

Causes and consequences of black money in india



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Black money is defined as factor incomes, property incomes which should have been reported to income tax authorities but are not. The various mediums of generating black money are Land transactions, Encroachments on land, Payment of bribe, Misuse of public property, Misappropriation of public funds, Evasion of taxes etc.

The growth of Black money is shown in the graph embedded below.

Black Money in Indian context

Many people confuse black money with

Parallel economy

A parallel economy is one which is illegal and runs opposite to legal economy. However in Indian case the legal and illegal economy are interlaced together. The legal economy emerges out of illegal and vice versa.

Illegal Economy

An illegal economy is one which completely originates out of illegal activities. However in Indian case legal and illegal economy is interlaced.

Irregular economy

Irregular economy is one which is run by irregular institutions. Irregular institutions are those which influence regular/formal institutions for economic advantage.

Unaccounted economy

It is one in which income is hidden from tax authorities. However Indian tax laws itself are full of flaws and let people hide their income easily.

Why Black Money

In Indian context the generation of black money occurs due to the interactions between the triad.

There is a constant conflict between capital and labor markets, the unorganized sector which always has been taken advantage of and a realization that manipulation of policies can win the market place has led to the growth of black money in India.

Major chunk of black money in India is invested in Real Estate and Share markets as in both these markets capital gains can exceed more than 30% mark. Both are ideal conduits for circulating black incomes

Conduits for black money

Hawala:

Illegal movement of money is done through a process called Hawala. An initial transaction can be a remittance from a customer (CA) from country A, or a payment arising from some prior obligation, to another customer (CB) in country B. A hawaladar from country A (HA) receives funds in one currency from CA and, in return, gives CA a code for authentication purposes. He then instructs his country B correspondent (HB) to deliver an equivalent amount in the local currency to a designated beneficiary (CB), who needs to disclose the code to receive the funds. HA can be remunerated by charging a fee or through an exchange rate spread. After the remittance, HA has a liability to

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HB, and the settlement of their positions is made by various means, either financial or goods and services.

Economics of Gold:

The next best option for investing black money is Gold. India is the highest consumer of gold in the world! In the early 90s, import and export of gold was restricted as the government realised that saving & investment in gold was leading to a loss of foreign exchange reserves. This was also because privately held gold did not help India's balance of payment situation. As a result, gold smuggling became a huge racket which was funded extensively by black money as people got a vehicle to park money which was illegally obtained. This was further accentuated by the fact that the money which was given to the importer and the smuggler would leave the country thus depleting resources. This eventually led to loss for our economy.

Rising share of services:

Black money has also played a big role in the development of the services sector mainly due to the fact that valuation of the activity is difficult, as a result of which an activity which is probably worth around Rs 5lakh is instead quoted at 10lakh to hide 5lakh of black money. Also, it has a large component of the unorganised sector in it. In India, the demand for services has increased manifold due to increased material production, specialisation in production and increased expenditure on advertising and other such activities. So, due to surge in service sector growth, the black money economy is also experiencing explosive growth.

Sources of Black Money:

Under-invoiced inventories: Sometimes the amount of inventory is under-invoiced so as to keep extra amount to sale in the black market. And the amount of sale is never reported in the account book.

Over-invoiced plant and equipments: The fixed costs on plant and inventory are reported higher than the actual amount so as to generate black money. For example, companies buy for perhaps Rs 5lakhs and instead get an invoice for Rs 10lakhs to cover up Rs 5lakhs of black money.

Informal sector activities including trade, films, production etc.: All the film industries in India – be it Bollywood, Kollywood or Mollywood are doing dreadfully bad, but still they continue to produce flop after flop after flop. Perhaps, it is because movies are being made simply to hide excess black money.

Illegal holding of precious metals, gem and jewellery: The most favourite of the sources is hiding metals and jewellery. There are countless instances of the same in the news all the time where prominent personalities' homes are raided and valuables worth crores are recovered.

Flight of capital for investments abroad: Also, black money is used to fund investments abroad as people try to hide their incomes and put it in foreign banks which are situated in the tax haven countries.

Transfer activities (like secondary share market and real estate) and buying of influence (bribe for work): Giving and taking bribe in India is pretty common in almost every day activities. Another common source of black money is real estate which is covered in detail later.

Illegal activities like smuggling, drugs, prostitution, and crime: The big fishes of all of these sources are smuggling, drugs, prostitution and crime. Being illegal activities, all this money is black money as there are no records of how they are generated and used.

Methods to estimate:

Methods have been developed to estimate and evaluate the illicit amounts of money, of which, two well-established economic models are based on “Model of Capital Flight”.

The World Bank Residual model is based on change in external debt or CED

The Trade Mispricing model which is based on the IMF Direction of Trade Statistics or DOTS database

But the problem with these methods has made the task of estimators all more difficult as these methods cannot capture genuine reversal of capital flight. Also another weakness with this method is that the inflows indicated by models of illicit flows are unrecorded, they cannot be taxed or utilized for economic development.

The more recent and more accurate method has been developed by Global Financial Integrity. It is called as “Block Recursive Dynamic Simulation Model of Illicit Flows”.

This dynamic simulation model examines the complex interactions between macroeconomic, structural and governance factors that drive illicit flow from India. Further probe into the model is out of scope of this study.

Conversion of black money to white money:

By far, the most important problem with black money has got to be, how do you distinguish between them?

Here we see two economies with the same activities and entities. At any point of time, one cannot make out whether black money is being used by households or white money is used in the market. To an extent, black money in the financial market is limited due to compulsory legislation that one must have a PAN Card number, but the money used for daily needs do not come into picture. If a person goes to Reliance Fresh and buys some groceries using black money, it has instantly been converted into white money the moment a receipt is obtained.

Few methods followed in real life to convert black money into white money are

Funding politicians: Suppose a businessman funds a politician with his black money to contest in the elections. When these politicians get elected, they return the favor in the form of favorable policies for the businessman which is known as “lobbying”. Finally the business man profits from their “investment” and generate “White Money”.

Selling black income in form of jewellery: Suppose a person having huge amount of black money in the form of gold or jewellery wants to change it to white money. He goes to a jewellery shop and sells the jewellery and gives 5 to 10% of the value to the shop owner. The shop owner then gives the person the receipt on which he has to just pay the capital gain tax and then the amount turns to white.

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Donation: When a person wanting his son to get a seat in a good MBA college and uses his black money and give it off to college authorities, no one asks for a receipt. The amount one pays cannot be shown officially because the giver and taker both will face government problem. Now the son armed with his MBA degree is ready to earn white money.

Does black money improve employment

In India, black money is that which is taxable and is not taxed, i. e. money that is hidden from taxation. However, in India, there are millions of people whose incomes do not touch the minimum income level and are thus not taxed. They also might involve in illegal activities like taking bribes which in effect must be classified as black money but are not. As a result, the value addition to the economy is actually much higher than recorded. So, what should ideally happen is that employment opportunities must increase and economy must grow because of more money circulating in the economy due to black money.

However, as people actually do not spend the black money and try to just hide it, the rate of savings gets increased and as a result the multiplier reduces which leads to lesser money in circulation in the economy. This lowers the potential growth rate and the employment potential and eventually leads to the dissatisfaction of the youth. So, what has happened is black money which should have ideally led to increase in employment is actually leading to its decrease and thus in India. As per statistics, black income generation results in overestimation of employment and wages by 5 percent.

Consequences

The black economy results in policy failure both because of inadequate allocations and due to ineffectiveness of expenditures. Primary schools intended to be set up do not materialize. Roads either do not get built or are of sub-standard quality needing frequent repairs. Badly laid water pipes lead to both shortage and contamination of drinking water. Investment gets diverted to unproductive sectors leading to shortage of savings for real investment. Scarcity of foreign exchange prevents import of essentials and technology.

The black economy has many economic ill-effects. The black economy and the erosion of institutions of democracy are interlinked. The institutions of democracy, legislatures, learning centres, judiciary, police, bureaucracy, police and media, are all compromised due to the functioning of the black economy. They are not doing what they should be doing and people's faith in democracy has eroded. Issues in elections have ceased to matter, devaluating the electoral process. As people's pressure has declined, illegality has grown. The involvement of the country's elite in illegality has eroded their commitment to work and this pervades society.

The nation is not short of resources but because of the existence of black economy, a large chunk of resources are not only wasted but are either lying idle or are siphoned off out of the nation. Paradoxically, the interests of those who have benefited the most from the black economy have been hurt the most since the growth has been stunted and dynamism has eroded. Much of the activity in the black economy is like digging holes and filling them. Many

are employed but society makes little progress and remains poor. As policy fails, individual solutions are sought, which result in making the resource shortage look worse and weakens the commitment to national goals.

Checking the growth of the black economy has become the single biggest task for the nation.

Remedies

The system has become decrepit but the country does not lack well intentioned people. Those substantially involved in the black economy are no more than 3% of the population. In other words, 97% are either not involved or marginally involved. In essence, the vast majority of the people are honest or can give up their expectations of involvement in illegality. Hence countering the black economy is feasible.

One step alone cannot eradicate black economy, what needed is a joint effort at numerous levels. First of all, the Political will is needed to curb the growth of Black Money. Double Taxation Avoidance Agreement (DTAA) and Tax Exchange Information Agreements with Tax haven countries will certainly help in bringing the capital flight problem. Electoral reform will not take place since the vested interests would not allow it. Movements which change the consciousness of people and make them strong enough to resist the temptations are needed for a turn around. When we have sufficiently worked on the consciousness and trust issues we can look at the following reforms as a package because if handled individually, they will turn out to ineffective:

Right to information, judicial, bureaucracy and Media Reforms should be encouraged which will result in increase of transparency in the system. Also, building a special task force to enforce the laws effectively will go a long way. Simplification of the tax laws should be done as it will make it easy to catch those who are fudging the accounts. The link between the politician and money power needs to be broken as this leads to the policy makers themselves resorting to sources for easy money. There should be three tier and interlinked representation in the legislatures on the same ground as party structures, which will increase the credibility of the contesting candidates. Increasing the accountability of institutions and individuals and especially of the policy-makers will act as big step in eradicating Black Economy in our country.

Conclusion:

The amount of black money stashed both inside and outside the country adds up to more than 40% of our GDP which could have solved a lot many problems plaguing India currently. Hence, a more concerted effort is needed on the part of the Government as well as the citizens of the country to put pressure on the tax haven countries to release information on these black accounts which can be brought back to our country.