



INDIA'S POST- DEMONETIZATION POLICY AGENDA

V. Anantha Nageswaran
and Gulzar Natarajan



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Carnegie Endowment for International Peace
Publications Department
1779 Massachusetts Avenue NW
Washington, DC 20036
P: +1 202 483 7600
F: +1 202 483 1840
CarnegieEndowment.org

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About the Authors

V. Anantha Nageswaran graduated with a master's degree in management (MBA) from the Indian Institute of Management, Ahmedabad in 1985. He obtained a doctoral degree in finance from the University of Massachusetts in 1994 for his work on the empirical behavior of exchange rates.

He teaches courses on international economics, exchange rates, and financial markets to graduate students at the Singapore Management University and at the Indian Institutes of Management in Bangalore and Indore in India. His co-authored book, *Economics of Derivatives*, was published by Cambridge University Press in March 2015. He co-authored the 2016 Carnegie Endowment report *Can India Grow?* He writes a weekly column for *Mint*, an Indian financial daily, and he is a regular commentator on global and regional economies for Bloomberg, Reuters, and CNBC.

Gulzar Natarajan joined the Indian Administrative Service, the elite tier of the Indian bureaucracy, in 1999 and was, until very recently, working as a director in the Office of the Prime Minister of India. He is currently based in London and works for the Global Innovation Fund.

He maintains a top-rated economics and public policy blog, Urbanomics, and has been a frequent contributor to leading newspapers in India. He co-authored the 2016 Carnegie Endowment report *Can India Grow?* and holds a bachelor's degree in engineering from the Indian Institute of Technology Madras, Chennai, and a master's in international development from Harvard Kennedy School.

Summary

Indian Prime Minister Narendra Modi announced in November 2016 that denominations of 500 and 1,000 Indian rupees would cease to be legal tender with immediate effect and that the Indian public had fifty days to deposit the old notes into their bank accounts, removing the notes from circulation. This demonetization was a drastic decision because these notes constituted 86 percent of the cash in circulation in India, a high cash economy. Given the mammoth scale and extraordinary nature of the exercise, it is almost an obligation on the government's part to reap a wide range of economic benefits from it and not just treat it as an exercise in raising tax revenues.

The Challenges After Demonetization

- Just as India needs to record and regulate economic activity, it also needs to facilitate and enable more formal activity. That is the breakout opportunity that the currency note withdrawal affords the government.
- Even by the standards of other developing countries, India's informal economy is large, and its economic consequences—mostly negative—are substantial. Shrinking the informal economy is essential to India's ambitions to achieve sustainable high growth.
- Because of the informal economy's pervasive nature, both financial and nonfinancial measures are necessary, with the latter involving efforts to lower the cost of undertaking economic activities.
- India needs a multi-pronged approach to address the twin challenges of limiting black money creation and encouraging formality.

What India Can Do

- Reforms to the largest sources of black money creation—real estate and political corruption—would curb that phenomenon. These policies will require long-term engagement.

- To increase the size of the formal sector requires measures to expand the tax base, enhance tax compliance, digitize transactions, lower the cost of doing business, and eliminate policy distortions and facilitate financial inclusion of small enterprises. Some of these policies can be pursued quickly; some will require expanding existing legislation.
- Merely making economic activity in the informal sector untenable and having it disappear without transferring it to the formal sector is harmful to the economy as well as to society at large.
- Eliminating regulatory distortions in the labor market should be on the medium-term reform agenda, though some of these distortions can be addressed expeditiously.
- Finally, the government may have to respond opportunistically on politically sensitive issues like agriculture income tax and campaign finance.

Introduction

On November 8, 2016, Indian Prime Minister Narendra Modi announced that denominations of 500 and 1,000 Indian rupees¹—specified banknotes (SBN), in official parlance—would cease to be legal tender with immediate effect and that the Indian public had fifty days to deposit the old SBN into their bank accounts, removing the notes from circulation. This was a drastic decision because these SBN constituted 86 percent of the cash in circulation in India and, by most accounts, India was a high cash economy.² The government asserted that the decision had been made to curb black money (funds on which taxes have not been paid, often as a result of informal or black market activity), terrorism, and corruption. However, it was widely feared that this move would cripple the Indian economy, at least in the near term. These fears have come true partially.

The provisional estimates of annual national income for 2016–2017 and quarterly estimates of gross domestic product (GDP) for the fourth quarter of 2016–2017 (January 2017 to March 2017) confirm a slowdown. Gross value added (GVA) in the Indian economy, measured in 2011–2012 prices, grew year-on-year at 5.6 percent in that quarter, compared to 8.7 percent in the fourth quarter of 2015–2016. GVA in the construction sector contracted 3.7 percent in the fourth quarter of 2016–2017, compared with 6 percent growth in 2015–2016. Investments or capital formation slowed to 25.5 percent of GDP at current prices in 2016–2017, down from 39 percent in 2011–2012.³ A developing economy can ill afford such a big slump in capital formation. Such was the cost of ridding the economy of black money and corruption.⁴

Because a large portion of black money is generated by the informal economy, the move could also be viewed as an attempt to reduce the pervasive informality that hurts the Indian economy. Although informal economic transactions tend to dominate small and developing economies, India's large informal sector, accounting for more than 80 percent of total employment in the country, is at odds with its aspiration to join the league of global economic superpowers. Indeed, such informality does not behoove a nation that claims to be the fastest-growing large economy in the world today.

Although Prime Minister Modi did not explicitly articulate this position on November 8, the national budget documents for 2017–2018 noted that recent

attempts to increase the formalization of the Indian economy would eventually boost its potential growth rate. There is no doubt that demonetization was disruptive, but follow-up actions are vital in order for the disruption to have a constructive effect on the national economy. Limiting demonetization to an exercise in mobilizing tax revenues would not do justice to the possibilities and the forces that the note-withdrawal exercise unleashed. This paper analyzes and identifies the follow-up measures that the Indian government needs to take to address both informality and its associated corruption, so that the price paid in terms of lost economic growth is recouped many times over.

The government has already taken several steps to enhance tax compliance, including the promotion of digital transactions. These measures should be implemented vigorously and complemented with measures to curtail informal markets, including policies to eliminate the gap between the market and official guidance values of real estate, to set limits on cash transactions for goods and services, and to lower the cost of doing business by digitizing government interfaces and reducing the incidence of taxes.

Explaining Informality

Informal economic activity, in simple terms, is not captured in official data. It could be legal or illegal. Activities that are not captured in official data are neither regulated nor taxed. The popular narrative of informality, especially in the aftermath of demonetization, has revolved around black money and tax evasion. This narrative frames informality as bad or even illegal, and it suggests that informal economic activity should be prevented or reversed

through policy actions. However, such a narrow view of informality misses important dimensions of the issue, especially those involving its origins and historical evolution across countries.

There is a compelling case that informality is the natural ordering of economic activity. It is the introduction of regulation that creates the distinction between what is formal and what is informal. Ravi Kanbur of Cornell University has explained this position elegantly: Imagine a world without state laws and regulations. When specified

laws and regulations are introduced into this world, economic agents must decide how to respond to them. Their responses create the distinction between the formal economy, which comes under the purview of the state, and the informal economy, which does not. Economic development is expected to enable firms to grow from small to large in terms of both size and output, to evolve from informal to formal, and to move from lower employment to higher employment.⁵

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In 2014, Andrei Shleifer of Harvard University and Rafael La Porta of Dartmouth College wrote that “although avoidance of taxes and regulations is an important reason for informality, the productivity of informal firms is too low for them to thrive in the formal sector.” They argue that “lowering registration costs neither brings many informal firms into the formal sector, nor unleashes economic growth,” and they state that it is unrealistic to expect informal firms to transition to formal status; such transitions happen all too rarely. Informal firms continue to function, often for years or even decades, without much growth or employment. Shleifer and La Porta conclude that as an economy expands, the share of informality shrinks without shrinking in absolute terms, simply because the formal economy has expanded.⁶

This position complements the argument made by Ravi Kanbur and Michael Keen of the International Monetary Fund. Kanbur and Keen state that informality, measured as a share of the population in informal employment, has persisted for more than two decades in several emerging economies.⁷ Globalization and the increased competition it creates for businesses have been factors in the increase in informal employment. Likewise, Shleifer and La Porta have noted that informal entrepreneurs in Africa repeatedly expressed their fear of competition from Chinese imports.⁸

Friedrich Schneider of Austria’s Johannes Kepler University has studied black economies around the world extensively and has sought to estimate their size over time. He has found that black markets usually arise because of tax rates and tax administration. In a 2007 study, Schneider noted that the shadow economy includes all market-based, legal production of goods and services that are deliberately concealed from public authorities to avoid compliance with taxes, social protections, workplace and product standards, and administrative procedures.⁹ In other words, any legal economic activity becomes informal because of noncompliance, whether because it is difficult or costly to comply or because of a willful indifference toward compliance itself.

The last category can be dealt with as per the laws of the land, but the government has an obligation to address barriers to compliance. Demonetization may have raised the cost of informality, but the government should bring down the cost of formality. If the underlying reasons for staying informal are not addressed, over time the fear factor that encourages compliance will fade, and business activities will return to the informal sector.

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The Dynamics of Informality in India

A 2012 white paper published by the Indian Ministry of Finance defined black money “as assets or resources that have neither been reported to the public

authorities at the time of their generation nor disclosed at any point of time during their possession.”¹⁰ The ministry identified two categories of black money:

The first is that the money may have been generated through illegitimate activities not permissible under the law, like crime, drug trade, terrorism, and corruption, all of which are punishable under the legal framework of the state. The second and perhaps more likely reason is that the wealth may have been generated and accumulated by failing to pay the dues to the public exchequer in one form or other. In this case, the activities undertaken by the perpetrator could be legitimate and otherwise permissible under the law of the land but s/he has failed to report the income so generated, comply with the tax requirements, or pay the dues to the public exchequer, leading to the generation of this wealth.¹¹

The popular narrative of informality refers largely to the second category. The white paper also pointed to the widely different nature of the challenges associated with addressing the two categories of economic activities: those that are illegitimate, and those that may be legitimate but involve either tax avoidance or evasion. Although the Finance Ministry advocated strong intolerance of illegitimate activities, it acknowledged the complexity of the latter and the necessity of a multipronged, long-term approach. In other words, dealing with illegitimate activities is largely a matter of strict enforcement, but addressing legitimate activities that involve either tax avoidance or evasion demands public policy actions at several levels. This paper will focus on the latter, but also will examine policies to address the major sources of black money that intersect with corruption.

On black money generated from legitimate activities, the National Commission for Enterprises in the Unorganized Sector defines the informal sector and informal workers as follows:

The informal sector consists of all unincorporated private enterprises owned by individuals or households engaged in the sale and production of goods and services operated on a proprietary or partnership basis and with less than ten total workers. . . . Informal workers consist of those working in the informal sector or households, excluding regular workers with social security benefits by the employers, and the workers in the formal sector without any employment and social security benefits provided by the employers.¹²

According to the 2011 census, India's total workforce is 481 million, of which an estimated 400 million are in the unorganized sector.¹³ The fifty-fifth round of the National Sample Survey administered by the National Sample Survey Organization divided the informal workers into ninety-nine occupational groups and forty-seven broad groups. Workers in the informal

economy—which includes self-employed, wage-employed, and home-based workers—contribute about 50 percent of India’s GVA.¹⁴

Ravi Kanbur has observed that the bulk of Indian enterprises are unincorporated and informal.¹⁵ Some evade formality (see column B in table 1 below). Some avoid registration by keeping their businesses below the formal threshold (column C). For example, only factories with ten or more workers (if the factory has electricity) or twenty or more workers (if it does not have electricity) are required to register themselves. The binding limit is currently ten workers, since even smaller firms operate with electricity. Some factories may choose to fragment themselves, limiting their installations to nine workers purely to avoid registration and the compliance that comes with it. They are the avoiders. But a vast majority are simply exempt (outsiders) since they operate with fewer than ten workers (column D). All three categories—evaders, avoiders, and the exempt—comprise the informal sector. Those that are large and comply with regulations constitute the formal sector (column A).

Table 1: Formal and Informal Firms in India, 2009–2010

Firm Categories*				
	Compliers	Evaders	Avoiders	Outsiders
Firm Characteristics	Annual Survey of Industries firms	NSSO** firms with 10 or more employees	NSSO firms with 9 employees	Other NSSO firms
Number of Firms	143,452	256,993	67,249	16,900,000
As a Share of All Firms	0.8%	1.5%	0.4%	97.3%
Total Employment***	11,500,000	4,543,668	605,245	29,700,000
As a Share of All Employment	24.8%	9.8%	1.3%	64.1%
Mean Employment, Number of Employees	79.9	17.7	9.0	1.8
Median Employment, Number of Employees	21	13	9	1
Median Labor Productivity, in Rupees****	135,626	59,820	74,000	23,400

* Power usage is ignored, and only the criteria of 10 or more employees is considered for registration under the Factories Act of 1948. Excludes firms with missing or zero employment.

** National Sample Survey Organization.

*** Includes unpaid family members and helpers working for the firm.

**** Labor productivity is the total gross value added divided by total employment.

Source: Ravi Kanbur, “Informality: Causes, Consequences and Policy Responses,” Charles H. Dyson School of Applied Economics and Management, Working Paper, August 2014, <http://publications.dyson.cornell.edu/research/researchpdf/wp/2014/Cornell-Dyson-wp1418.pdf>.

It is evident from table 1 that Annual Survey of Industries (ASI) firms, or those in the formal sector, constitute just 0.8 percent of the total enterprises in the country, and yet they amount to 24.8 percent of the employment generated by all enterprises. Large enterprises constitute a very small share among registered ASI firms. Only 16.8 percent of ASI-registered firms have one hundred or more workers. However, they provide 76.5 percent of all employment provided by ASI-registered firms and 81.5 percent of the output of all ASI-registered factories.¹⁶

The challenge for policymakers in the aftermath of demonetization is obvious: raising the share of ASI firms, and the firms among them that employ one hundred or more workers, from an infinitesimal figure (16.8 percent of 0.8 percent) to a slightly less miniscule one (perhaps 20 percent of 1.0 percent, to start with). That may be a more realistic objective than ambitious targets to shrink informality. In fact, it can be safely assumed that the informal sector is unlikely to shrink significantly soon. As Shleifer and La Porta noted, the most effective strategy to shrink the informal economy is to expand the formal economy through economic growth.

The High Cost of Doing Business

India has one of the most restrictive business environments of all the major economies, ranking 130 out of 190 countries in the World Bank's 2017 Ease of Doing Business Index.¹⁷ Businesses constantly deal with officials from a wide variety of state actors—the labor, environment, and taxation departments;

local governments; the police; and customs and immigration agencies—during normal operations. These interactions, often protracted, provide officials with considerable leverage over businesses under their jurisdictions.

A legal enterprise in India must register separately with multiple state and central government entities. In the case of the former, it must register with the Labor and Employment Department under the state's Shops

and Establishments Act, with the area's local government under its respective municipal or panchayat acts, and the Commercial Taxes Department for indirect tax assessments. Moreover, there are several state-specific laws that an enterprise must follow; the Labor and Employment Department, for example, has thirty-five legislations under the control of the state government. An enterprise must also register with various central government bodies, such as the Ministry of Corporate Affairs for incorporation as a company under the Companies Act, the Central Board of Direct Taxes for direct tax assessments, and the Labor and Employment Department's Employees' Provident Fund Organization and Employees' State Insurance Corporation. Further, there are specific registration procedures depending on sector or occupational categories.

India has one of the most restrictive business environments of all the major economies, ranking 130 out of 190 countries in the Ease of Doing Business Index.

Manufacturing enterprises with more than ten employees, for example, must register with the Labor and Employment Department under the Factories Act.

In addition to physical compliance with these regulations—in terms of making payments, designing human resource strategies, or meeting physical infrastructure standards—firms also have onerous periodic reporting requirements. According to current labor laws, service enterprises and factories must maintain twenty-five and forty-five registers, respectively. They must file semi-annual and annual returns in duplicate and in hard copy. Furthermore, the salary and attendance documents have tens of columns.

The additional cost of preventing whimsical actions and harassment adversely affects business competitiveness, especially for start-ups and small firms. To mitigate this problem, India will need to create an environment in which such harassment and corruption are minimized and the state's ability to deliver on its commitments effectively is strengthened.

High Labor Costs and Tax Incidence

Friedrich Schneider has identified high taxes and tax administration as factors that encourage businesses to go informal.¹⁸ Compliance costs are high in general, but labor costs matter too, as do taxes. Together, they constitute a formidable barrier that stunts the growth of Indian businesses.

Manish Sabharwal, the chairman of TeamLease Services, a staffing company, wrote that salaries of 15,000 rupees (approximately \$231) per month end up being only 8,000 rupees (about \$123) after all the deductions.¹⁹ Employers make deductions for pensions, health insurance, and even bonuses, which are statutorily payable in India. The cost to the company is higher when these are paid in addition to employees' salaries, so employers deduct these amounts from salaries before workers are paid. Employee contributions are also deducted from salaries. Consequently, the net (or take-home) pay for a worker earning less than 15,000 rupees a month is only slightly more than half of gross wages. This affects low-wage workers in particular. For higher-wage workers, it is not as much of a problem because the threshold effects kick in, lowering the incidence of deductions as a percentage of gross wages. In these matters, international comparisons are difficult and can be misleading. Nonetheless, a cursory exercise suggests that India's deductions are among the highest in the world and are a deterrent to business formalization.²⁰

Similarly, the total tax incidence for a medium-sized company in India is 60.6 percent, one of the highest in the world. According to the World Bank, the "taxes and contributions measured include the profit or corporate income tax, social contributions and labor taxes paid by the employer, property taxes, property transfer taxes, dividend tax, capital gains tax, financial transactions tax, waste collection taxes, vehicle and road taxes, and any other small taxes or fees."²¹ This measure of computation considers some or all of the labor

deductions discussed above, and accounts for both deductions and exemptions. A recent study of corporate tax rates across the Group of Twenty (G20) nations by the U.S. Congressional Budget Office showed that India's tax treatment of debt-funded investment in real estate is far more favorable than its tax treatment of investment in equipment.²² This is a double whammy, because it reduces tax revenues and dampens productive capital formation in the economy.

India has a high share of payroll deductions. Its tax policies incentivize capital formation in buildings and structures. Its tax administration is usurious and corrupt. On top of that, its existing fragmented production structure has faced a significant competitive threat since China's entry into the World Trade Organization in 2001. It should be no surprise that informality is so pervasive and persistent in India.

Fragmented Industrial Sector

Informal employment in India constitutes a far higher share of total nonagricultural employment compared with that of any other major economy.²³ Nearly 84 percent of employment in the nonagriculture sector and 93 percent of total employment is in the informal sector.²⁴ In other words, less than 50 million of the country's nearly 500 million workers are employed in the formal sector. Though the informal sector employs nearly 93 percent of India's labor force, it produces just 57 percent of the country's GDP, leaving the formal 6 percent to generate 43 percent of GDP.²⁵

Apart from inadequate labor protections, informality helps keep India's industrial and tax bases very narrow. According to the country's 2013 Economic Census, India has 58.5 million enterprises, only 793,446 of which are registered as companies. Of these, just 122,571 have paid up capital of more than 5 million rupees (about \$76,923), 24,327 have paid up capital above 50 million rupees (\$769,231), and a mere 6,512 have paid up capital of more than 250 million rupees (\$3.8 million). This includes 705,733 private nonfinancial companies, of whom just 2,776 (or 0.4 percent) have paid up capital above 250 million rupees and only 51,484 (or just 7.3 percent) had paid up capital more than 10 million rupees (\$153,846).²⁶

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The narrow industrial base is reflected in the corporate tax base. For instance, 618,806 companies filed corporate income tax returns for 2012–2013 in the amount of approximately 2.4 trillion rupees (\$36.9 billion). At just 2.4 percent of GDP, this is one of the lowest shares among all major emerging economies. Further, 55 percent of these companies reported losses or were not required to pay taxes, just 31,472 companies had more than 10 million rupees (\$153,846) in income before tax, and a meager 1,044 had income more than 1 billion rupees (\$15.4 million). India's much-discussed broad information technology sector had 25,031 taxpayers, just 4.1 percent of total corporate taxpayers, and

the 212 billion rupees (\$3.3 billion) they paid in taxes formed 8.7 percent of total corporate tax collections.²⁷

India also has too many enterprises, a far higher amount per capita than in any developed country.²⁸ The overwhelming majority of these are small subsistence enterprises that hire informally, are run out of homes, and create virtually no jobs. Further, several studies and regular surveys by the Ministry of Statistics and Program Implementation confirm that enterprises in India start small and informal, and remain so.²⁹ Given that in other parts of the world, small firms create jobs when they grow into medium-sized enterprises, India appears to be seriously handicapped by the constraints that keep firms informal. The objective of public policy, therefore, should be to not only encourage new entrepreneurs but also to help existing small (and mostly informal) firms grow, and to create new jobs in turn.

How does demonetization help address the problem of the Indian economy's pervasive and persistent informality and the country's consequently inefficient and fragmented production, which is marked by low productivity? Demonetization has focused attention on the thorny issue of informality. It should be judged by different standards than those used by critics and supporters thus far (see box).

Demonetization: A Breakout Moment?

There are two problems with addressing fundamental economic or social challenges such as pervasive informality. First, its resolution requires the coordination of several complementary policy levers. The sheer complexity of the challenge generates enormous inertia against any action. Even identifying various reform interventions, sequencing them, and formulating an action plan can be a massive challenge. Second, at least some of the policy changes are likely to be unpopular or would have to overcome entrenched and powerful vested interests.

It is in this context that demonetization assumes significance. The underlying reasons and intentions, the implementation failings, and its costs and benefits have been widely debated in India. Reasonable people can have differences about all these. However, it would be far less contentious to claim that demonetization has performed better than conventional approaches to raising structural issues like pervasive informality, the low tax base, and the predominance of cash transactions to the top of the policy agenda in India's rambunctious democracy. It is unlikely that measures to encourage the digitization of transactions, information sharing between tax departments, and

disclosure requirements for political donations would have been undertaken with the same speed and urgency without demonetization.

This approach evokes the political economist Albert O. Hirschman's principle of the "hiding hand."³⁰ Hirschman said that governments are often either too risk-averse or too intimidated to undertake large, complex endeavors. He argued that in such cases it would help to have a hiding hand that encourages policymakers and politicians to underestimate challenges and nudges them to pull the trigger. Although Hirschman's examples may have been about massive infrastructure projects with long construction times, site acquisition and rehabilitation challenges, and massive expenditures, his reasoning applies just as well to structural policy reforms.

This is not to elevate demonetization as an end, but rather to view it as an instrument to call attention to, and put political capital behind, the resolution of intractable problems. It is also not to overlook the need to follow up such critical junctures with substantive policy action, the absence of which would defeat the very purpose of taking such a step in the first place.

Beyond Demonetization: Policy Measures for Future Growth

Demonetization provides an additional impetus for the government to curb the growth of the informal sector and expand the tax base. The following sections discuss several policy measures that will improve India's economic capabilities and efficiency.

Reduce Informality and Related Corruption

Any meaningful attempt to address informality must address the distortions in India's capital, labor, and land markets, both to encourage formality and reduce informality, and to limit the creation of black money. A multipronged approach to address these twin challenges is necessary.

Following Ravi Kanbur's form of classification, for the outsiders (firms with fewer than ten workers), it is low productivity that leads to informality. For tax evaders and avoiders, it is enterprises' responses to regulation that leads to informality. Treating all three categories—evaders, avoiders, and outsiders—as one large informal sector challenges policymaking since each requires a different response. To deal with evaders, existing laws and regulations must be enforced. For avoiders, the distortion they create results in lower productivity and hence is economically costly; therefore, policy toward them should be aimed less at ensuring and enforcing compliance and more at removing or reducing the economic distortion that arises from the avoidance of costs. Outsiders, because of their small size, need help and inclusion.

To encourage formality, measures must be taken to expand the tax base, enhance tax compliance, digitize transactions, lower the cost of doing business, eliminate policy distortions, and facilitate financial inclusion. To address the creation of black money, reforms to real estate and campaign finance are crucial.³¹

Expand the Tax Base

A broad industrial base and a large middle class contribute to the total tax revenues required to create infrastructure and deliver public services. India's narrow

industrial base and limited pool of middle-class taxpayers is reflected starkly in its very low tax-to-GDP ratio, which has plateaued in the range of 13 to 16 percent for decades.³² This is one of the lowest figures among the G20 countries.

There are several explanations for this. Finance Minister Arun Jaitley's 2017–2018 budget speech points to the primary reason—narrow income- and corporate-tax bases—and illustrates the scale of the challenge. Only 17.4 million

of the 42 million people engaged in organized sector jobs, and just 18.1 million of the 56 million informal sector enterprises, file tax returns.³³

India's narrow industrial base and limited pool of middle-class taxpayers is reflected starkly in its very low tax-to-GDP ratio, which is one of the lowest figures among the G20 countries.

Among the 37 million individual tax payers in 2015–2016, 10 million had income below the threshold of 250,000 rupees (\$3,846), 19.5 million had incomes in the 250,000–500,000 rupee (\$3,846–\$7,692) range, 5.2 million earned between 500,000 and 1 million rupees (\$7,692–\$15,385), 2.4 million had incomes above 1 million rupees, and a mere 170,000 had incomes of more than 5 million rupees (\$76,923). Of the 1.39 million registered companies, 597,000 filed their 2016–2017 tax returns, of which 276,000 reported losses or zero income, 285,000 had profits below 10 million rupees (\$153,846), 28,667 had profits between 10 million and 100 million rupees (\$1.5 million), and just 7,781 declared profits above 100 million rupees.

The finance minister's verdict is stinging:

We can contrast this with the fact that in the last five years, more than 1.25 crore cars have been sold, and [the] number of Indian citizens who flew abroad, either for business or tourism, is 2 crore in the year 2015. From all these figures, we can conclude that we are largely a tax non-compliant society. The predominance of cash in the economy makes it possible for the people to evade their taxes. When too many people evade taxes, the burden of their share falls on those who are honest and compliant.³⁴

A strategy for tax-base expansion must encompass the full array of policy tactics, from rationalizing the rate structure and base to including all income sources and focusing compliance efforts.

In the aftermath of demonetization, and in the context of informality, commentators have argued that India's income tax threshold is very high and that lowering the tax threshold and taxing agricultural income could help expand the tax base. However, neither approach is likely to yield significant gains. Even assuming a 10 percent tax on all 10 million people with incomes above 100,000 rupees (\$1,538) and below 250,000 rupees (\$3,846), and assuming that each of them have a taxable income of 250,000 rupees, expanding the tax base in such a manner would add just 0.1 percent of GDP to the tax-to-GDP ratio. This is a rounding error.

Further, a lower tax threshold encourages tax avoidance. It is not just a theoretical possibility. In a survey of small- and medium-sized enterprises conducted in three states in India in 2011, respondents, particularly in the state of Tamil Nadu, confirmed that they made efforts to avoid paying income taxes more than they tried to avoid any other form of payment to the government or with respect to regulations. Further, informal payments or bribes to avoid compliance were common among the enterprises surveyed across all three states. There again, the dominant reason for making informal payments was to avoid paying income taxes.³⁵ As Ravi Kanbur observes, the advantage of raising thresholds is that enterprises would not have to engage in distortionary tax avoidance measures that undermine productivity and economic growth.³⁶

Given that agriculture formed 29 percent of India's GDP in 2011, and that just 30 percent of the country's 180 million rural households got their income from cultivation—only a minuscule proportion of which are likely to contribute any significant amount to tax revenues—the scope of squeezing out significant tax revenues from even agricultural income is marginal.³⁷ This is not to pass judgment on the merits of taxing agricultural income, but it does illustrate the futility of expecting a significant increase to the tax base from such efforts.

Another explanation for the low tax-to-GDP ratio is the slew of exemptions, especially in the corporate tax code, that encourage innovative tax avoidance practices. A 2015 World Bank paper on tax regimes in South Asia noted that generous corporate tax incentives require a higher tax rate compared to what would be needed if all firms were subject to the same tax regulations.³⁸ Tax incentives may benefit privileged firms, but they worsen the overall investment climate and put disproportionate pressure on a narrow range of taxpayers. Often, such tax incentives are offered to less productive firms or activities, dragging down overall economic productivity even as they introduce distortions and send the wrong message to productive, efficient firms. Encouragingly, the finance minister has already announced an intention to simultaneously eliminate corporate tax exemptions and lower corporate tax rates.³⁹

The policy implications are clear. India needs lower tax rates, higher tax thresholds, and a drastic and rapid elimination of ad hoc tax exemptions and concessions. The government made an initial effort in this direction in the 2016–2017 budget, when it announced a gradual reduction in corporate income tax rates and a phase-out of exemptions. However, the 2017–2018 budget did not follow through on those steps.

Whichever combination of policies to expand the tax base is pursued—base expansion, forensics, agricultural income, higher income tax rates, and so on—it is most likely to fall significantly short of the 3–5 percentage-point increase in the tax-to-GDP ratio that one would expect from a country at a comparable stage of economic development. All such reforms ought to be attempted, but expectations should be tempered given the country's narrow tax base.

Enhance Tax Compliance

Tax compliance involves consolidating and analyzing spending data from multiple sources and then responding to credible, actionable information. It is less about arbitrary inspections and high-profile raids, which are typically counterproductive and harass taxpayers.

The economist Indira Rajaraman has argued that the path to increasing tax revenues requires the detection and reduction of tax evasion.⁴⁰ She advocates focusing on occupational categories with high incomes and high-value purchases of goods and services, as well as tracking individuals for tax payment proportionality. The Indian Ministry of Finance has initiated several steps in this direction following demonetization.

As the figures in the finance minister's 2015–2016 budget speech corroborate, there is large-scale tax evasion at the highest levels of the income ladder. It is also reasonable to assume that this is concentrated in a few occupational categories. A few economic actors come to mind, such as lawyers, doctors and hospitals, professional colleges, tuition centers, entertainers, construction contractors, and real estate developers. Purchases to scrutinize include vacations (hotel bookings or air travel), gold, real estate, luxury durables (vehicles, designer wear, antiques, and art), management quota seats in colleges, club memberships, wellness services (spas and cosmetology), entertainment services, and other general high-value transactions. These monitored activities should be coupled with data on credit card spending, savings account transactions, and financial market investments.

It is critical that this data analysis should not be used to unleash a regime of inspections and raids. Instead, it should inform policy measures to plug leakages. An example is the recent decision to make some form of identity validation, such as through individuals' Permanent Account Number (PAN) card and Aadhaar number (a biometric identification system), mandatory for high-value transactions.⁴¹ A digital workflow that captures these income transfers and transactions and forces compliance while filing tax returns should be the preferred strategy. Even when individual scrutiny is required, intrusive strategies (such as the use of tax inspectors) should be undertaken only under exceptional circumstances, when all impersonal channels of communication have reached their limits.

It may not even be necessary to adopt rigorous enforcement actions at the outset. Merely informing individuals about the observed discrepancy between their expenditures and income tax payments and seeking an explanation may be adequate to ensure significant compliance.⁴² This would avoid the inevitable harassment and corruption associated with enforcement-based tax campaigns, which bring disrepute to such well-intentioned efforts.

Communicating such discrepancies to individual taxpayers would require access to different departmental databases at the central, state, and district levels, most of which are unlikely to be readily available. This in turn highlights the need to share and exploit the information within various government agencies; the level of such interdepartmental coordination is currently minimal. For example, although it appears obvious that the owner of a business that reports large revenues in its indirect tax filings would likely have an income and therefore should be paying income tax on it, this simple matching currently does not happen.⁴³ Income tax filings on business income appear to be underreported. In early 2016, the Central Board of Direct Taxes and the Central Board of Excise and Customs, the two key revenue collection arms of the Indian government's Finance Ministry, signed a memorandum of understanding (MoU)

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to kickstart this process. It is incredible that two departments of the same ministry must sign an MoU to share data, as if they were two different nations.

Why has India not been able to improve its tax policy? As with other failures of governance, this can be traced back to weak state capacity and corruption. The Central Board of Direct Taxes should quickly establish professionally competent tax policy design and research and data analytics divisions. It should develop a system for data sharing, including appropriate safeguards, with various state and central government departments. The former should use the data for better tax policy design, and the latter should use the data to improve assessments, compliance, and collection.

Assembling and analyzing the data required to identify such leakages is no easy task. For a start, it is painstaking work to extract data on occupational categories and individual purchases. There is no single, readily available data-

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base for these numbers. But with administrative resolve, it is possible to develop such systems over a three- to five-year period. Assembling this information would be a massive exercise in interdepartmental coordination and would necessitate engagement with a variety of stakeholders at different levels. Apart from overcoming strong resistance from entrenched interests within the various silos of the government, legal constraints and privacy concerns would

have to be addressed. It would also require compliance and other business reporting formats to be reconfigured.

Then there is the matter of analyzing this data on occupational categories and individual purchases with respect to actual tax assessments. This too requires far more than sophisticated software-based analytics. As Rajaraman points out with the example of Israel's use of presumptive taxable income estimates linked to transaction values, such analytics must be built on painstaking groundwork.⁴⁴ The Revenue Department of the Ministry of Finance, on its own, does not have the capacity or the convening power to carry out this level of assessment. It would require the collective support of the entire cabinet and the political leadership. Fortunately, demonetization may have made it politically acceptable to push ahead with such efforts. Persistence is required to build this capacity and institutionalize these processes.

Digitize Processes and Transactions

An important and increasingly salient strategy is to address informality through digital platforms. There is great promise in harnessing the power of information technology and data management to capture all financial transactions, and thereby formalize them. Although policy efforts in many of these areas have begun, they need to be accelerated and deepened.

A low-hanging fruit for addressing informality is the digitization of regulatory compliance. As previously discussed, enterprises must register with multiple entities and face onerous reporting, payment, personnel, and workplace standards, as well as other compliance requirements. A single online portal that integrates all state and central government departmental registrations into a single workflow application could be among the most effective systems to ease the process of business reform. Once an enterprise registers with one entity under this system, its relevant data and verification details should be captured and available for use with other registrations. This would significantly lower registration costs and reduce inspection and other verification formalities. Further, compliance efforts relating to payments and reporting requirements can be simplified. A firm should be able to log in to this portal and report all relevant details. Once all data are captured, reports can be generated and made available to meet the various legal requirements.

The government of India has already taken steps in this direction. The Department of Industrial Policy and Promotion's eBiz portal seeks to integrate all these processes. It integrates the registration entries with the Ministry of Corporate Affairs, the Central Board of Direct Taxes, and the Labor and Employment Department, and it makes corporate PAN accounts unique identifiers for businesses. Similarly, the Labor and Employment Department has integrated registration data under nine central labor laws into the single Shram Suvidha Portal. However, progress on this has been painfully slow, with limited levels of workflow integration even within departments.

Further, there have been efforts to integrate state and substate entities. This demands the merger of the core activities of at least three central government departments, departments of 30-odd state and union territories, 4,000-odd towns, and around 250,000 gram panchayats (local self-governing bodies). In terms of coordination, this is as much if not a greater challenge than the implementation of the Goods and Services Tax in July 2017. Nonetheless, doing so will provide a unified regulatory channel for all business activities across India.

Recent developments in digital payments for the government, businesses, and consumers have the potential to expedite formalization. The combination of the Pradhan Mantri Jan-Dhan Yojana (the national financial inclusion program to ensure access to banking services), the Aadhaar biometric system, and mobile phones—referred to as the JAM trinity in the Ministry of Finance's *Economic Survey 2014–15*—offers an unprecedented opportunity to dramatically expand financial inclusion. The JAM trinity could then be coupled with the expenditure information network (EIN) recommended by the Ministry of Finance's Technology Advisory Group for Unique Projects in 2011.⁴⁵ The EIN would manage and monitor end-to-end all fund releases from central and state

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governments, make the government's treasury management more efficient, and ensure that program funds are provided on time to the implementing entity.⁴⁶ Similarly, the Goods and Services Tax Network (GSTN), the information technology infrastructure underpinning the Goods and Services Tax, could help capture a large volume of commercial transactions. A combination of all three—the JAM trinity, EIN, and GSTN—would have unprecedented network effects encompassing all economic transactions involving the state. Apart from the obvious benefits of reducing evasion and leakages and better targeting

public spending, this combined system could dramatically increase the efficiency of public service delivery and the utilization of scarce public resources.

Reducing or eliminating commercial transactions in cash and replacing them with digital payments increases information flows between businesses and government entities. It not only facilitates tax collection but also provides information on consumption habits and preferences

and improves regulation. In the aftermath of demonetization, a digital payments infrastructure has rapidly emerged, and there has been spectacular growth in digital transactions. If in a few years India continues to experience high levels of digital transactions because of demonetization, then this should be counted among the finest achievements of well-conceived public policy.

All current innovations in digital finance are focused on the payments side. None of these cover lending and investments. Given the limited access to credit for both poor individuals and micro and small enterprises, the impact of digital financial services could be far-reaching. This may be the next frontier. In countries where trust in online payment mechanisms and private financial intermediaries is a major constraint, government intervention may be useful to catalyze the market for lending and digital payments. Rural users are far more likely to trust government-sponsored financial intermediation than similar services offered by private providers. The challenge for the government is to understand when and where to step back and let the market take over.

Eliminate Regulatory Distortions

India's restrictive labor market regulations and prohibitive labor taxes are a major constraint on the growth of formal employment. Policy debates have focused on the former, while the latter has received only limited attention.

As discussed earlier, existing mandatory deductions impose prohibitive costs on both employees and employers. At low wage levels, it is unreasonable to expect employees to contribute their share, and any employer's share is generally a transfer that reduces the amount in an employee's paycheck. Any reform that dispenses with social protection is not only undesirable but also unlikely to pass muster. The only option available may be a publicly funded

Reducing or eliminating commercial transactions in cash and replacing them with digital payments increases information flows between businesses and government entities.

social protection in the form of a pension and insurance. For example, the widely acclaimed Hartz IV reforms Germany enacted in 2003, which have been credited as being the critical ingredient for the country's ongoing manufacturing resurgence, embrace public funding of social protections for low- and mid-level jobs.⁴⁷ The government took over a share of the contributions, but with a phase-out scheduled over a defined number of years.

For India, a more prudent strategy involving labor market reforms would revolve around lowering mandatory payroll deductions and replacing them with publicly funded social protection, currently programmed for a gradual phase-out. As a step in this direction, the 2016–2017 union budget announced that the government of India would pay employers' contribution of 8.3 percent to the Employees' Pension Scheme in the first three years for all new employees with monthly salaries of up to 15,000 rupees (\$231) who enroll in the Employees' Provident Fund Organization. Extending this idea further, it may be useful to make the current mandatory employee contributions voluntary.

Ideally, public financing of employer contributions should help employers in the informal sector or in sectors where the job creation, productivity, and output gains from joining the formal economy would be greatest. Nevertheless, given the challenges associated with reliable identification and the well-known dangers of picking such beneficiaries, it may be prudent to cover all small- and medium-sized enterprises in the manufacturing sector.

The magnitude and duration of the incentives should be large enough to encourage enterprises to either convert to the formal sector or start as formal enterprises. An incentive amounting to 12 percent of employee costs, equivalent to each of the mandatory employee and employer contributions to the Employees' Provident Fund Organization, may be adequate to nudge firms in this direction. Similarly, a twelve-year phase-in period would be long enough to ensure that natural wage increases would more than compensate for the reduced incentives. State support could take the form of the government contributing a matching 6 percent share each for employee and employer contributions. It could be phased out over a twelve-year period with annual decreases of 0.5 percentage points on each share.

The concerns with any such labor incentives are twofold. First, businesses may be tempted to cut wages and not pass through the benefits to their employees, and second, the incentives would apply to firms that would have created jobs regardless. Regarding the former, although it is most likely that firms would not pass on the full incentive, they would most certainly pass on a share of the incentive in the form of higher wages. In any case, the benefit from becoming or starting as a formal commercial actor would by itself be a substantial achievement. Regarding the latter, existing firms would not be likely to formalize without some incentive that lowers the cost of doing business. In addition, the incentive would be more outcome-focused and targeted than any other fiscal concession available.

The program could be reviewed after three years for its impact in terms of creating and converting formal sector jobs. At a later stage, if the fiscal costs became large enough, the categories of firms could be adjusted. Further, an upper limit on the amount claimed by a firm could also be considered.

This would also correct a less-discussed distortion in India's industrial policy. Industrial promotion incentives from both state and central governments are mostly targeted at encouraging capital investments by way of fiscal concessions. This creates a situation in which a labor-abundant country, with 12 million new workers each year, ends up subsidizing investments that displace labor.⁴⁸ Restrictive and intrusive business regulations and labor deductions further penalize the hiring of labor.

Improve Inclusion Efforts for Small Enterprises

In Ravi Kanbur's classification, the biggest category of informal enterprises is the outsiders. For such firms, Kanbur sees a role for financial inclusion.⁴⁹ These firms may not become large enough to even consider tax avoidance strategies, but easier access to finance could help increase their productivity and employ-

ment generation. The Micro Units Development and Refinance Agency (MUDRA) Bank, which provides loans to microfinance and nonbank financial institutions to lend to small entrepreneurs, was established in early 2015 with this objective in mind. It seeks to provide funding to raise productivity and improve working conditions for mostly self-employed workers and small firms even as most of

them stay informal. They may never make it to the compliant category, but their economic output and working conditions would improve substantially.

It is clear that, at different stages of economic development, state support for businesses is required, even essential in some cases. An initiative like the MUDRA Bank is needed to address productivity and working conditions in the informal sector and in informal employment. To ensure successful outcomes and to meet policy goals, it is vital that the beneficiaries of MUDRA loans do not see them as handouts or as loans whose repayment would be waived. Loans and continued support should be conditional on improvements and enhancements to their businesses.

Policy interventions without benchmarks and other measurements are incomplete and ineffective. The absence of bookkeeping, production or financial, does not help, and this needs to change. All MUDRA borrowers must be required to report on their employment generation and productivity parameters, such as output produced per unit of capital and labor employed. Before requiring borrowers to report on their progress (or lack thereof) on the identified parameters, the government should develop benchmarks and share them with lenders so that performance measurement is appropriately contextualized. At least some MUDRA beneficiaries could be provided a form

Policy interventions without benchmarks and other measurements are incomplete and ineffective.

of subsidized business development support to help them adopt basic management practices like monitoring, evaluation, and target setting. Research finds large productivity improvements in different small business settings that adopt such practices.⁵⁰

In sum, much of the discussion and the recommendations above are premised on the goal that avoiders should be discouraged from adopting low-productivity tactics and methods. The policy package directed at this economically important category of informal enterprises involves deregulation and enhanced thresholds and lowered costs of operation and compliance.

Limit the Creation of Black Money

The Ministry of Finance's 2012 white paper on black money pointed to real estate as the biggest source and circulation platform for black money.⁵¹ It suffers from distortions caused by artificially low land registration values, which in turn cascade throughout the economy.

The reported registration value of the overwhelming majority of private land transactions in India is far below the actual sale prices. They are reported at the officially notified rate, termed the guidance value, which in most cities is far below the prevailing market value. The difference generates black money. In fact, even though property prices have risen exponentially in recent years, the guidance values have been revised only minimally and often too infrequently. The lower registration value helps buyers avoid the high stamp duty on land registration and sellers evade the capital gains tax.

A study by the real estate consultancy Liases Foras estimated that 30 percent of the value of real estate transactions in 2012 was black money.⁵² Another study by the real estate services firm CBRE Group estimated the total contribution of the real estate sector to the country's economy at 6.3 percent in 2013 and forecast it would reach 13 percent by 2025.⁵³ This translates to current black money generation of nearly 2 percent of GDP, a figure that is forecast to double to 4 percent of GDP by 2025.

The elimination of the dual-price market requires two complementary reforms. First, the combination of registration fees and stamp duty has to be lowered to no more than 2 to 3 percent of the land value from the current range of 5 to 12 percent. Second, the guidance value system has to be gradually phased out and replaced with a transparent and market-determined system of price dissemination.

The reduction of these rates would minimize the incentive to underestimate registration values. Simultaneously, the guidance value could be increased in a phased manner to converge with the prevailing market value over a preannounced period of five years, thereby making it superfluous. The government could dispense with the notification process for registration values at the end of this period. A combination of the two measures would likely ensure that the rate reduction is revenue neutral.

The discovery and dissemination of prevailing market values will not be easy. The government should proactively support the creation of a national database for land transactions.

The discovery and dissemination of prevailing market values will not be easy. The government should proactively support the creation of a national database for land transactions that would consolidate property sale information from all sources (housing lenders, real estate agencies and websites, and registration departments) on a single platform. However, given the absence of anything remotely resembling a credible property registry, this database would have to evolve constantly and innovatively over time. A market-driven initiative, supported by the government, is most likely to meet this objective. The recently promulgated Real Estate (Regulation and Development) Act of 2016 is a significant step in the direction of formalizing real estate transactions. All these steps, in addition to stricter monitoring of housing finance transactions, would go a long way toward limiting the creation and circulation of black money derived from real estate transactions.

Advance Campaign Finance Reform

Nothing is more important than campaign finance reform for the success of any meaningful attempt to restrict the black money that fuels corruption and corrodes India's political system. Elections cost a huge amount of money. Faced with legal spending limits, candidates and their parties must mobilize huge amounts of black money to fight elections. Successful candidates use the privileges of public office to recover their electoral investments as well as mobilize the resources needed to compete in subsequent elections.⁵⁴

There are two challenges here. One is the high cost of elections. The other is black money financing. Any meaningful effort at campaign finance reform must address both issues simultaneously by making elections less expensive and reducing the role of black money. At the same time, this reform effort should also acknowledge the reality of electoral politics in India. Unfortunately, for a variety of reasons, parties have become entrapped in a prohibitively expensive equilibrium. It is unreasonable to expect that regulations and transparency can break this vicious cycle of competitive electoral spending.

For a start, given these realities, it is essential that current electoral spending limits be revised upward. Candidates often spend tens of times more than the 7 million rupee spending limit for parliamentary elections.⁵⁵ In fact, the Indian Election Commission of India should consider revising electoral spending limits every five years. But even with increased spending limits, it would be necessary to manage expenditures. It is unlikely that political parties on their own will be able to coordinate on this. Enforcement, therefore, will have to be strengthened. Apart from the current approach of focusing on visible expenditures and tracking physical transfers of cash, it is necessary to identify the major sources of electoral spending and monitor these suppliers.

It does not help that, again, informal suppliers are likely the dominant sources of election spending.

The prevailing campaign-finance-related regulations allow for a high degree of opacity as well as weak enforcement on violations by political parties, which are not required to reveal the names of donors who give less than 20,000 rupees (\$308). Therefore, it is unsurprising that nearly 70 percent of the 113.7 billion rupees (\$1.7 billion) in donations received by all political parties between 2004–2005 and 2014–2015 supposedly came from unknown sources.⁵⁶ Even though regulations mandate that political parties have their accounts audited and tax returns filed, the laws are riddled with loopholes that render them largely ineffectual.

In acknowledgment of this issue's growing salience, the 2017–2018 union budget capped cash donations from individuals at 2,000 rupees (\$31). The budget also introduced an electoral bonds arrangement, through which donors can purchase bonds that can be redeemed in favor of a particular political party.⁵⁷ Further, going against the trend toward transparency, simultaneous efforts to cap cash and noncash donations and make their disclosure mandatory are laudable but may be impractical.

Instead, given the sheer scale of transformation required, a prudent compromise is required. It may be appropriate to focus first on maximizing the payments made to political parties through formal and legal channels. In this context, the government should dispense with the current limit on corporate donations, which is capped at 7.5 percent of a firm's average net profit over the past three years. In fact, it may not be a bad idea to have a much higher disclosure threshold for corporate donations. Once incentives and regulations are aligned toward clean money, it may be appropriate to focus efforts on disclosure requirements. To this extent, the decision in the last budget to limit cash donations to 2,000 rupees is a very good first step. In fact, it may be useful to limit cash transactions to below 500 rupees (\$8).

This policy revision on cash donations should be complemented by vigorous efforts to audit the accounts of political parties and to make income tax filings mandatory. The election commission should be empowered to take strong action against delinquent parties. In addition, in order to eliminate shell entities registered to serve as conduits for the main parties (as the election commission has suggested), only those political parties that contest elections and win a minimum vote share should be allowed to receive electoral donations.

Public financing of elections is arguably the most widely discussed campaign finance reform.⁵⁸ Such public financing, either as a matching subsidy or as a share of the donations raised, may be inevitable. To encourage the mobilization of small donations, all such noncash donations below a certain amount, perhaps 1,000 rupees (\$15), could be incentivized with a much higher public matching share.

It is essential that current electoral spending limits be revised upward.

As a caveat, there are several implications of campaign finance reform, such as the impact on the budget and the moral hazard associated with public financing of elections. Therefore, it may be useful to pilot these efforts in state elections and learn from the experience before scaling up this idea across the country.

Conclusion

The withdrawal of the SBNs was an immense policy exercise planned in near-total secrecy. Indian citizens endured the inconvenience and the severe cash crunch in some parts rather stoically. The economy has taken a hit. Given the mammoth scale and extraordinary nature of the exercise, it is almost an obligation on the government's part to reap a much bigger harvest from the seed it has sowed.

Demonetization may have been meant as a one-off exercise in mopping up the stock of black money held in cash, discouraging future tax evasion, and curbing it through the digitization of most transactions. These endeavors are necessary and important. But just as India needs to record and regulate economic activity, it also needs to facilitate and enable more formal activity. That is the breakout opportunity that the SBN withdrawal affords the government. It is an opportunity that should not be missed; even by the standards of other developing countries, India's informal economy is large and its economic consequences—mostly negative—are substantial. Shrinking the informal economy is essential to India's ambitions to achieve sustainable high growth. Because of its pervasive nature, both financial and nonfinancial measures are necessary, with the latter involving efforts to lower the cost of undertaking economic activities.

Just as India needs to record and regulate economic activity, it also needs to facilitate and enable more formal activity.

Some of the policies to improve the quality of financial inclusion of small enterprises and eliminate corporate tax exemptions can be pursued quickly. Some other measures to enhance tax compliance and digitize processes and transactions, which have received a boost in the aftermath of demonetization, can be expanded and pursued. The elimination of regulatory distortions in the labor market should be on the medium-term reform agenda, though some of these distortions can be addressed expeditiously. Policies to address black money creation from land transactions require long-term engagement. The government may have to respond opportunistically on politically sensitive issues like agriculture income tax and campaign finance.

Crucially and more importantly, the government must acknowledge that its structural reforms raise short-term uncertainties as they upend known ways of doing business and conducting economic transactions. In the past two years, the government, the central bank, and the judiciary have launched several policies and decisions that have injected a great deal of uncertainty into India's economy. That is why, as mentioned earlier, capital formation has declined and

value appreciation in the construction sector has contracted. The government has demonetized high-value currency notes, introduced legislation to resolve cases of bankruptcy and insolvency faster, drafted a law for *benami* (transactions undertaken in another person's name) to outlaw false ownership of real estate, and established a new regulatory framework for the real estate sector. Further, it has intensified measures to tighten scrutiny of tax returns and increase tax revenues. The Reserve Bank of India has been pursuing delinquent borrowers through various means. The Supreme Court, for its part, put a sudden ban on the sale of automobiles that conformed to an earlier, but not new, more rigorous emissions standard. It also banned the sale of alcohol near national highways.

Most of these measures might be desirable for the long-term health of the economy, but it is inevitable that they will slow the economy in the short term. However, to the greatest extent feasible, the government should mitigate this pain. No surgery is administered without painkillers, and no postsurgery recovery is achieved without the occasional use of painkillers. The government must therefore emphasize reducing the incidence of taxes; improving the tone, quality, and attitude of tax administration; and removing the regulatory burden on small- and medium-sized firms. To this end, the government should develop a list of parameters and trends that it will track to assess the success of demonetization, including the following:

- An above-trend increase in the number of income tax filers and payers, especially by self-employed professionals;
- An increase in the ratio of noncorporate income tax to GDP;
- A reduction in employment in the informal sector and rise in employment in the formal sector; and
- An increase in the average size of factories and production units in terms of employment and output.

The last point is important since it measures the success of the government's efforts to increase the size of the formal sector. Merely making economic activity in the informal sector untenable and making it disappear without replacing it in the formal sector is harmful to the economy and to society at large.

Finally, any sustainable attempt at curbing black money must strike at the business model of politics. Reforms aimed at greater transparency in campaign finance would be the strongest possible statement of intent from the government that demonetization was the first of many measures to address a much larger problem.

There are no easy answers to development challenges in a large, complex, diversified, and fragmented economy such as India's. It is unlikely that India can transition to a significantly less informal economy over the medium term.

Government must acknowledge that its structural reforms raise short-term uncertainties as they upend known ways of doing business and conducting economic transactions.

Even if this is achieved, it likely will not be the sole determinant of India's economic fortunes. As argued in the 2016 Carnegie Endowment report *Can India Grow?*, the government should work toward persistent economy-wide capital accumulation that grows the country's national income to create a large consuming class, encourages firms to operate formally and then grow, and builds up the required state capacity to regulate efficiently.⁵⁹ Inclusive economic growth may be the best antidote to informality. It requires diligent and urgent action on multiple fronts. Indeed, that is the best tribute the government can pay itself for its extraordinary action on November 8, 2016.

Notes

- 1 Throughout the paper, currency conversions are based on an exchange rate of \$1 equaling approximately 65 Indian rupees. Most U.S. dollar figures are rounded to the nearest whole number, except those over \$1 million, which are rounded to the nearest tenths decimal place. In this case, 500 rupee and 1,000 rupee notes are worth about \$8 and \$15 respectively.
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