CBDT, the rise in figures amply demonstrate the positive results of the government’s commitment to fighting the menace of black money and that the organisation is committed in its resolve to eradicate tax evasion in a non-intrusive manner and widening of tax base. Government has been able to manage the transition extremely, effectively and with the least pain. With demonetization's short term effects having played out completely, it is the long term positive impacts which will be still working its way to contribute beneficially to India's economy and well-being of its people. Demonetization of old currency notes surely has some positive impact like reducing the cashflow toterror organizations, dismantling of counterfeit currency infrastructure, better income tax and indirect taxation, boost to digital economy.

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