Demystifying demonetization

2016

Introduction

On 8 November 2016, the government announced demonetization of INR 500 and INR 1000 currency notes with the objective to cleanse the economic channels of the stock of black money.

India had previously witnessed demonetization in the year 1946 and 1978; the difference being that on these two occasions, demonetization was undertaken for high denomination currency notes, such as INR 1000, INR 5000 and INR 10,000. This time, the currency notes demonetized were in wide circulation and commonly used. This time demonetization also aims to remove fake currency from the economy which is used in terror funding and anti-national activities.

Having said that, it is also important to point out the continuing effort of the government to curb black money. These efforts have preceded demonetization, demonstrating the government's commitment to eradicate a malaise of this economy and push the hitherto cash-based economy towards a near cashless economy.

The steps undertaken by the government were:

- Pursuant to a Supreme Court judgment, a Special Investigation Team (SIT) was formed with the objective of strengthening the country's battle against generation of unaccounted monies;
- Amendment to Benami Transactions (Prohibition) Act, 1988 which provides for prosecution provisions for entering into Benami transactions
- Levy of Tax Collection at Source on cash sales exceeding INR 2 lakhs;
- Requirement of disclosing assets and liabilities in the Return forms was introduced effective assessment year 2013-14;
- Introduction of Black Money (Undisclosed Foreign Income and Assets) and Imposition of Tax Act, 2015 to track down and bring back black money stashed in foreign banks and offshore accounts;

- Renegotiation of Tax Treaties and Automatic Information Exchange Agreements with Tax Havens;
- Introduction of Income Disclosure Scheme in Budget 2016 to tackle domestic black money;
- Penalty on Real Estate Transactions undertaken in cash exceeding INR 20,000;

Government has also proposed an amendment in the tax laws to enable voluntary disclosure. That, it is hoped, will also bring some more money in the accounted economy and would give a boost to tax collections.

Impact

The government's decision to abolish the pre-existing stock of high denomination currency notes took all market participants by surprise. The short term implications were mostly negative and are playing out now. However, the crucial aspects are – looking at how consumer behaviour can change after this shock, what is the impact on businesses, how can businesses cope and lastly what more can one expect from the government in its drive to end the parallel economy.

The near term impact is negative

The immediate effect on growth is squarely negative as most people are starved of the resources to transact in the markets and while the event appears to be structurally positive, growth forecasts may need to be revised downward. Important to note that as of now, one only has anecdotal evidence and very few hard numbers. Also, while there would have been no "good" time for such a big step, this move came at a time when the growth recovery was broadening with rural demand recovering after two years of insufficient rains. The overall impact on growth will crucially depend on how quickly the government is able to replace the currency in circulation and whether the current disruption lasts for more than the current quarter.

The slowdown will essentially be on the back of:

A disruption in cash transactions.
The move to demonetize comprises of replacing 86% of the cash in the system in a country wherein 98% of all transactions were settled in cash. India continues to be one of the most cash dependent nations in the world. As such, while cash in circulation is likely to be lesser in the immediate future with a number of people moving to cashless modes of transaction and in general lesser hoarding of cash, it is believed that the situation will take some time to normalize.

A negative wealth shock to some individuals that will also result in postponing of some expenditure.
A number of people with excessive cash or unexplained cash will possibly take some discount by way of taxes or loss of wealth. Anecdotal evidence suggests a cut back of production and lower sales of white goods and big-ticket items such as cars. This effect is likely to last for around one to two quarters before the situation normalizes.

Caution on account of expectations of future income and anxiety due to the government's focus on black money.
The move to demonetize has temporarily stopped the activities of informal money lenders and people would take time to adjust to the new set of circumstances. Transactions in the real estate sector are likely to suffer due to the absence of cash in the short term and stricter vigilance over the medium to long term.

These factors are going to have a negative impact over the next 3-6 months after which the situation should return to its norm. Accordingly, the year started with a growth estimate in the range of 7.6%-7.8% for FY17 and which had to be scaled back to a range of 7.1%-7.3% with a downside bias. The overall growth story remains intact, but there will be a short term setback on account of the government's decision to demonetize and consequently the upturn is now expected to take longer. Furthermore, it is now expected that the investment cycle may also get delayed as consumption gets hit in the near term.

The INR is likely to remain weak

Markets are expecting some slowdown in growth over the next 1-2 quarters, which has in turn put some pressure on the currency. That said, the overwhelming influence on the currency has been on account of international factors such as the increasing possibility of a Fed rate hike. Accordingly, we expect the INR to move with a slight depreciation bias.

Interest rates likely to go down over the medium term

There are likely to be three major factors influencing interest rates in the future. For one, we are likely to see the RBI cut rates as inflation remains range bound. Secondly, the banking system is likely to remain flush with funds as currency in circulation reduces with more people relying on cashless modes of payments and people being sceptical of withdrawing huge sums of money. Thirdly, credit growth is likely to remain subdued as industrial growth is unlikely to move up in a meaningful manner. These factors are likely to ensure that interest rates move down going into the next calendar year.

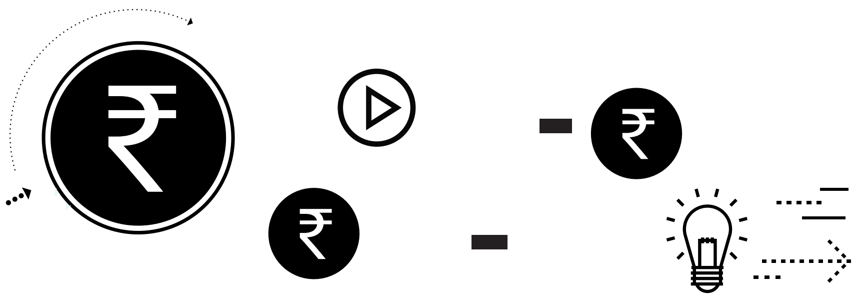
Medium term outlook remains positive

Passing over the near term effects, a broad-based recovery had been premised in the economy on the basis of higher consumption expenditure. This trend appears to have remained intact and consumption expenditure should start to move upwards from 1QFY18. This analysis is based on the back of some structural positives accruing to the consumers.

- Improvement in rural demand due to sufficient rains. Preliminary data suggests that rabi sowing is slightly higher than the previous year and incremental measures taken by the government could mean some relief for the agriculture sector.
- Moderation in inflation and subsequent increase in purchasing power of consumers is likely to continue playing out. A combination of subdued global commodity prices, supply side measures by the government and a suppression of demand in the near term is likely to mean inflation within the target zone of the RBI.
- Lower interest rates to benefit consumers and could also lead to higher investments in the future.
- Wage hikes on account of complete implementation of the pay commission in the governments sector would continue to help consumption grow.

But with a change in attitudes

The government was able to achieve the element of surprise with the move to demonetize and as such this will have some long term implications for consumer behaviour.
Some of the factors that are likely to come into play are:



Higher tax compliance:
Expect more people to start paying more taxes as the government increases scrutiny and hoard lesser amount of cash. The implementation of GST is also likely to help in more indirect tax payments as economic agents through the value chain are likely to demand bills to get input credits.

Higher asset demand:
There could be a possibility of an increased demand for gold, which can have negative consequences for the external account.

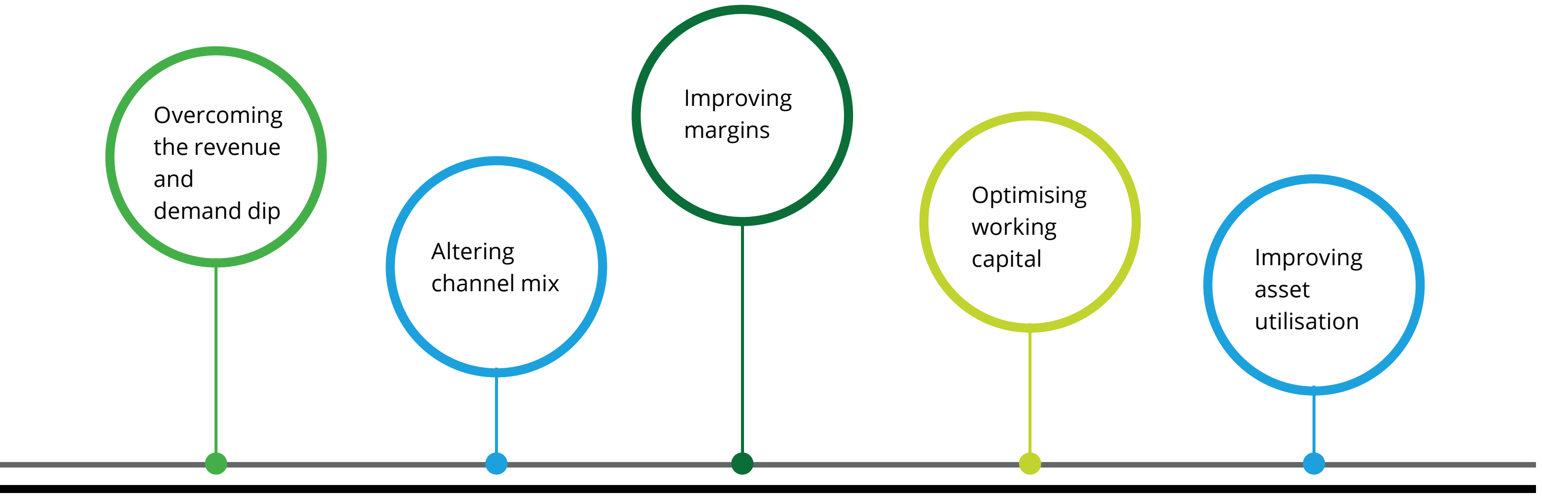
Faster adoption of banking and technology:
Given the inconvenience that a very large part of the populace is experiencing, there could be a faster adoption of cashless methods of payment and banking in general. Overall savings are also likely to get a boost from this move.

Companies will have to adapt too

This new set of circumstances is largely positive for corporates in the formal sector but does create new challenges for a variety of reasons. The squeeze in liquidity and availability of funds is likely to take a toll on sectors where the primary sales channel is B2C. Similarly, a cascading effect is also likely to be felt by companies in the B2B trade. As stated earlier, the growth momentum should pick up over the next couple of quarters although in the immediate term sales are likely to get hit. The major sectors that are likely to get impacted are real estate, retail (FMCG), automotive, construction, ancillary industries (steel, cement), etc.

The benefits and disadvantages of the government's decision will be fully visible in the medium to long term; this move is expected to have a major impact on the business and operating model of companies across several key sectors. Companies will face significant challenges across all areas of their operations including – sales, working capital management, business margins, vendor & supplier management, manufacturing & production, logistics and human resources. This move requires companies to respond appropriately, both to meet the challenges in short and medium term and also undertake structural changes for the future.

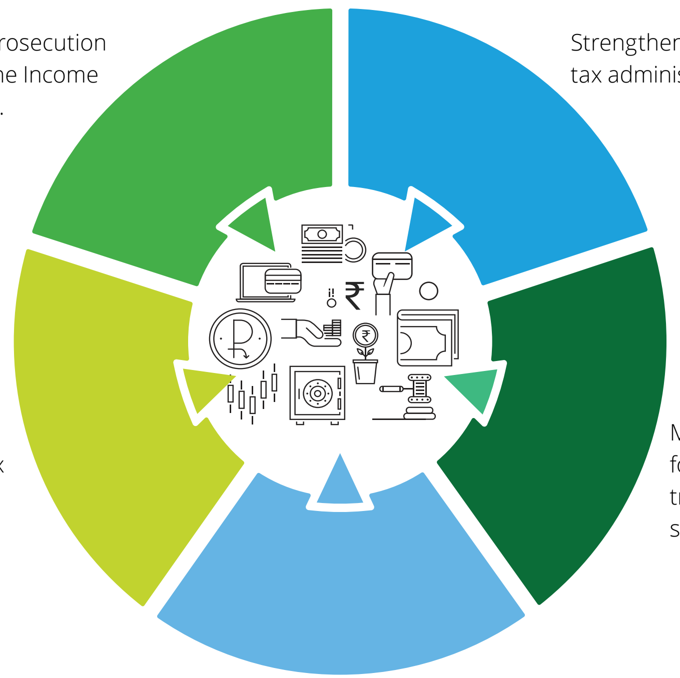
Some immediate concerns that would need to be addressed are:



The demonetization exercise is likely to give a fillip to the formalisation of the economy and, over the medium to longer term, benefit existing players in the sectors.

This is not the end. More likely on the anvil

To realise the long-term benefits of the move, it is expected that the government may go in for more measures to curb the extent of the parallel economy. Furthermore, the current measures have had an impact on the stock of black money and the government will have to bring in changes to decrease the generation of black money. As such, one can expect steps in the following areas:



Steps in the aforementioned areas can go a long way in eliminating the parallel economy and bringing about a sustainable change in how the economy functions. Such steps will bode well for the long-term health of the economy and can be seen as one of the many steps on the way to a cleaner economic structure.

Tax implications on cash deposits

With the announcement of INR 500 and INR 1000 notes ceasing to be legal tender with effect from 9 November 2016, a substantial amount of these currencies are being deposited in the bank. The depositor will have to explain the source and nature of such cash deposited based on the cash in hand balance as on 8 November 2016 in the books of account, if any, maintained by the depositor or the cash withdrawals made in the past. The depositor is required to quote his/her Permanent Account Number in the document submitted to banks for depositing cash exceeding INR 250,000 during the period 9 November 2016 to 30 December 2016.

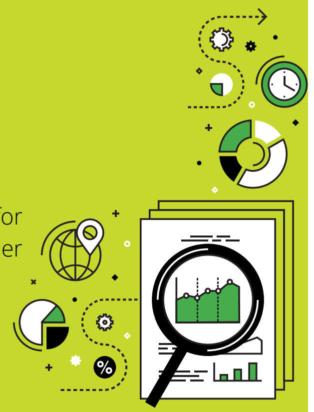
Provisions under Income Tax Act for unexplained cash credit/money held by the assessee

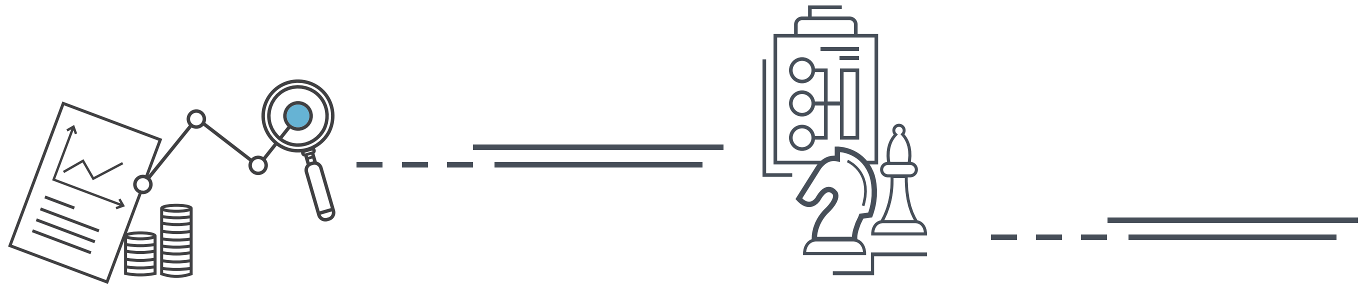
The unexplained cash credit/money may be deemed to be the income of the person, if no satisfactory explanation is offered about the source and nature of such items. Currently, such income is chargeable in the following manner:

- No deduction for any expenditure or allowance or any set-off of any loss is allowed against the income
- Gross income taxable @ 30% (plus applicable surcharge and education cess)

It is proposed to increase the rate of tax for taxing the unexplained income from 30% to 60%. It is further proposed to levy a surcharge @25% of the tax amount on such income

In addition to tax, there would be interest liability for shortfall in the payment of advance tax in the earlier instalments.





Proposal to revise levy of penalty on unexplained income

The Government has proposed to introduce a new penalty provision for levying penalty on unexplained income referred to above, which provides the following:

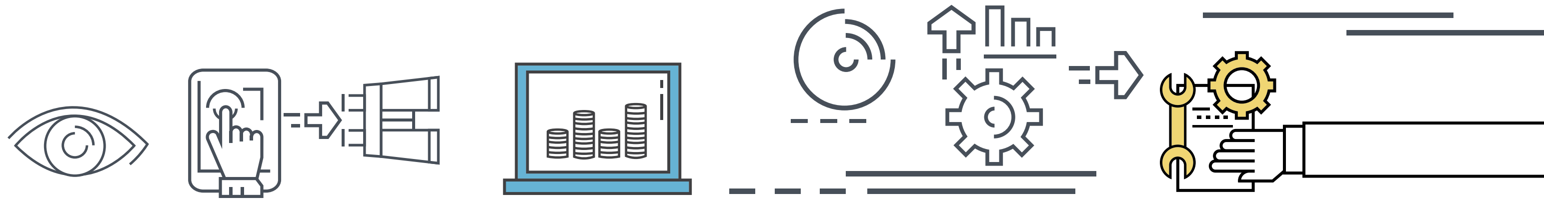
- Levy of penalty @ 10% of the tax amount on such income in addition to tax payable @ 60%;
- No penalty to be levied in cases where such income is voluntarily included by the assessee in his Return of Income and the entire tax on such income is paid on or before 31 March 2017.

It is proposed that where the search is initiated, penalty @30% - 60% of the undisclosed income would be levied subject to fulfillment of certain conditions stated in the section.

Tax officer's power to call for information

Tax officer has powers to call for more information to know the source of income and other details of deposit.

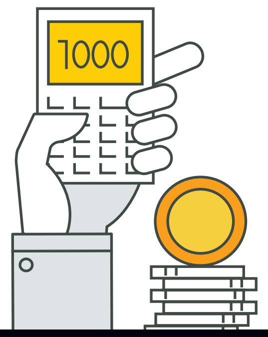
CBDT has made amendment to Income-tax Rules pursuant to which banks and Post Office are required to report cash deposits during the period 9 November 2016 to 30 December 2016 aggregating to INR 1,250,000 or more in one or more current account of a person and INR 250,000 or more, in one or more account (other than a current account) of a person. Based on this information, action may be taken by the tax department. Though banks and Post Office are required to report cash deposits exceeding INR 1,250,000 and INR 250,000 only, the tax officer may also question cash deposits made upto INR 1,250,000 and INR 250,000, as the case may be.



Proposal to introduce "Taxation and Investment Regime for Pradhan Mantri Garib Kalyan Yojana, 2016"

It is proposed to introduce "Taxation and Investment Regime for Pradhan Mantri Garib Kalyan Yojana, 2016". The salient features of this Scheme are as under:

- The Scheme would be effective from the date to be notified by the Central Government;
- Any person may declare any income in the form of cash or deposit in an account maintained by Reserve Bank of India, any banking company or co-operative bank, any Post Office or any other entity as may be notified by the Central Government which is chargeable to tax for any assessment year prior to assessment year 2017-18;
- Gross income declared shall be taxed @ 30% plus surcharge @33% of the tax amount and penalty @10% of the undisclosed income; the effective rate works out to 49.9% of undisclosed income;
- The declarant shall deposit an amount of at least 25% of undisclosed income in Pradhan Mantri Garib Kalyan Deposit Scheme, 2016 before filing the declaration; this deposit shall not bear any interest and the declarant will be able to withdraw the deposit after four years subject to fulfillment of conditions;
- The amount declared under this Scheme will not be included in the total income of the declarant;
- Declaration filed shall not be admissible as evidence against the declarant under any Act, subject to certain exceptions.



Impact on NRIs

Demonetized currency notes having denomination of INR 500 and INR 1000 can be deposited by an NRI into his NRO accounts without any limits. NRIs are also permitted to authorise any other person in India (in writing) to visit their bank branch in India and deposit such currency on their behalf.

Conclusion

One of the boldest reform measures taken till date, demonetization is the latest in the line of steps that the Government has initiated such as tightening of the tax laws, integrating systems for seamless flow of data (through Aadhaar), increasing the number of transactions that need to be routed through the banking channel, and amending the Benami Transactions (Prohibition) Act.

While one can expect a decline in inflation and negative impact on GDP in the current quarter, one is likely to see some sectors such as real estate, retail, etc. getting negatively impacted. On the contrary, sectors such as Banking and Financial Services, eCommerce, fintech, etc. are expected to have a positive impact.

Overall, though demonetization throws up some challenges and difficulties in the short run, the bigger challenge would be to address the issue of black money in the long run.

Deloitte.