

## Demonetization: Redefining Indian economy

<sup>1</sup> Anil I Ramdurg, <sup>2</sup> Dr. Basavaraj CS

<sup>1</sup> Assistant Professor, Sangolli Rayanna First Grade Constituent College, Belagavi, Karnataka, India

<sup>1</sup> Research Scholar, Dept of PG Studies & Research in Commerce, Gulbarga Univeristy, Kalaburagi, Karnataka, India

<sup>2</sup> Professor, Dept of PG Studies & Research in Commerce, Gulbarga Univeristy, Kalaburagi, Karnataka, India

### Abstract

This article has made an attempt to assess how the tool of Demonetization can be used to eradicate parallel economy. Demonetization is one of the big steps initiated by Government in addressing the various issues like black money, counterfeit currency, corruption, terrorism etc. History of demonetization in India and around the world is addressed. Lesson from historically demonetization guides us how to redefine economy of country by overcoming the earlier causes for failure. Demonetization obviously brings many inconveniences to common people but it is for only short term. However the long term benefits of demonetization overrides the short term challenges. Government initiatives like Income Declaration Scheme 2016, Black Money (Undisclosed Foreign Income and Assets) and Imposition of Tax Act 2015, Joint Declaration of AEOI between India and Switzerland to address black money etc. in redefining Indian economy are to be appreciate and these initiatives leaves their footsteps as part of history.

**Keywords:** demonetization, Indian economy, black money, parallel economy, tax evasion, Swiss bank, counterfeit currency, corruption

### Introduction

“In popular parlance, the unofficial economy goes by the name of black money and the official of white money. Black and white are also variously substituted by number two and number one, unaccounted and accounted, unreported and reported, unrecorded and recorded and so on...”

Prof J. C. Sandesara

Money is the life blood of every economy. With the growth of civilization and mankind, the needs of human beings increased. In order to fulfil humans unlimited wants barter system emerged. But over a period of time, the invention of money became a strong pillar to build an economy. Money exchange appears to be more convenient than barter because it obviates the “double coincidence of wants” and is capable of sustaining relatively complex economy. Money exchange facilitates ease of doing business, facilitates taxation and national integration. All activities such as production, exchange, distribution, services etc. form an economy. It is called formal economy. An informal economy is economic activity/activities that is neither taxed nor monitorised by Government, contrasted with a formal economy. Presence of corruption, black money, counterfeit currency, poor governance etc. promotes and establishes parallel economy.

Parallel economy means functioning of an unsanctioned sector in the economy whose objective is to evade tax and run parallel in contradiction with the objectives of official or sanctioned or legitimate sector in the same economy. This is popularly known as illegal economy, unaccounted economy, unsanctioned economy, tax evaded economy or black economy etc.

Let us consider an example: Suppose a person, who is a manufacturer of say X product, manufactures 10,000 (assumption) units, on which tax is leviable. But he declares

only 8,000 units as manufactured and pays taxes on it and sells those units with proper sales bill. Remaining 2,000 units is sold without bills and without paying any kind of taxes. This amount which he receives by selling those 2,000 units is black money.

Let us consider another example: Mr. A wants to sell his house property to Mr B at Rs. 25 lakh. If it is executed as per the agreed price then Mr. A, who receives Rs. 25 lakh is subject to long term capital gain tax at 20% and Mr B who buys house property needs to pay stamp duty around 6%. However, the property valuation as per Government rules is usually less than the agreed price let us assume it be Rs. 15 lakh. Given the situation parties Mr A and Mr B make a legal agreement for Rs 15 lakh and tax / duty will be paid accordingly. The remaining amount of Rs. 10 lakh is paid by Mr B to Mr A in the form of cash which is nothing but BLACK MONEY.

In order to mitigate parallel economy or to redefine formal economy Government takes many initiatives such as DEMONETIZATION, Voluntary Income Declaration Scheme, economic liberalisation, reducing tax rates etc.

### Meaning

The dictionary meaning of DEMONETIZE is “To deprive (a metal) of its capacity as a monetary standard” or “To withdraw from use as currency” So, demonetization is the act of stripping a currency unit of its status as legal tender. It is the act or process of removing the legal status of currency unit. A currency on which Governor of RBI on behalf of Central Government guarantees by making statement “I promises to pay the bearer, the sum of money .....” which empowers it a legal status. From the date of demonetization, all old currencies which are demonetized will cease to be a legal tender. Such currency cannot be used as money to do any transaction henceforth, but to replace with a new currency.

### **History around the world**

Demonetization is not new to India or to the outside world. Various Governments across the world have decided to ban currency note in circulation, rendering huge amount of cash useless overnights, due to plethora of reasons. These include fighting counterfeiting, stopping terror activities, battling black money etc. Many countries have adopted this process of demonetization to overcome hyperinflation, to curb black money, to bring economic stability, to remove counterfeit currency etc. One of the best and recent examples of demonetization is that of adoption of Euro currency among the nations of European Union. In order to switch to the Euro currency, authorities first fixed exchange rates for the varied national currencies into Euros. When the Euro was introduced, the old national currencies were demonetized. However, old currencies remained convertible into Euros for a while so that a smooth transition through demonetization would be assured. Some of the notable examples of demonetization around the world are:

#### **Zimbabwe**

In order to overcome hyperinflation, Government of Zimbabwe called for demonetization of its high value currency note with a face of one hundred trillion dollars. This obviously rendered lesser denominations obsolete, which were taken out of circulation quickly.

#### **Soviet Union**

In an attempt to remove black money and increase the currency value, under the leadership of Mikhail Gorbachev, in January 1991, the country withdrew 50 and 100 Ruble notes from circulation by way of demonetization. The removed notes formed around one third of the total money in circulation.

#### **Myanmar**

Demonetization took place in this country many times. The present currency called Kyat was introduced in 1952 by demonetizing the Indian rupee at par along their earlier country currency. In May of 1964, the 50 and 100 kyat notes were demonetized, and in 1985 the 20, 50, and 100 kyat notes were demonetized. The last demonetization occurred in 1987, when the government demonetized the 25, 35, and 75 kyat notes, rendering three quarters of the country's currency valueless.

#### **Australia**

To stop widespread counterfeiting, the Reserve Bank of Australia had released the world's first long lasting and counterfeit-resistant polymer (plastic) banknotes in 1996. Thus Australia became the first country to have a full series of circulating polymer bank notes after replacing all paper-based notes, which the Government systemically made non-tender for legal purposes.

#### **Ghana**

To reduce tax evasion, address corruption and clear excess liquidity, the country demonetised its 50 Cedi currency note in 1982. However, the move resulted in the public turning to foreign currency and physical assets. The general public lost confidence in the banking system and a fresh black market for currency began.

#### **Nigeria**

Military government led by Muhammadu Buhari conducted an anti-corruption crackdown in 1984, issuing new currency notes with new colours so that old notes would be rendered unusable within a limited time frame. The goal had been to fix a debt-ridden and inflated economy but was not successful.

#### **Zaire**

In the early 1990s, the Dictator Mobutu Sese Seko administration rolled out successive currency reforms along with a plan to withdraw obsolescent currency from the system in 1993. The successive reforms resulted in increasing economic disruptions until Mobutu was ousted in 1997.

#### **Pakistan**

Pakistan has decided to phase out all currency notes with old designs. From 01.12.2016, all currency notes across denominations will cease to be legal tender in Pakistan. Islamabad has been trying to bring in new designs and security features to its currency. However, its citizens have nearly a year and half to exchange old notes. The country had earlier demonetised 5 and 500 denomination notes.

#### **North Korea**

The demonetisation that happened in North Korea in 2010 left people with no food and shelter. Kim-Jong Il introduced a reform that knocked off two zeros from the face value of the old currency in order to banish black market.

#### **History in India**

India had an experience of demonetization of its currency twice before. The first was when Rs. 1000, Rs. 5000 and Rs 10000 notes were taken out of circulation on 12<sup>th</sup> January 1946, a 1 ½ year before the Independence. The highest denomination note ever printed by RBI in India was Rs. 10000 note introduced for the first time in the year 1938. However all three of Rs. 1000, Rs 5000 and Rs. 10000 notes were again reintroduced in 1954. The second phase of demonetization was done on 16<sup>th</sup> January 1978 when an ordinance was promulgated to phase out notes with denomination of Rs. 1000, Rs 5000 and Rs. 10000.

On 12<sup>th</sup> January 1946 demonetization was resorted to but the Direct Tax Enquiry Committee in its interim report observed, "Demonetization was not successful then, because only a very small proportion of total notes in circulation were demonetized in 1946 and its worth was Rs. 1,235.93 crores". On 16<sup>th</sup> January 1978, demonetization of high denomination notes was introduced. The high demonetization notes as on that day amounted to Rs. 146 crore and total notes tendered to RBI amounted to Rs. 125 crore as per data available till August 1981.

#### **Objectives of Demonetization:**

The main objectives of demonetization are:

1. To eradicate black money
2. To remove counterfeit currency
3. To fight against terrorism
4. To stop money laundering activities
5. To mitigate corruption and so on

**Need for Demonetization**

Demonetization is one of the Government’s bold steps towards transformation of Indian Economy. It is probably one of the biggest big-bang reforms undertaken by Government after a long time. In spite of many reasons quoted by Government, RBI in its FAQ on “Withdrawal of legal tender character of existing bank notes in the denomination of Rs. 500 and Rs. 1000” mentions reasons why this scheme is introduced. It reads as follows: “The incidence of fake Indian currency notes in higher denomination has increased. For ordinary persons, the fake notes look similar to genuine notes, even though no security feature has been copied. The fake notes are used for antinational and illegal activities. High denomination notes have been misused by terrorists and for hoarding black money. India remains a cash based economy hence the circulation of Fake Indian Currency Notes continues to be a menace. In order to contain the rising incidence of fake notes and black money, the scheme to withdraw has been introduced”.

Prime Minister Shri Narendra Modi quoted the following reasons for demonetisation during a television address to the nation on 08.11.2016: “In a historical move that will add record

strength in the fight against corruption, black money, money laundering, terrorism and financing of terrorists as well as counterfeit notes, the Government of India has decided that the five hundred and one thousand rupee notes will no longer be legal tender from midnight, 8th November 2016. The Government has accepted the recommendations of the RBI to issue Two thousand rupee notes and new notes of Five hundred rupees will also be placed in circulation.”

One more reason for demonetization is to minimize Fiscal Deficit. It has subsidiary benefits as it will take out the counterfeit notes from circulation and the unaccounted money, if does not come out, will be of no use. It will stop Hawala trade too. Some of the facts and figures to describe the existing parallel economy can be viewed and analysed as follows: First of all, if you look at our currency system, India is a cash-based society. 70% of values of transactions are in cash and even our gross domestic product (GDP), 45% of our GDP comes from informal sector. Informal sector accounts for 80% of our population.

Let us look at the currency in circulation, both in quantity as well as in value.

**Table 1**

Volume of currency notes			Value of currency notes		
Denomination	Volume in crore pieces	% of all currency notes	Denomination	Value of rupees in crore	% of currency Value
2 and 5	1,162.6	12.88 %	2 and 5	4,500	0.27 %
10	3,201.5	35.47 %	10	32,000	1.95 %
20	492.4	5.45 %	20	9,800	0.60 %
50	389.0	4.31 %	50	19,400	1.18 %
100	1,577.8	17.48 %	100	1,57,800	9.61 %
500	1,570.7	17.40 %	500	7,85,400	47.85 %
1000	632.6	7.01 %	1000	6,32,600	38.54 %
Total	9,026.6	100 %	Total	16,41,500	100 %

**Source:** Information published in Business line daily newspaper dated 17.11.2016

So, if you look at our currency in circulation, India probably has one of the highest currency in circulation ratio. From the above table it is clear that Rs. 500 and Rs. 1,000 notes account for only 24% of the volume in circulation whereas the same notes account for about 86% of the value of currency in circulation. The amount of money that Government aims to withdraw from circulation is Rs. 14,18,000 crores (86% of value) by demonetising the 2,203.3 crores (24% of Volume) currency notes of Rs. 500 and Rs. 1,000 denomination. But only time will decide how much money will be deposited into bank including that of black money.

Between 2014 – 2016 around 25.45 crores bank accounts have been opened under Jan Dhan Yojana, which was introduced in 2014, with bank deposit of Rs. 45,302 crores, averaging Rs. 1,780 in each account and at the same time it is true that about 30% accounts are with zero balance.

There are only 2.5 crore individuals who are filing income tax returns, many with nil tax. So, the tax net has to be widened. Tax to GDP ratio in India is one of the lowest in the world that is around 10.6% which is equal to African countries. Even the BRIC countries or other Asian countries have much higher tax to GDP ratio. So the government has to increase the tax net and that was another reason.

It is really difficult to estimate how much money is in the form of black money. Because black money is not kept only in the form of cash but also invested in land, gold, foreign currency etc. As per the world bank estimates the black money in India is around 20% of GDP, whereas Indian Government estimates

it around Rs. 10-15 lakh crores, which is much lower than 20% of GDP.

One more big reason for demonetisation is counterfeit currency. We are being plagued by counterfeit currency and the estimate is about Rs400 odd crore is in circulation. Predominantly in Rs. 500 notes.

As per the intelligence sources, it feels that there is a printing press across our borders which are printing these notes for nefarious activities. So, demonetization was needed for the safety and the security of the nation. Even if it means inconvenience and hardships, this had to be done. There have been a lot of hardships, there has been inconvenience, there have been long queues in the bank and common man is impacted very much. But there was a survey done by a newspaper which said 86% or 82% of the people interviewed said it is a very good thing for the economy.

India has agreements with the tax havens that information will be passed on to the Indian government from the tax havens about money stashed there. Then the black money bill of 2015 which was to bring foreign money back, this did not help because only Rs 2,500 crore came back. And finally, was the income declaration scheme which just ended in September. Here the government says it collected Rs. 65,250 crore. In spite of all this, out of Rs. 10-15 lakh only a small amount has come out, so the government had to do this.

So, in the light of above it can be justified that for long term growth of economy this step by govt is very much essential.

### Pros and Cons of Demonetization

Black money is nothing but money generated in transactions which are hidden from Government in order to avoid tax. This is usually done cash because cash transactions do not reveal the identity of the person who is doing it. So in the process of financial system cycle somewhere black money gets converted into white money. Let us see a person who holds black money uses it for purchasing luxurious products such as car, gold, precious metal etc, for which he pays in cash. Here, for the one who receives cash against his proper sales bill became white money. Let us see another example, a person with black money donates to various temples or institutions, the recipient of black money gets it as white money. So, it creates a vicious cycle of black and white money.

If we look at earlier demonetization, entire amount in circulation was not reached back to Government. It means certain amount of money which was in circulation is lost. Therefore it leads to deflationary conditions. Earlier demonetization was said to be the failure due to lack of financial infrastructure to trace black money holders. But the present action has logically better chance of success. Because people across India were given an Identity (Aadhaar) and bank accounts were opened under Jan Dhan Yojana. Now, people can transfer money using various methods such as mobile transfer, internet banking, NEFT, RTGS and even pay through Debit / Credit cards also. However, existing system of demonetization too have certain loopholes. As per the CBDT notification quoting of PAN is mandatory for transactions exceeding Rs. 50,000 during any one day or an aggregate amount of exceeding Rs. 2,50,000 during 09.11.2016 to 30.12.2016. Means a person with bank account without PAN can deposit up to Rs. 2,50,000 in multiple deposits of less than Rs. 50,000 on various days. Hypothetically a person who can use around 10 people with their bank account having few transaction, to deposit Rs. 2,50,000 per person without PAN can convert his black money into white money. Even a person who does not have bank account can exchange their old currency by providing ID proof up to Rs. 4,000 per day. So a person who has black money (in cash form) through paid agents gets converted his black money into white. Looking into the misuse of this exchange, Government reduced the ceiling limit to Rs. 2,000 and use of indelible ink mark on the right index finger of the customer so as to identify that he/she has exchanged the old currency notes. However, this cannot be overcome with cash based economy meaning thereby we must move towards cashless economy to completely eradicate the menace of parallel economy.

Recalling back to the opinion expressed by I.G. Patel, who was Governor of RBI when the ordinance of demonetization was promulgated in 1978 are as follows: "such an exercise seldom produces striking results. Most people who accept illegal gratification or are otherwise the recipients of black money do not keep their ill-gotten earnings in the form of currency for long. The idea that black money or wealth is held in the form of notes tucked away in suit cases or pillow cases is naïve. And in any case, even those who are caught napping or waiting will have the chance to convert the notes through paid agents as some provision has to be made to convert at par notes tendered in small amounts for which explanations cannot be reasonably sought. But the gesture had to be made, and produced much work and little gain."

Jay Dubashi writer of India Today, in one of his articles asserts

that demonetization is not entirely effective as it is difficult to define black money in precise with its all shadow and one cannot really know how much black money is there in circulation. In continuation he also mentions that "Black money stashed as high value currency is much less than black money as untaxed income, part of which might be splurged in conspicuous consumption or used for investment in real estate, commodities, stock, benami lending or plain graft to secure political or administrative goodwill".

All of us know that black money is not kept as hard currency in home for long time but rather used to buy gold, precious stone, luxurious goods or it is invested in real estate. This sort of black-money driven consumption is out of purview of the legitimate formal economy. The effect of demonetization on such consumption will be positive. However, this will hit in short run but will take its own way in long run.

Agriculture sector is considered to be backbone of Indian economy, which contributes 15% to Indian total output. Here, cash is the primary and prevalent mode of transactions. So, agriculture which is primarily cash based economy has negative striking effect of demonetization. Agriculture is impacted through the input-output channels as well as price and output feedback effects. Sale, transport, marketing and distribution of ready produce to wholesale centres, is dominantly cash dependent. Disruptions, breaks in the supply chains feedback to farmers as sales fall, increased wastage of perishables, lower revenues etc that show up as trade dues instead of cash in hand and when credited into bank accounts with limited access affect the sector. Looking at these disruptions, Government relaxed some of its demonetization norms in agriculture sector. So again it cracks down the motive of demonetization.

Former chief statistician of India Pronab Sen said with 86% of value of money in circulation, the economy will have to make do with only 14% of money in circulation at least for short period, until when there are restrictions on withdrawing money. This will impact a large number of cash transactions which will have a multiplier effect on the economy. "If I am not going to be able to sell, I am not going to buy from my suppliers which will kickstart a chain reaction. So even if the first round impact of lower money circulation may not have a large impact, the chain effect will be large." Sen warned that it is the informal sector accounting for around 40% of the economy which will be impacted the most, especially in rural India and likely to reduce GDP growth by one percentage point in this year (2016-17)."

Finance minister Arun Jaitley, responding to a question at a press conference, ruled out any short-term impact of demonetization on growth, holding that it will rather benefit growth in the long run because "all this will impact the size of the GDP itself because more transaction that were happening outside the (formal) economy will get into the economy itself". One thing is sure one way or the other every common was affected in the short run. We have to wait and watch long term results.

### Black money in Swiss Bank

Around CHF 1.95 billion (INR 92.95 billion or USD 2.1 billion) was the total amount of deposits in all with Swiss bank. Ministry of External Affairs, Switzerland has confirmed these figures upon request for information by the Indian Ministry of External Affairs. As per the data provided by Swiss Bank in

2011, India is topping the list with almost \$1500 billion of its black money deposited with them, followed by Russia \$470 billion. The amount of black money is increasing year by year significantly.

In redefining the Indian economy Government is fighting the menace of black money stashed in offshore accounts mainly in Swiss Bank. Switzerland, which has always been at the centre of the debate on black money allegedly stashed by Indians abroad, used to be known for very strong secrecy walls till a few years ago around its banking practices. A huge global pressure on Switzerland and global efforts to crackdown on illicit fund flows in the system, Switzerland had ratified its multilateral convention on administrative assistance in taxation matters.

Prime Minister Shri Narendra Modi on 6th June 2016, had met Swiss President Johann Schneider-Ammann at Geneva and discussed the need for expeditious exchange of information for combating tax evasion together with an early start to negotiations on the Agreement for Automatic Exchange of Information (AEOI). As a follow up, 15th June 2016, both countries agreed to move towards an early agreement for the implementation of AEOI between the two countries.

As a result of this Switzerland on 22nd November 2016, agreed to automatic sharing of information with India on Swiss bank accounts of Indians as of September 2018 and onwards. The 'Joint Declaration' for implementation of AEOI between India and Switzerland provides that both countries will start collecting data in accordance with the global standards in 2018 and exchange it from 2019 onwards. While Switzerland has conformed to the global standards on automatic exchange of information with the signing of the declaration, India, on its part, has promised to safeguard the confidentiality of the data. Again it is one more mile stone of Government in redefining Indian economy.

### Measures needed to sustain demonetization benefits

After a lot of efforts to erase the parallel economy, the efforts should not go waste. So, one of the old proverbs says "Prevention is better than cure". So it is better to implement some of the preventive measures against development of parallel economy once again and to sustain reformed healthy economy. Following are a few measures which will help sustain the dividends of demonetization:

1. **Implementation:** The problem is not the existence of parallel economy or finding the measures to curb it, but it is implementation of all those measures to overcome menace of parallel economy. If Government takes initiation in implementing at least majority of the measures available before Government, then this problem finds solution on its own.
2. **Linking of Aadhaar:** All multiple bank accounts must be linked with Aadhaar. Even not only bank accounts but also various departments such as Income Tax, sales tax, VAT, Excise, Customs, Service Tax, Licensing department etc. so that, various transactions can be traced easily. This not only creates awareness among the people but also as controlling mechanism. Linking of Aadhaar must be made mandatory to get civil benefits.
3. **Reduced tax rates:** One of the main motives behind tax evasion is high tax rates. If we look at tax heaven countries, India has high tax rates. Tax rates are to be brought down to such extent that cost of compliances must be lower than

the cost of tax evasion. This can be achieved only when we widen our tax net.

4. **Mechanised System:** Due to corruption we find there are leakages in generating revenue to Government. If we plug those leakages, Government can reduce its tax rates. Reduced human interference in the system will reduce corruption. Even some strong measure must be implemented on corrupt officers too.
5. **Declaration of assets:** Like wealth tax act which was in force earlier, it must be made mandatory to declare every persons asset to Government. Undeclared assets if found by Government, then the same can be seized by Government. This prevents mobilisation of black money in the form of gold, land, house property etc.
6. **Simplified tax structure:** Many people are finding it difficult to understand various taxes and its calculation. So a movement of GST may bring transparent and clear picture of indirect taxes. At the same time removal of various tax mechanism in direct tax such as surcharge, education cess, short term capital gain u/s 111A etc may be removed, which will simplify the tax calculation mechanism.
7. **Uniform Property Registration Software:** Developing a uniform software network like stock exchange to register properties throughout the country linked with Aadhar is necessary to overcome holding of benami properties. It can be done without disturbing the state govt power to generate revenue of stamp duty, just as a control mechanism.
8. **Good Governance:** Control on holding of cash and physical money both in India and abroad, must be brought under the legal framework. People must believe in good governance and support for it. Winning public faith in good governance is very much essential to build strong economy. Many more preventive measures must exist in the system to hold and retain the healthy economy.

### Conclusion

Demonetization is a general measure to mitigate the problems of black money and counterfeit notes, though there are specific measures to tackle the same menace. Demonetization is, usually, immediately or simultaneously followed by remonetisation, as there is no other way. The Government has already introduced new notes of Rs. 2,000 and Rs. 500 and likely to introduce notes of Rs. 1,000. It is everybody's wish that there should not be a situation for demonetization (of new notes) once again, in the near future. So, our efforts should be focussed in a big way towards popularising e-banking and e-commerce. However, no stone should be unturned in making e-banking fool proof as the security complacency in electronic transactions may be much more disastrous than the limitations of the hard currency. It is high time to take stock, evaluate options and implement all such relevant measures which may be of help in availing and sustaining the dividends of demonetisation for a long period to come and keep black money menace at bay.

"When you expect an honest Government with no corruption and malpractices, you also have to be honest. Honesty is not one way road" – Prime Minister Shri Narendra Modi

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