



mintessay

Six battlefronts for the war on corruption

To truly disrupt the shadow economy, reforms targeting gold, hawala, real estate, taxation, politics and elections, and administration are a must

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Corruption in India evokes an image of suitcases of cash. The action by the government of demonetizing Rs500 and Rs1,000 notes has hit all persons who have piles of cash that they cannot justify.

Persons placed in such a predicament will not burn or shred the currency notes. These will be sold at a discount, and laundered in various ways. The person who has unaccounted cash will have to bear a substantial loss of 25-50%. This is a good thing.

There is much *schadenfreude* on the part of the people who have always resented corruption and criminality in high places. This taps into the latent anger of ordinary people. The government has succeeded in portraying itself as being against corruption. This has come at a price, of course, in terms of a disruption of the economy. Cash is a large part of India's money supply, and is a critical vehicle for transactions. The action of 8 November is a large contractionary monetary shock, which has had adverse implications for the business cycle.

While, in the public eye, piles of cash are synonymous with corruption, we should be careful about distinguishing between the three components of black economy. The first is the underlying source of corruption. An example of this would be the high stamp duties on real estate transactions that lead to payments in cash. The second is the method adopted for storing unaccounted wealth. An example of this would be holding assets in gold. The third element is the method through which transactions are effected. This could involve cash.

The black economy involves all three elements. Targeting unaccounted cash on one particular day is only a small part of the story. There is a game of musical chairs being played. One day, the music stopped playing and the persons who were holding the cash were penalized by 25-50%. Can we set our sights higher and disrupt the entire game?

People who participate in the black economy are likely to be more circumspect about trusting the new Rs500 or Rs2,000 notes. But this does not pose a significant impediment for them. Bundles of rupees can be replaced by bundles of US dollars. We expect that by the end of the year, Indian small businessmen will be as fluent with bitcoin as they are comfortable with US dollar bills. Then, there is always the "barbarous relic", gold, to fall back upon. To have an impact on corruption, we have to go deeper.

The main focus of the war on corruption should be to go after the core corrupt activity. We see six battlefronts in this war: gold, hawala, real estate, taxation, politics and elections, and administration.

GOLD

Bollywood movies of the 1970s depicted the world of gold smuggling, and the illegality that went with it. In 1991, we put an end to that world by eliminating restrictions against gold imports.

A great deal of work went into the establishment of a white-money gold and jewellery business. This developmental work received a major setback in 2013, when the customs duty on gold was reintroduced. Every buyer of gold now has a bias in favour of making cash payments in order to get a discount. This has dealt a body blow to the world of gold and jewellery conducted through white money.

We can set up police stings targeting thousands of jewellers and millions of their customers. But it would be better to eliminate the customs duties and solve this at the root cause. Customs duties are "bad taxes" and should go.

HAWALA

Similar problems afflict India's cross-border activities. India's businessmen and citizens have a glorious history of business activities in East Africa, West Asia and South-East Asia. For all Indian citizens, international diversification helps reduce risk. Yet, our cross-border activities are mired in complicated regulations. The conflict between Tata and Docomo is an example of how even the most sophisticated players are tripped up by India's capital controls. Cross-border activities are vital to sophistication of business, and the cost of doing business has been escalated by the system of capital controls.

The hawala business came up in the 1960s and 1970s in response to capital controls that were a part of Indian socialism. We can set up police action against everyone involved in this illegality. But it would be better to kill the hawala business at the root.

On 11 November, in a speech at the Confederation of Indian Industry (CII)-Keidanren Business Luncheon, Prime Minister Narendra Modi said, "My resolve is to make India the most open economy in the world". This requires capital-controls reform. There is an internationally accepted measure of capital-account restrictions—the Chinn-Ito index. India is at the bottom of the table, and can easily get up to the median value for emerging markets.

REAL ESTATE

The real-estate business is enveloped in illegality. Buying agricultural land, obtaining urban infrastructure like electricity and water, and getting a building plan approved, all are mired in problems. Buying real estate on the secondary market generally involves a cash component.

Cash payments are favoured so as to avoid stamp duty. Stamp duty, like customs duty, is a bad tax and should go, and the real-estate sector should be merged into the goods and services tax (GST).

Land title systems are critical infrastructure that make the market economy possible. At present, buying land and settling disputes often involves criminality, as there are title disputes. The equity market has shown how to build infrastructure for tracking property rights and achieving frictionless transactions. Building sound land-title systems will enable law-abiding



PTI

a high rate or a low rate. And a low rate pushes both the tax administrator and the citizen in favour of compliance. With income tax, the sound path in tax policy involves the draft Direct Tax Code, a sharp reduction of taxation of corporations, and a low-peak income-tax rate.

A new Tax Administration Act is required, which sets up the Central board of direct taxes and Central board of excise and customs with sound processes for their legislative, executive and quasi-judicial functions, and their top level governance. Taxes other than income tax and GST, at the central level, should be removed. This will take us to a high-compliance and low-corruption environment.

ADMINISTRATION

Arbitrary power is the root cause of corruption. We have to be cautious when persons in government have the discretion to change a rule, give a licence, conduct an investigation, or hand down punishment. Each of these situations must be covered by procedural law, which enshrines good governance. When a coal mine is to be allocated, it must be done through a well-structured due process. Before any punishment is meted out, the accused must be given a statement of the accusation and the evidence in writing, and be given an opportunity to defend himself. These examples may seem like basic hygiene, but it is presently lacking in many parts of the Indian state.

Regulators are particularly problematic, as they combine legislative power (the power to write law, i.e. regulations), executive power (the power to give licences, the power to conduct investigation) and quasi-judicial power (the power to award punishment). This adds up to extreme power. There are regulators in India, where junior officials put a new law on a website without warning, where licences are given out to friends, where investigations are inflicted at will, and where punishments are meted out without a hearing or reasoned order.

In 1946, the US put an end to this with the "Federal Administrative Procedures Act" which imposes basic hygiene upon all federal agencies. In India, there are 120 sections of law in Justice Srikrishna's draft Indian Financial Code, which need to be enacted on a similar scale.

POLITICS AND ELECTIONS

Running a political party and fighting elections requires large-scale resourcing. The procedures in India all but force political parties to engage in these activities using black money. This is reinforcing political parties as family businesses, which can hold secrets and manage treasuries through informal systems. Fundamental reforms are required in order to change over to a political system grounded in white money. This will also take us beyond family-dominated political parties.

*Comments are welcome at
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citizens to buy and sell land without a brush with cash or criminality.

Urban governance is the key to solving the problem of getting approvals for building plans and getting connected to water and electricity. This requires establishing a city government that controls urban governance and is accountable to its voters.

TAXATION

At our level of limited capabilities in tax administration, tax policy must put a low "load" upon the tax administration by favouring simplicity and low rates. We must first learn to run this tax administration without corruption. Once that is achieved, in the future, we can look at the possibility of raising rates. Under present levels of state capacity, when tax policy flirts with high rates and a complex tax code, we collapse into high corruption.

In the GST, we need a single rate, so as to eliminate discretion in classifying a given product at