



THE SECOND MAHESH BUCH MEMORIAL LECTURE

Understanding Black Money in India

by

Dr. Y.V. Reddy,
Ex-Governor, Reserve Bank of India

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I am greatly honoured by the invitation from National Centre for Human Settlements and Environment to deliver the second Mahesh Buch Memorial Lecture. I knew him well at a personal level though I did not work with him directly. He had formidable reputation for intellect, courage of conviction, and impeccable honesty. He was prophetic in anticipating the importance of environmental issues. He was special to Bhopal and Bhopal was very special to him.

Buch Saab has been a role model for many people in the Indian Administrative Service. He has been kind to me and very appreciative of my work in Reserve Bank of India. Therefore, I am beholden to Mrs. Nirmala Buch for giving me the opportunity to come here and pay my tributes to a great son of India and a pride of the IAS.

Mahesh Buch was acutely sensitive to contemporary issues and at the same time valued deep understanding of relevant systems. Apart from his laudable value, he was superb in detail, but he never missed the big picture and system wide context. Considering his interests and inclinations, I decided to speak on 'Understanding Black Money in India'.

Experiences

My interest in Black Money goes back to 1960. I was registering for Ph.D. I wanted to take the subject Black Money in India for my thesis. My guide, Professor V V Ramanadham said that it would not be an appropriate subject for a Ph.D. degree; there was no data available. I, therefore, changed the subject to Monopoly and Concentration of Economic Power in India. I worked for three years on the subject, and I had to change that subject also for a variety of reasons.

At a policy level, I came into contact with the issue of black money when we were going through the balance of payments crisis in 1991. India Development Bonds were floated to obtain foreign exchange from non-residents to help us tide over the crisis. At that time, there was a consensus that the tax regimes and control systems that were prevalent before 1991 would be dismantled. It was the general understanding that there would be a regime shift in the policies away from a system that provided incentives to accumulate wealth outside India. The country was also desperately in need of foreign exchange to get over the crisis. Amnesty was granted under some conditions.

General understanding at that time was that this dispensation of amnesty was an extra-ordinary and one time measure. The IMF team which was negotiating with us its support was not confident that the bond issue will succeed even with amnesty, because at that time one of the reasons of the crisis was withdrawal of NRI deposits. We felt that NRIs confidence in our economy will be restored with reforms initiated, and they will put in money without waiting for formal upgrade by rating agencies. The returns for them were attractive but not excessive.

We succeeded in raising the foreign exchange from NRI bonds, soon after balance of payments crisis in 1991, with elements of amnesty.

I was hoping that it will remain one off measure. It did not.

In 1997, there was a Voluntary Disclosure Scheme which did not have any relationship with a foreign exchange crisis or a regime shift in policy. However, there was an assurance of changes in policy, giving one last chance to come clean. By then I was a Deputy Governor. I expressed my reservations about its desirability, for well-known reasons; i.e. moral hazard, and global experiences. Some people criticised it saying that "coming clean" became more attractive than paying taxes on current incomes also.

This had no link with forex or a crisis, but facilitated conversion of some of the stock of black money to non-black money channels.

I am not aware of evaluation of its performance in terms of original objectives.

The issue of black money came up indirectly in the context of capital account liberalisation in 1997. As Deputy Governor, RBI, I had already taken an unconventional view in a public speech in 1996 that the import of gold was inevitable and, therefore, it should be enabled through official channels. My approach was from the point of foreign exchange market. A genuine forex market cannot be developed if a large import item is imported unofficially by receiving finance through unofficial channels. There was a criticism that by permitting import of gold liberally, we were allowing use of gold for purpose of storing black money. I explained that a liberalised gold policy by itself would not add to the incentive for generating and using black money. I argued my case for liberalisation of gold imports, at a very small level of duty partly on the ground that Gold is the main property right and insurance for women folk of India. Gold is essentially a form of wealth for womenfolk in India. Tarapore, Chairman of the CAC and members took note of it and acknowledged my suggestion and made appropriate recommendations in favour of such liberalisation. Demand for gold by the masses is dominant relative to use of gold for black money. In the total stock of black money or in transactions involving gold, gold is not dominant. Import of gold was liberalised, and duty was made nominal. As a result, the gold imports were "officialised". Imports and domestic gold market which were underground for decades became legitimate.

Experience with liberalisation of gold shows relevance of acceptance of economic realities and limits to the authority of State. The policy continues with occasional deviations.

In 1998, consequent upon imposition of sanctions by USA as a reaction to our nuclear explosion, many observers felt that we had to mobilise extra-ordinary financing for balance of payments support. I was closely involved in the design of the Resurgent India Bonds. There was a strong feeling within Government that amnesty should be given. My position

was that it would set a bad precedent and, in any case, inadvisable on grounds of theory, empirical evidence and our experience. My input during discussions was that we should be prepared to pay higher interest cost rather than extend the amnesty. Governor Jalan and Minister Sinha resisted the pressures and temptation to follow the precedent, and decided on the proposal not involving amnesty.

Simply stated, we proved that amnesty was not needed if the intention was to raise money from NRIs since an attractive rate was enough. It was not addressing issue of black money or money illegally stashed abroad.

In September 2003, I took over as Governor. By then we had faced Ketan Parekh Scam, and the Parliamentary Committee that enquired into the subject, made a reference to the role of Overseas Corporate Bodies and Participatory Notes in the Scam. OCBs are Overseas Corporate Bodies owned by NRI but they could easily be fronts for others. (Beneficial ownership is not known. PNs are derivatives which are traded abroad and held by investors whose beneficial ownership is unclear). There were enough grounds to believe that these two mechanisms were being used for round tripping, that is, illegally taking the money out from India and bringing it back to invest in India. Concealed incomes, untaxed, go out and earn incomes that are not taxed.

OCBs were permitted to disinvest and repatriate, but they were not permitted to make new investments. This amounted to a ban on inflow from them. One of the two big windows of round tripping of money was thus closed.

There was a second route for round tripping called Participatory Notes (PNs), which was serving a similar purpose. I had spoken to Chairman SEBI, and he promised to ban PNs immediately after my action against OCBs in 2003. Later, he mentioned that the SEBI Board did not approve and that the government was not supportive of the measure. I took up the matter with the government, without much success.

In November 2005, an Expert Group (Chairman, Dr. Lahiri) appointed by Government gave a report encouraging FII flows. It was in favour of a liberal approach to PNs, but with safeguards put in by SEBI. The representatives of the Reserve Bank of India in an unusual gesture appended a Note of Dissent. The RBI asserted that nothing short of banning of Participatory Notes would be appropriate.

Clearly, there is a subsisting interest in influential policy circles to keep a window for round-tripping open.

Recent Official Policies

Since my retirement as Governor in 2008, I have been indulging in academic activities. In that capacity, I have been watching recent developments. A White Paper on Black Money was tabled in the Parliament

on May 21, 2012; and, the paper is, perhaps, the most comprehensive account of official position on black money.

The Paper defines 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'. The paper explains that black money can be generated either through illegal activities like crime, drug trade, terrorism and corruption or simply failing to pay dues to the public exchequer in one form or another, though activities might be legal.

The paper, wisely, does not provide an estimate of the amount of black money currently generated in India, citing lack of uniformity, unanimity or consensus about the best approach to be used. Certain sectors are highlighted as being more vulnerable to black money issues. These include land and real estate, bullion and jewelry, financial markets, public procurement, the non-profit sector, informal sector and cash economy. The Paper highlights the issue of Indian assets held abroad, particularly in Swiss banks.

The White Paper is an excellent account of the problem and the approaches to remedy the situation mainly from the point of view of Tax Administration. The paper gives an impression that the main focus is on two areas: Income Tax and Foreign Exchange Regulations; in addition to Prevention of Money Laundering.

Understandably, the issue of election funding has not been highlighted. More recent sources of generation of black money like education and health have not been analysed.

In January 2011, the Supreme Court in response to a writ petition asked Government why the names of those who have stashed money in the Liechtenstein Bank have not been disclosed. The court felt that the government should be more forthcoming in releasing all available information on what it called a "mind-boggling" amount of money held illegally in foreign banks.

The Supreme Court on 4 July 2011, ordered the appointment of a Special Investigating Team (SIT) headed by former Supreme Court judge to act as a watch dog and monitor investigations dealing with the black money. This body would report to the [SC](#) directly and no other agency will be involved in this.

SIT has been making a series of recommendations, and main issue relates to action against those who stashed money outside the country. Indian Government has reportedly argued before the Court that it cannot divulge the names. It was further argued that the privacy of individuals would be violated by the revelation of data.

The fifth one in the series of recommendations was issued on July 4,

2016. Among other things, there is a reference in the notification to misuse of Participatory Notes for money laundering. It notes efforts of SEBI to obtain identity of the PN holders.

My view has been that the design of intent of the instrument is to conceal the beneficial ownership. Regulator has to depend mostly on non-verifiable details. The dissent note of RBI in 2005 explains the rationale for banning PNs remains.

It is not clear to me whether these extra-ordinary arrangements have served the purpose; whether the resources spent yielded commensurate results, and whether exit from these has been considered.

The Centre on May 2016 disclosed the various decisions and steps it had taken to curb the "menace" of black money both within and outside the country in last two years. They include: enactment of a new Black Money Act with strict penalty provisions.

Allowing people to declare undisclosed income or assets, and escape any action after paying 45% tax, giving "one last chance" for people to come clean (It has yielded 0.45 percent of GDP as against 0.60 percent in 1997 scheme).

Amendments to Prevention of Money-laundering Act, 2002, strengthening discretionary powers of the agencies investigating.

Amendment to Foreign Exchange Management Act (FEMA), 1999 providing for seizure and confiscation of value equivalent, situated in India, in case any person is found to have acquired any foreign exchange, foreign security or immovable property, situated outside India.

The approach is clearly one of strengthening the punishment approach to violating an expanding list of violations. In addition, there are elements of a throw-back to the reintroducing of detailed regulation (e.g. stock of foreign assets) and reporting requirements.

My Understanding

First, black money often described as parallel economy is not exactly parallel with white money since there is continuous mingling of the two. Let me illustrate. Many buildings are constructed by real estate developers with a significant share of black money. The developer may be paying wages to the construction workers in the evening out of his black money. For the construction worker, however, it is white money earned for hard work, and when he spends to buy the groceries in the evening, it is pure white money transaction. However, when the owner of the grocery shop has to pay protection money to the mafia in the night, it becomes black money with the mafia. At the same time, when the grocery shop pays electricity bill or pays municipal tax, they are all white money transactions. In brief, the black and white components keep changing through the transactions, and all moneys are fungible.

Second, experience with tax amnesty to convert black money into white has not helped in curbing generation of black money and amounts of black money mobilised through amnesty is a very small part of the estimated stock. In fact, such amnesty has led people to argue that yesterday's black money can become today's white money if the policy of the government changes. In other words, the stigma attached to the black money and the differentiation on ethical grounds between black and white money, lose their significance with recourse to amnesty by the government. Both in theory and in practice, both in India and globally, tax amnesty proved to be counter-productive.

Third, black money is both a stock and a flow. It is in the form of stock when it is invested in real estate, in gold, and finally in foreign assets. It should be clear that all foreign assets held by individuals is not black money, and further, only one part of the black money is invested in foreign assets. As regards the flow of black money, as already explained, depending on the parties to the transaction, there is a continuous inter-mingling of black and white money. There are also transactions confined to black money. Depending on the tax systems and other legal frameworks as well as culture of compliance or non-compliance, black money may be generated, but once it is generated, it can go into the flow as well as into the stock. Black money keeps flowing in and out of stock. Black Money generated in India may be stored or used in India. A part of such Black Money domestically generated may be moved out stashed abroad or used abroad has been taken out may come back through "round tripping". Like Gold, Swiss Accounts (of black money) is part of a problem, but only a part. We should not equate black money with money illegally stashed abroad.

Fourth, black money which is in the form of foreign assets may not be held purely as bank deposits or in liquid form. Very often, there is a popular demand for bringing back the black money that has been (stashed) abroad. While the money at some stage could have been in a bank deposit, it is most unlikely that the foreign assets funded by black money remain un-invested in other financial instruments. In fact, it is quite possible that a large part of black money taken by resident Indians abroad, has been brought back through tax havens for investing in Indian financial markets. The current policy regime of portfolio flows provides ample opportunities for such "round tripping" of black money with considerable material benefit to those indulging in such round tripping.

Fifth, the extent to which the black money is held in the form of foreign assets by Indian residents depends also on the policies of other countries involved. For instance, there have been efforts recently in many advanced economies to identify tax evasion and trace unaccounted money, especially the cross border flow of unaccounted money.

Sixth, it is useful to make a distinction between black money generated by cross border criminal activities such as drug trafficking and

terrorism, from black money generated from tax evasion and for purposes of regulatory arbitrage, circumventing legal provisions. Some funding for political activities may also be involved in these transactions. Obviously, public policies have to address different sources of generating black money with different set of policy instruments.

Seventh, gold economy in India has been associated with smuggling and black money since there was an official ban on import of gold till 1997. After liberalisation of gold imports, the non official channels in gold imports relate more to criminal underground activities like drug trafficking. Most of the domestic demand for gold is rooted in our culture and tradition. Demand for gold is both from honest tax- paying citizens in lower middle classes and middle classes, and of course, to some extent, by those who want to store black money generated. Addition to supply of gold in India is entirely out of imports. The political and social impact of demand for and supply of black money are domestic, and are very very negative and rooted in our governance systems.

Eighth, black money stashed abroad is viewed with greater concern than black money in India. This is a hangover of the past, especially 1957 till end of the century, when we felt foreign exchange is valuable relative to rupee. In fact, if our policy moves towards goal of fuller capital account convertibility, there would be no legal restrictions on taking money in and out of India, though black money taken out will still be black money until it is round-tripped when it becomes legal.

Review of experience

Firstly, when we started with the reform process, we assumed that high level of taxation encouraged generation of black money. As of now, income tax rates for the higher income earners in India are, perhaps, among the lowest taxed in major economies of the world. Similarly, India is one of the few that does not have inheritance tax and no wealth tax, and substantively no gift tax. Even after the taxes have been brought down to this level, the record of compliance with tax law is dismal.

Both, the generation of black-money and cross border movement of black money are not explained by current level of taxation.

Secondly, transfer of money outside the country is a subset of the bigger problem of black-money. We believed that a realistic exchange rate though our reforms would put an end to a premium for foreign currency in informal markets. We succeeded in that.

Foreign exchange is freely available for all current account needs of our citizens through official channels. So, there should be no incentive to hold forex abroad, on account of genuine needs.

Thirdly, we had in the past years very strict regulations, punishments, etc. under the draconian Foreign Exchange Regulations Act. Prior approvals

of transactions made no sense when there was information asymmetry. Declaration of holding of stocks involved humongous information that could not be put to use. There is no evidence either globally or within India that micro regulation of transactions and threat of severe punishments have worked in any sector.

It is difficult to assert that deregulation resulted in generation of more black money, while there is evidence that such policies facilitated growth, efficiency and resilience in the economy.

Fourthly, there is a view that fairness promotes compliance with tax laws. If a rich person buys and sells shares, and reinvests, he need not pay any tax. But, a person who works for a living has to pay full income taxes. Similarly, most of those who do not pay taxes seem to go unpunished. There is a view that tax regimes turned unfair during reform. There is also a view that the economic reforms were basically "business friendly" and not "market friendly".

Market friendly means that there would be a set of rules and in a sense, opposite of crony capitalism.

Fifthly, and most important, there is a view that black-money is often generated not because people do not want to pay taxes, but because they do not want to deal with processes involved: hassle or harassment. Unfortunately, there is no study or data about these burdens imposed by the tax administration on a tax-payee.

Asking Different Questions

Most important lesson from a review of experience is that our policies relating to curbing black money or bringing back the stock of money illegally parked overseas have been less than successful. There is no reason to believe that more of the same will work better. We do not seem to know what might work better. Perhaps, we should ask different or right questions in order to understand the issues relating to black money.

Benami Transaction (Prohibition) Act was enacted in 1988. For some reason or the other, no regulations were issued under the Act. In other words, it remained unimplemented for more than 25 years. The President seemed unconcerned about implementation. The Parliament was indifferent. The Executive had no compulsion to explain. The Judiciary did not consider it a matter of public interest to dwell on that. However, an Amendment Bill was introduced in Lok Sabha in May 2015. It has been passed in August 2016. What explains the lack of enthusiasm among all wings of public policy to do what is universally accepted as very critical to issue of black money?

We are proceeding on the assumption that government agencies should be empowered to punish the citizens who generate black money. At the same time, the Supreme Court wants to make sure that such powers are

not used selectively by the executive as illustrated by the work of SIT. Implicitly, Supreme Court does not trust the Executive to discharge its executive functions unless the Court takes over supervisory functions. Is it possible that generation, circulation and multiplication of black money are a symptom of lawlessness in the system: all pervading lawlessness? Is lawlessness defined as lack of respect for contracts, explicit or implicit, prevalent both in dealings by the Government and the citizens?

There are many interactions between government and citizen; and between citizens. Payment of taxes is one of them. If the government does not perform its duties honestly, say accepting a First Information Report (FIR) by Police Station or delaying refund of income tax, is there an assured remedy? In a dispute between a lender or a bank and borrower, what are the chances that a lender can enforce a contract expeditiously through judicial processes? What are the chances that a tenant of a building of a branch of public sector bank can get it vacated at the expiry of contract period? In other words, is black money a manifestation of broader problem of lack of mechanisms for enforcement of contracts between private parties and between government and private parties or even between agencies within public sector?

More generally, is it possible that generation, perpetuation and multiplication of black money is merely a reflection of inappropriate laws, and undermining of such laws by public institutions themselves? How far are the three wings of governance, legislative, executive and judiciary responsible for the large presence of black money?

In brief, and most importantly, it is possible that black money is merely a symptom of a deeper disease, and that disease is very complex.

Some Theory

Often, theory helps us understand complex issues better, though it seldom provides practical solutions ready to be used. So, in preparation for this presentation, I searched my small personal collection of books gifted to me. I found useful books. They are:

"**Law & Economics**" by Robert Cooter and Thomas Ulen gifted to me in 2001, and "**Lawlessness and Economics**" by Professor Avinash K. Dixit, gifted to me in 2007. Both books helped me get a rough sense of advances in knowledge that may help us enhance our understanding of black money.

Professor Kaushik Basu in his book "An Economist in the Real World: The Art of Policymaking in India" published recently, devoted a whole chapter to Law and Economics. Two paragraphs in the Preamble to the section are very relevant to the subject.

"A poorly implemented law or, for that matter, a well-implemented one can do devastating damage to an economy. In the minds of most people the law is about crime, retribution, justice, and fairness. The fact that the law can be critical in determining the rate of growth of the GDP, the length of the queue for buying some essential commodity, or the level of unemployment is not something that is widely appreciated. This is especially true in developing nations."

"But the fact remains that many a developing nation has brought great harm upon its economy and development prospects by not enacting a law or by failing to implement a law that has been enacted or by enacting and implementing a faulty law. This is one area where there is a lot yet to be understood and much to be gained from such an understanding."

Professor Basu goes on to discuss issue of corruption and makes a suggestion; but, I will not dwell on that. The general point made by him relates to the importance of law and of governance in the process of economic growth and welfare.

The issue of black money can be viewed as one of crime and punishment. It can also be viewed as one element of broader governance.

If people perceive a threat to their property rights, whether from the government or from any other source, one of their responses will be to conceal their assets to the extent possible. They will hide tangible property. They will deny the existence of intangible property; for example, highly productive individuals will pretend to have low productivity because they know that if the truth is revealed, the government will simply force them to work harder. But the cost of achieving perfect revelation by direct supervision or observation is likely to be prohibitive. Therefore, the

government will find it desirable to supplement direct auditing or monitoring policies with others that offer the people material incentives to expend effort and to reveal their assets and skills.

Markets will not succeed unless they are supported by adequate governance institutions. Most economic activities and interactions share several properties that together create the demand for an institutional infrastructure of governance. Conventional economic theory recognises the importance of law for governance, but it takes the existence of a well-functioning law and legal system for granted. It assumes that the state has a monopoly over the use of coercion. It also assumes that the state designs and enforces laws with the objective of maximizing social welfare. The usual implicit assumption is that the law operates costlessly. About forty years ago, economists realised that these assumptions are not valid since there are transactions costs, information asymmetries, principal-agent problems and incentives.

In the economist's ideal picture, the government supplies legal institutions that are guided solely by concern for social welfare and such institutions operate at low cost in the sense they are too small to matter. In reality, the apparatus of law could be costly, slow, weak, and even biased.

What happens if transaction costs are high and legal system too slow or weak? Economic activity does not grind to a halt because the government cannot or does not provide an adequate underpinning of law. For many people, too much potential value would go unrealized. Therefore, individuals, groups and societies create alternative institutions, instruments and practices, to provide the necessary economic governance. For instance, it is widely recognised that it is difficult to have smooth business transactions without recourse to use of black money either directly or indirectly (say through input suppliers or liaison officers).

It is easier to grow from a low level of income per head to a middle level than it is to remain as a middle income country and reach to a high level. In the first phase of the growth or transition, economic activity is on a small scale, trade is localized, and economic transactions involve a relatively small group of people. In such a setting, networks of information flows, norms of behavior, and sanctions for deviants may already be present from the social environment, or can develop quickly as people interact economically among themselves. Therefore, self-enforcing governance is feasible. But for a sustained growth, ruled based governance must prevail over relation based ones.

Relation-based and rule-based systems are conceptual pure categories that mix in different ways in practice. In some situations, the diminishing returns of a relation-based system can be countered without going to a fully centralized rule-based alternative.

The processes of creating the institutions and the apparatus of state law, and of improving them to the point where rule based governance dominates and functions well, can be slow and costly.

The fixed costs of rule-based governance are a public investment; therefore society must solve a collective-action problem to put such a system in place. This is not automatic; there are the usual problems of free riding, under-estimation of the benefits to future generations in today's political process, and the veto power held by those who stand to lose from the change.

Even when the public investment for a rule-based system has been made, people used to the relation-based system who want to switch must make some private investments to learn the rules and their operation. Their benefit from the switch will depend on how many others make the switch. This positive feedback externality can lead to too few switchers, or even a lock-in that keeps the old system in use. In turn, the expectation of this can reduce the social benefits of the changeover and therefore delay or deter the initial public investment.

The benefits of the new system may be unequally distributed, and some participants may even lose. The system of rules and their enforcement itself must at first establish a reputation for integrity and efficacy. This takes a long time and strict supervision even given much good will.

The economic theory of criminal behavior holds that rational criminals compare the benefits of crime with the expected punishment imposed by the criminal justice system.

The economic theory of crime offers a predictive model of criminal behaviour and a clear goal for criminal law. The predictive model of criminal behaviour could be based upon a theory of the rational choice to commit. The goal for criminal law and policy: should be to minimize the social cost of crimes. Optimal policies should ideally be computed on this basis.

Economic theory of optimal punishment suggests that the goal should be the sum of the social harm caused by crime and the cost of deterring it. There are alternate ways to deter crime, say fines or imprisonment. The optimal level of deterrence and optimal allocation of society's resources among alternative ways to deter crime can also be determined. In other words, the amount of resources that a society or government can afford to spend on punishment as a deterrent is not unlimited. No doubt, it is not appropriate to reduce every aspect of life to costs and benefits, but then one cannot entirely ignore opportunity costs, merely because of strong feelings.

Conclusion

Let me conclude by saying that black money is not merely an issue of taxation or non declaration or committing crime and imposing punishment. It is manifestation of a bigger problem of governance. In countries that are moving from relation based systems to rule based systems, there are challenges. In dealing with this issue, we cannot take a simplistic view of a benevolent state versus a manovelent market participant. It is interesting that people urge severe actions by government precisely in those countries where governments are reputed to be weak in governance systems. If generation of black money is a consequence of weak governance, how could empowering precisely the same governance systems solve the problem on a firm footing?

Let me thank Mrs. Nirmala Buch, my batch-mate and friend, Mr. Mahendra and a host of others.