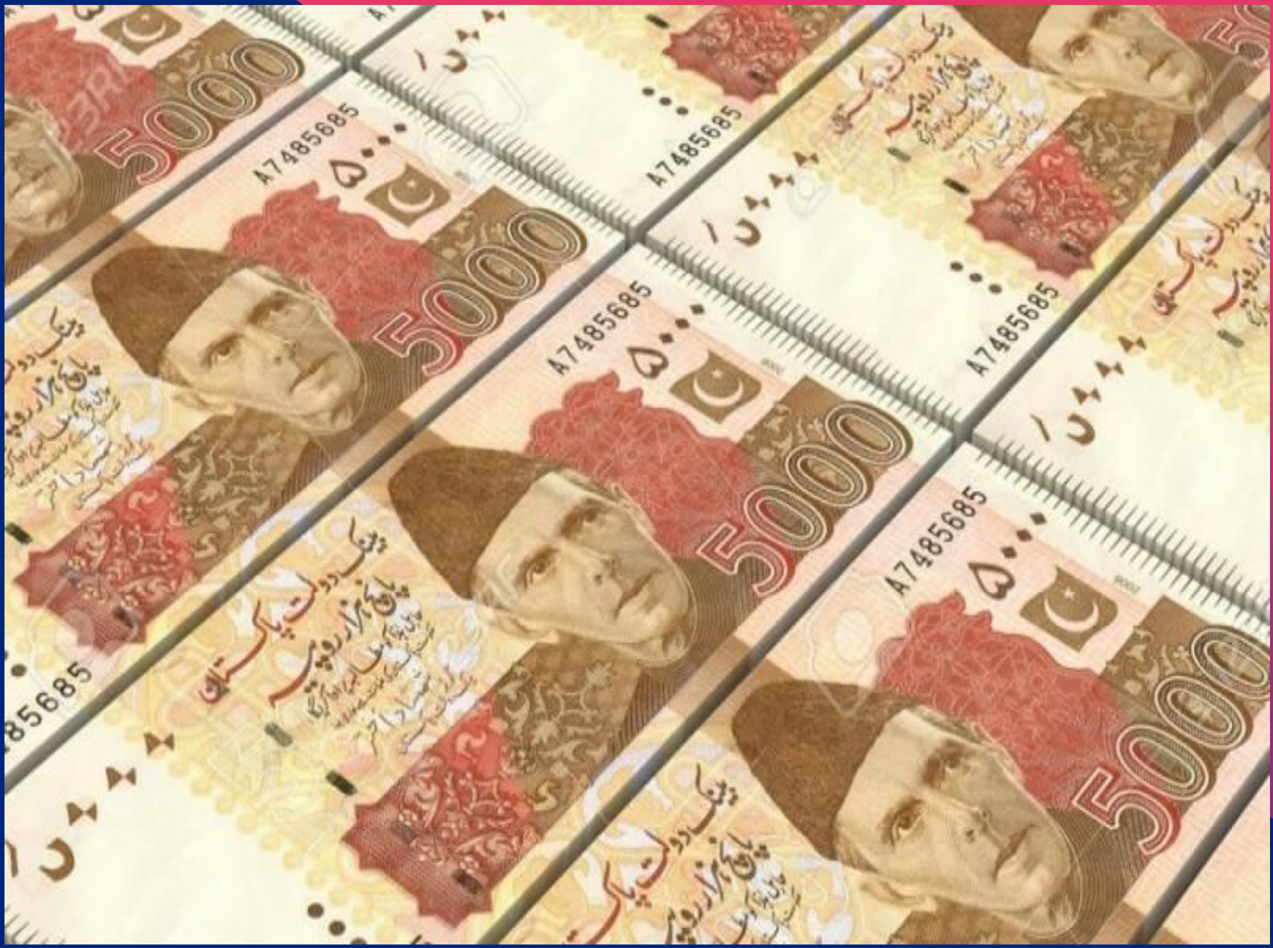

The Pros and Cons of Demonetization

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Pakistan Economy

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Introduction

There have been statements by agencies like the PBC and the OICCI that Pakistan should undertake the demonetization of the largest currency note of Rs 5000. This is based on the argument that recent efforts by the FBR to raise revenues have involved enhancement of tax rates, like the corporate income tax rate and the general sales tax rate, on existing taxpayers. The time has come instead to broaden the sources of revenue and tap into income evaded or generated in the black/informal economy.

Recently, the former Chairman of the FBR, Mr. Shabbar Zaidi, has spoken in the media in favor of the process of demonetization of the Rs 5000 note. This is probably based on his perception that substantial additional revenues could be generated by identification of large holders of the Rs 5000 note in the process of demonetization as tax evaders.

The objective of this special report is to analyze the pros and cons of the case for and against demonetization in Pakistan. The report presents first the experience with demonetization in other countries. This is followed by analysis of the level and trend in key monetary ratios in the economy of Pakistan, especially the currency in circulation as a percentage of the GDP.

The third section focuses on cross-country analysis of the monetary ratios and how these change as development proceeds. This will enable a quantification of the extent of deviation of the currency in circulation to GDP ratio of Pakistan from the projected level given its state of development. The fourth sector identifies the extent to which the withholding/fixed tax regime in the income tax system of Pakistan already taps into the incomes in the informal sector. Finally, recommendations regarding demonetization are presented in the last section.

Experience with demonetization of countries

The most often quoted experience with demonetization is that of India. On the 8th of November 2016, the Prime Minister of India announced the demonetization of all Rs 500 and Rs 1000 bank notes of the Mahatma Gandhi series. New Rs 500 and Rs 2000 notes were to be issued in exchange.

The justifications provided were the need to reduce the size of the shadow economy, increase cashless transactions and reduce the funding of illicit activities, including corruption and terrorism.

The announcement of demonetization created cash shortages in the week that followed, which led to disruptions. People seeking to exchange their demonetized banknotes had to stand in lengthy queues, and several deaths resulted in the rush for cash.

The BSE Sensex and NIFTY 50 stock indices fell over 6% in the day after announcement. The move also reduced industrial production and the GDP growth rate.

The hurried nature of the move was met with protests, litigation, and strikes. It was also hotly debated in the Indian Parliament.

Earlier, there had been two prior rounds of demonetization in India–once in 1946 and 1978. The goal was to combat tax evasion in the black economy. However, in 2012 the Indian Central Board of Direct Taxes recommended against demonetization because of the perception that black money is largely held in the form of benami properties, bullion, foreign currency and jewelry. According to data from income tax probes, only 6% of black money was held in the form of cash.

The process adopted in 2016 was that the demonetized notes could be deposited over a period of fifty days up to 30th December 2016 and exchanged over bank counters. The limit for such an exchange was Rs 4000 per person and increased gradually.

The overall assessment was that the impact process of demonetization was not large. It did not lead subsequently to a big increase in the number of income taxpayers.

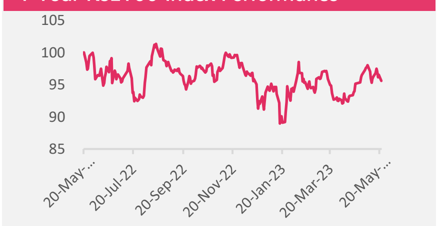
The trend in currency in circulation in India as a percentage of the GNP is shown in Table 1. There was a big decline in this ratio following the demonetization. It fell from 10.8% in 2015-16 to 7.77% in 2016-17. However, there has subsequently been a strong recovery in this ratio, and it now stands at 11.7%, even higher than the ratio of 10.8% in 2015-16.

Pakistan Economy

Key Data	
KSE100 Index	41,195
KSE-All Share Value (PKRmn)	2,880
KSE-All Share Value (USDmn)	10.0
KSE-All Share Volume (Shmn)	97.8
Market Capitalization (PKRtn)	6.2
Market Capitalization (USDbn)	21.7
KSE100 Index 1 Year High	43,888
KSE100 Index 1 Year Low	38,136

Source: PSX, Next Research

1 Year KSE100 Index Performance



Source: PSX, Next Research

Table 1 - Currency-in-Circulation and GNP of India *(Rs in billion)*

	Currency in Circulation	GNP	Currency in Circulation as % of GNP
2014-15	14,480	139,856	10.35
2015-16	16,640	153,572	10.83
2016-17	13,350	171,711	7.77*
2017-18	18,250	193,636	9.42
2018-19	21,370	205,048	10.42
2019-20	23,700	199,497	11.88
2020-21	28,300	241,089	11.73

*Following demonetization

Source: International Financial Statistics, IMF.

Some of the other developing countries which have engaged in the process of demonetization include the following:

Ghana, 1982	There was demonetization of the 50 cedis note. Subsequently, there is evidence of a large-scale diversion towards physical assets.
Nigeria, 1984	The change in currency notes was one of the factors contributing to the collapse of the economy.
Myanmar, 1987	The demonetization of almost 80% of the currency led to mass protests which killed many people.
Zaire, 1990	This is generally considered as a case of successful demonetization; with the process conducted in an orderly manner.

Demonetization has also been undertaken in Zimbabwe in 2010, North Korea in 2010 and Philippines in 2016.

The overall experience is not very encouraging, especially in terms of the disequilibrium created in economic activities, loss of lives in the rush for exchange of currency and no substantial improvement in the tax base on a long-term basis.

Trends in monetary ratios in Pakistan

The magnitude of currency in circulation, broad money and GP at current market prices are presented in Table 2 from 2005-06 to 21st of April,2023.

The findings of Table 2 are, first, there was only a modest change in the currency in circulation as a percentage of GDP from 2005-06 to 2014-15. It remained in the range of 7.5% to 9%.

Second, there was a once-and-for-all jump in the ratio of 1.8 percentage points in 2015-16. This was the year when the FBR made the ill-advised move of introduction of 0.6% fixed tax on banking transactions. Also, the fixed tax on interest income from bank deposits has been raised from 10% to 15%.

Third, the ratio of broad money to GDP has shown a U-shaped long-term trend. It was 41.1% in 2005-06 which declined to 34.5% by 2010-11. Since then, it has increased and reached a peak in 2019-20. The year, 2019-20, also witnessed a significant jump in the currency in circulation as a percent of broad money by 1.6 percentage points. This is due to increased perception of risk of a COVID-19 attack and the need for liquidity to finance costs of medication and/or hospitalization.

Table 2 - Currency in Circulation, Broad Money, GDP and Monetary Ratios in Pakistan *(Rs in Billion)*

	Currency in Circulation	Broad Money	GDP	C-in-C as % of Broad Money	Broad Money as % of GDP	C-in-C as % of GDP
2005-06	740	3,407	8,298	21.7	41.1	8.9
2006-07	840	4,065	9,424	20.7	43.1	8.9
2007-08	982	4,689	10,957	20.9	42.8	8.9
2008-09	1,152	5,137	13,726	22.4	37.4	8.4
2009-10	1,295	5,777	15,609	22.4	37.0	8.3
2010-11	1,501	6.695	19,381	22.4	34.5	7.7
2011-12	1,647	7,642	21,496	21.9	35.6	7.8
2012-13	1,938	8,856	24,175	21.9	35.6	8.0
2013-14	2,178	9,967	27,433	21.9	36.3	7.9
2014-15	2,554	11,282	30,187	22.6	37.4	8.4
2015-16	3,333	12,825	32,785	26.0*	39.1	10.2
2016-17	3,911	14,581	35,552	26.8	41.0	11.0
2017-18	4,387	15,997	39,190	27.4	40.8	11.2
2018-19	4,950	17,799	43,798	27.8	40.7	11.3
2019-20	6,142	20,908	47,540	29.4**	44.0	12.9
2020-21	6,907	24,298	55,775	28.4	43.6	12.4
2021-22	7,572	27,602	66,950	27.4	41.2	11.3
2022-23 (21st of April)	8,901	29,094	82,533	30.5	35.2	10.3

*Impact mostly of the introduction of a fixed tax on banking transactions of 0.6%.

**Due to COVID-19

Source: SBP

Cross country comparison of monetary ratios

The issue is whether the circulation of currency in Pakistan at between 10 to 12% is high in relation to the other developing country ratios, after controlling for the level of development. The expectation is that expansion of the financial sector during the process of development will lead more to banking transactions through deposits and further the process of digitalization of the economy.

The currency in circulation as a percentage of the GDP and the per capita income (in PPP US$) is shown for selected developing countries in Table 3, for 2021-22.

A number of conclusions emerge from Table 3 as follows:

Table 3 - Currency in Circulation as % of GDP and Per Capita Income in US$ (PPP) 2021-22

	Per Capita Income (US$, PPP)	Currency in Circulation as % of GDP
Nepal	3,831	17.6
Cambodia	4,354	13.5
Pakistan	5,232	11.3
Bangladesh	5,919	7.3
India	6,582	12.0
Philippines	8,004	11.3
Bolivia	8,052	13.9
Morocco	8,058	27.8
Egypt	11,566	12.1
Indonesia	11,838	5.2
Sri Lanka	13,386	3.4
South Africa	13,411	2.5
Brazil	14,592	3.7
Chile	25,449	5.8

Source: IMF, International Financial Statistics

I. The generally inverse relationship between per capita income and currency in circulation as % of GDP is observed in developing countries. There are also some deviations, as in the case of Morocco.

II. The other perhaps surprising finding is that in 12 out of the 15 countries there has been an increase in the currency in circulation over the years rather than a decline.

A regression equation of the following type is estimated for the selected countries:

$$100\left(\frac{C\ in\ C}{Y}\right) = \beta_0 + \beta_1 Y_{PC}$$

Where C in C is currency in circulation, Y is GNP and YPC is per capita income.

As expected, the estimated equation in 2021 has a negative slope ($\beta_1 < 0$):

$$100\left(\frac{C\ in\ C}{Y}\right) = 16.731 - 0.00062\ (Y_{PC})$$

(-4.98)

$$\bar{R}^2 = 0.271 \qquad F = 4.44$$

It is possible to estimate the predicted value of the currency in circulation ratio as a percentage of the GDP of Pakistan. It is 13.5% in 2021-22. This implies that the actual ratio is lower by 2.2% points.

Measures for reducing tax evasion

There are reasons to believe that Pakistan's currency in circulation ratio is relatively low because the informal/black economy has been tapped for revenues due to a comprehensive regime of withholding / fixed taxes as part of the income tax system. This has effectively contributed to reducing the extent of tax evasion in the economy. The major withholding / fixed taxes are described below. Their contribution to total income tax revenues is over 60%.

Table 4 - The Major Withholding / Fixed Taxes in the Income Tax Ordinance

Section of ITO	Description	Tax on	Tax Rate
148	Fixed Tax on Various Imports	Commercial Importers	1% - 4%
150	Fixed Tax on Dividends	Shareholders	7½% - 15%
151	Interest Income Tax	Bank Depositors	15%
152	Fixed Tax on Rendering of Services	Service Providers	3% - 10%
153	Payment on Contracts	Contractors	3% - 8%
153	Sale of Particular goods	Retailers	1.5% - 4.5%
231	Motor Vehicles	Car Owners and Private Transporters	Fixed Amounts
234	Tax on Goods Transport and Passenger Transport Vehicles	Transport Owners	Fixed Amounts
235	Electricity Bills	All Consumers	7.5% - 12%
236	Telephone and Internet Bills	All Consumers	10% - 15%

There is also a case for expansion of the number of bank branches to increase the number of depositors. The number of bank branches is relatively low in Pakistan at 10.4 branches per 100,000 adults. The corresponding number in India and Sri Lanka is 14.6 and 17.3 per 100,000 adults respectively. Banks today in Pakistan are focused more on investing in Government bonds and treasury bills, which is facilitated by OMOs by the SBP, and not on expanding their deposit base. Further, the process of digitalization of the economy must be actively promoted.

Recommendations

The former Chairman of the FBR, Mr. Shabbar Zaidi, has recently modified his stance on demonetization. He is of the view that instead of holding Rs 5000 currency notes, large tax evaders have now increasingly opted for US dollars, gold, and investments in real estate, with the increasing potential of large capital gains. Therefore, demonetization will not yield substantial results. Also, the above research findings negate the perception that the currency in circulation ratio with respect to the GDP is relatively high in Pakistan.

There is need to emphasize that demonetization will lead to a rush into bank branches for conversion of the demonetized notes and this could lead to trampling and deaths, like what we have seen in the process of distribution of free wheat bags. This also happened at the time of demonetization in India.

The country is characterized today by an exceptionally high level of political and economic uncertainty. A process of demonetization will further disrupt economic activities and cause a big fall in the stock market, as happened in India when the stock market crashed by 6% immediately after the announcement of demonetization.

Overall, the recommendation is that the process of demonetization must be avoided. Instead, the following alternatives should be considered:

- Emphasis by the banking sector must be on expansion of the number of bank branches and accelerating the process of digitalization in the country.
- Tax evasion should continue to be tackled by reforms in the withholding/fixed tax regime in the income tax system and in other taxes.
- The fixed income tax on deposits of 15% is a big disincentive to small potential depositors. Instead, it should be converted into an advance tax. The option of including this income in the income tax return and claiming a part tax refund will increase the incentive not only to convert cash into deposits but also induce the filing of more tax returns.

- The real estate sector has been attracting huge liquidity amid significantly lower FBR rates of immovable property in the tax documents compared to their actual transaction value (leading to low tax liability). This practice results in dealings in a huge amount of hard cash even for non-speculative purchases. This cash, as discussed above, is either converted to real estate assets or kept in hard cash for more of such investments, as it has largely become unofficial. Although significant increases have been made in fair market values by the FBR since 2016, the values of immovable properties in major cities of the country are still significantly lower than their actual market values. With an increase in real estate projects and investors, the amount of hard cash involved in this sector is increasing, and demonetization of large denomination currency notes is unlikely to bring this liquidity back to the banking system. It is therefore essential to record and tax these transactions at their actual values, which would greatly help in bringing the cash back in the banking system and a significant increase in government's tax revenues can be achieved.
- There has recently emerged a trend of large tax evaders shifting to investing in benami property rather than holding large cash balances. This has been facilitated by the very low incidence of federal and provincial taxes on property and real estate. The urban immoveable property tax of the provinces is based on a very outdated assessment of Gross Annual Rental Values (GARVs). The policy should be to update these assessments by setting them at 3% of the capital values at the neighborhood level determined by periodic FBR surveys throughout the country. Also, there should be a minimum tax of 10% on capital gains from transactions in properties irrespective of the holding period. As a policy, no tax amnesty should be given in future.
- Further, while the policy is to apply double the fixed tax rates on those who are not in the Active Taxpayers list (ATL), an incentive may be introduced whereby a new tax return filer will not be subjected to audit for the first three years.

Therefore, as a policy the effort should be made to tackle tax evasion indirectly through policy measures of the type described above and not directly through demonetization.