2

Black Money: Some Preliminaries

1. Concepts and Definitions

THE black economy (alias the parallel economy, the unaccounted economy, the underground economy, the unreported economy, etc.) in India has been a matter of grave concern for a number of years. Thirteen years ago the Wanchoo Committee Report (Government of India, Ministry of Finance, 1971, p.6) depicted the phenomenon as a "cancerous growth in the country's economy which, if not checked in time, will surely lead to its ruination". Since then numerous articles (and some books) have been written pointing to the various deleterious consequences of the black economy, diagnosing its causes and suggesting a wide range of remedies. A number of efforts have also been made to estimate the quantitative dimensions of the problem. Over the past six or seven years a considerable body of literature has developed which examines similar problems in a number of foreign countries[1]. Despite all this intellectual effort, the meaning of phrases such as "black money" or "the black economy" is less than crystal clear. One of our purposes in this chapter is to discuss and clarify some of the alternative connotations of these terms. The goal is not to arrive at *the* "correct" definition (an entirely hopeless enterprise) but to be clear about the alternatives and *our* use of these alternatives in this report.

First of all, it is important to distinguish between the *flow of black income* over a period of time (such as a year)and the *stock of black wealth* at any given point in time. Such a distinction between income and wealth is equally important for the analysis of the regular (or "white") economy. Unfortunately, the term "black money" is frequently, and confusingly, used to refer to both black income and wealth (for example, in the Wanchoo Report), when, in fact, its meaning, strictly speaking, should be limited to that portion of black wealth which is held in the form of currency and liquid bank deposits, in short, money. Less frequently, "black money" also refers to *black turnover* (e.g., Sandesara, 1983a), that is, when the turnover is not reported to tax authorities for purposes of tax evasion, or because the transaction in question is illegal (for example, black market sales of price-controlled commodities).

In this report we focus mainly on *black income*, especially when it comes to exploring quantitative dimensions'. There are several reasons for this. First, as we shall see, coming to grips with black income is a difficult enough task. Second, wealth accounting is notoriously difficult; it is no accident that the Central Statistical Organisation (CSO) does not publish any annual estimates of national wealth analogous to their regular estimates of national income and output. Third, the concept of black wealth is prey to even more ambiguities than is the case with black income, especially given the possibilities of "laundering" black income and wealth into white.[2]

The concept of black income is not unambiguous. We can distinguish at least three different connotations in the literature:

i. income which is illegal;
ii. income which evades tax;
iii. income which escapes inclusion in national income estimates.

We shall try to narrow down these three different connotations into two workable definitions.

At the simplest and most commonsensical level black incomes refer to those incomes which have some element of *illegality* associated with them. These may arise from illegal economic activities such as gambling, smuggling and prostitution, or from unauthorized "sale" of permits, licences, postings or favours, or from black marketing of products and services which are legally required to be sold at controlled prices and/or through specified channels. Alternatively, the activities and income sources may be perfectly legal, but to the extent the incomes made are understated to tax authorities, the law is broken and black incomes are made.

The notion of illegal incomes can be made congruent (almost) with the notion of tax-evaded income once we recognize that, *in principle*, income from illegal activities and sources is taxable, though it would be wholly unrealistic to expect such receipts to be voluntarily *declared* for taxation. The Income Tax Act, 1961, allows for no specific exclusions of illegal incomes. And the Income-Tax Department has always taken the view that illegal incomes are taxable under one or other of the six heads (salaries, business, house· property, etc.) depending on the source of the income. Thus, if a trader makes black market profits, they are deemed taxable under the head "business"; that black marketing is illegal is held immaterial to the taxability of incomes.

The lack of congruence between these two notions of black incomes arises when the total of illegal source incomes accruing to an individual, together with his legal source incomes, falls below the prevailing exemption limit. In such a case the issue of tax evasion does not arise. But the individual will nevertheless have received incomes which are black in the sense of being from illegal sources. Leaving this difficulty aside we can subsume the first two connotations of black income into a single *Definition A*:

The aggregate of incomes which are taxable
but are not reported to the tax authorities

For brevity we shall sometimes use the phrase *tax-evaded incomes* for this definition.

More specifically, this definition of black income will include *non-reporting or under-reporting of incomes* and receipts from the following categories[3].

1. Income from current, legal economic activities;
2. Income from legal transfer payments[1], e.g., pensions;
3. Income from realized capital gains on legally transferred assets;
4. Income from current illegal economic activities, e.g., smuggling, gambling, black marketing and prostitution;
5. Income from realized capital gains on illegally transferred assets, e.g., from such sales of land and property as are prohibited by law;
6. Income from illegal transfer payments, e.g., various forms of bribes, kickbacks and cuts.

The first three items refer to evasion of incomes from *legal* activities and sources. We could consider the first trio to constitute a "narrow" legal version of Definition A, while the "broader" definition would extend to encompass the latter three illegal elements.

The first thing to note about *Definition A* is that it can be applied either at the level of an individual taxable entity or for an aggregate of tax entities. The total of black income generated in the country in a given year is simply the total of black incomes made by all tax entities in the nation. Second, not all cases of black incomes need fit neatly into this six-fold classification, though our contention is that the overwhelming majority would. Third, it is important to stress that of the six categories of income only items (1) and (4) reflect returns to productive factor engaged in current economic activity; and item (4) is conventionally excluded from the ambit of official totals of national income. However, as far as an individual recipient is concerned all six categories enhance his economic power, that is, his ability to command goods and services in the economy. Fourth, while it is important to distinguish between different kinds of black income, it is at least as important to recognize that the level of any single category of black income is not wholly independent of the level of the others. Thus, for example, an increase in the scale of smuggling in a small economy reliant on foreign trade could substantially alter the total of incomes from current, legal economic activities, as well as the proportion of such income which evades tax.

The above "disaggregation" of Definition A assists comparison with an alternative connotation of black or unaccounted income which is frequently encountered in the literature on this subject and which we define as follows:

Definition B. The extent to which estimates of national income and output are biased downwards because of deliberate, false reporting of incomes, output and transactions for reasons of tax evasion, flouting of other economic controls and related motives.

For brevity, we shall sometimes refer to this definition of black income by the phrase *unaccounted income.*

It should be clear that the two definitions are conceptually quite different. By well-established convention the scope of national income is limited to the aggregate of factor earnings from current, lawful economic activities, that is, to item (1) of the six items enumerated under the definition of tax-evaded income [5]. Changes in the levels of the other five items are relevant for Definition B only to the extent that they have repercussions on the levels of true and recorded national income.

Aside from these obvious, and important, conceptual differences, the practice of national income accounting can, and does, drive a wedge between the two concepts of black income advanced above. Even in sectors of lawful current economic activity, tax evasion does not necessarily lead to underestimates if the information supplied to the revenue authorities does not form a basis for estimating national income in that sector. Of course, the two concepts are not wholly unrelated. They are *directly* linked to the extent that underreporting of incomes, output and transaction values to tax and regulatory authorities *does* get reflected in the data sources from which national income estimates are compiled. A couple of examples can illustrate these points for India.

Consider the case of a private doctor who underreports his earnings for 1980-81 (assessment year 1981-82) to the income tax authorities. Such evasion will have no influence on the national account estimates of incomes from professional services for 1980-81. This is because the latter are computed on the basis of survey estimates of value-added per worker for some earlier "benchmark" year which are moved forward in time with the help of price indices and then multiplied by estimates of total work force for the relevant professional service to obtain current price estimates of value-added in that sector [see Government of India, CSO, (1980)]. None of the key elements of this national accounting calculation are affected by the doctor's current underreporting of income. Of course, underreporting by respondents *at the time of the benchmark survey* would get reflected in the nationnl account estimates for that and subsequent years.

By contrast, the estimates of value-added in the registered manufacturing sector are based on the results of the Annual Surveys of Industry (ASI). The information compiled in these surveys is typically consistent with the financial accounts submitted by the relevant enterprises to the tax authorities. Thus, in this case, underreporting of taxable profits will usually be associated with a downward bias in the estimates of value-added for this sector.[6]

Which of the two alternative definitions of black income proposed above is more fundamental or relevant? As is the case with most definitions, it all depends on the purpose at hand. Normally, tax authorities are likely to be more interested in Definition A, while economists and national income statisticians will tend to focus on Definition B. As this study is sponsored by the Central Board of Direct Taxes (CBDT) we have chosen to give primacy to Definition A.

While we have chosen to define black income as "the aggregate of incomes which are taxable but are not reported to the tax authorities", it is important to avoid the fallacy of inferring that evasion of income tax is the sole, or even the main, *motive* for underreporting of incomes. Especially in India, where more than 80 per cent of the tax revenues of the Centre, States and Union Territories is raised through indirect taxes, evasion of income tax may often be a by-product of falsification of accounts (or wholesale nonreporting) which is motivated by the desire to evade sales, excise or customs duties. Furthermore, income tax evasion can also be a by-product of actions taken to flout economic controls. Thus, for example, an enterprise may inflate the cost of imported inputs (and thus reduce taxable profits) through over-invoicing of imports triggered by a desire to circumvent foreign exchange controls and accumulate balances abroad. Frequently enterprises are motivated to generate black income in order to meet certain costs which cannot be shown on the books. Such costs may range from petty bribes to low-level government functionaries to substantial "political contributions". Finally, in the case of all the illegal elements of black income (that is, the latter three elements of Definition A), income tax evasion is quite incidental to the breaches of the laws and regulations which are central to making such incomes.

2. Black Income Generation: Some Examples

The conceptual remarks of the previous section can be illustrated through a series of examples. In each case we shall describe a hypothetical set of transactions and attempt to answer the following questions:

i. Do the transactions lead to the generation of black income in the sense of Definition A?
ii. Do the transactions add value in the economy, and given the present system of national income accounting, does this increase in value-added get recorded in the estimates of national income?
iii. Do the transactions lead to the generation of black income in the sense of Definition B?
iv. What are the consequences for different categories of taxes?

EXAMPLE 1

A trader suppresses a part of his turnover and profits in reporting to sales and income tax authorities. Out of his undeclared profits he pays "haftas" to the local policeman, the tax inspector, health inspector and a few other functionaries. He also purchases the services of a doctor who does not declare these earnings in his income tax return.

The consequences of this set of actions are as follows:

i. Both the trader and the doctor make black income, in the sense of Definition A, and so probably do some recipients of the "haftas" (in some cases their aggregate incomes from all sources may be so low that the income from "unexplained" sources, or bribes, may not render them liable to tax).

ii. The earnings of the trader and the doctor add value to the economy, but given the methods of national income accounting for these sectors, the estimate of national income for these sectors is *not* affected by the individual accounts of these two agents. The "haftas" received are in the nature of transfer payments, which do not add value.

iii. Conversely, the false declaration of their accounts for tax purposes by the trader and the doctor does not influence the estimate of national income, and hence no black income is "generated" in the sense of Definition B.

iv. Sales tax and income tax are evaded.

EXAMPLE 2

A manufacturing company, registered under the Factories Act, suppresses output declared for excise taxation and keeps the sales of this output off the books. The profits from the sale of the suppressed output are distributed to the controlling owners of the company. At the same time the controlling owners charge some of their personal consumption (in the form of travel, entertainment, use of cars, guest houses, servants, etc.) to the company's account.

The implications are as follows:

(a) Black income in the sense of *Definition A* is generated in several ways. First, the company's profits are understated, both by the misdeclaration of output and by the inflation of expenditures.[7] Second, the controlling owners also enjoy black income from the illegal profit distribution on undeclared output as well as the personal expenses on company account.

(b) The company's operations add value, but only a part of the true profits is actually recorded in the company's financial statement and it is this part which gets picked up in the estimates of national income for the manufacturing sector. The distribution of profits on sale of suppressed output to the controlling earners is in the nature of illegal transfer payments and such profits do not constitute additional value-added.

(c) The underestimation of national income in the manufacturing sector resulting from the tax evasion and business malpractices in this case constitutes black income in the senses of *Definition B.*

(d) The transactions lead to the evasion of company income tax, personal income tax, excise duties and, perhaps, sales tax.

EXAMPLE 3

A home owner sells his house for Rs 10 lakh, receiving Rs 5 lakh in cheque, corresponding to the price shown on the transfer deed, and the remaining Rs 5 lakh in cash. Assuming, that he originally purchased or constructed the house at the cost of Rs 2 lakh (all "white") his sale yields a true capital gain of Rs 8 lakh and a declared capital gain of Rs 3 lakh. The implications are as follows:

i. The seller generates black income, in the sense of Definition A, to the tune of Rs 5 lakh, on his undeclared capital gains.
ii. The transaction does not add value in the economy.
iii. There is, therefore, no question of black income in the sense of Definition B.
iv. Aside from evading the tax on capital gains, the transactors evade stamp duty and registration fees, and the seller reduces his subsequent wealth tax liability—as compared to a situation where he received the full sale "in white".

EXAMPLE 4

A municipal corporation gets a public works project completed through private contractors. But the expenditures shown in the corporation's accounts for the project are far in excess of the actual value (in terms of materials and value-added) of the completed project. The difference is siphoned off through a variety of bribes, cuts and kickbacks to the contractors, a few senior officials of the corporation and suppliers of materials. The implications include:

(i) Black income, in the sense of *Definition A*, is made by many of the recipients of the various bribes and kickbacks, as well as in the form of undisclosed profits in the hands of the contractors and suppliers of materials.

(ii) Value is added in construction activity, though given the methods of estimating value-added in this sector, the actual operations on the project probably do not influence the estimate made for the nation. However, total public sector investment will be overestimated (since it relies on budget documents), and private sector investment will be underestimated by an equivalent amount, with the overall total of fixed investment—estimated by the commodity flow method—remaining unchanged [Government of India, CSO, (1980)].

(iii) Conversely, the siphoning of incomes, cheating on the quality and value of materials, etc., probably do not lead to an underestimation of value added in construction; that is, the transactions do not lead to the generation of black income in the sense of *Definition B*.

(iv) Income tax is clearly evaded by the contractors and the recipients of the bribes, kickbacks and cuts.

EXAMPLE 5

A landlord arranges to receive two-thirds of the rental for the premises "in black" and only a third through cheques. He only declares the latter amount both for purposes of income tax and for valuation of house property tax. As a consequence:

i. He makes black income in the sense of *Definition A*.

ii. Value is added under the sector "ownership of dwellings" and use is made of his returns to the municipal authorities in arriving at the estimates. As a consequence, only a part of the actual value-added is captured in the national income estimates.

iii. Correspondingly, black income in the sense of *Definition B* is generated.

iv. The transaction results in the evasion of income tax, municipal property tax and, perhaps, wealth tax.

In the case of illegal incomes the issues regarding direct accounting relationships to national income estimates do not arise. However, for the sake of balance it may be useful to list a few of the myriad ways in which illegal incomes are generated in India:

— grant of licenses and permits in return for bribes or political "contributions";
— "speed money" to accelerate administrative procedures;
— "sale" of jobs, postings or transfers in various public services;
— regular bribes to petty functionaries from different government departments (e.g., factory inspector, boiler inspector, health inspector, police, tax inspectors for different taxes);
— "pugrees" to circumvent rent control legislation;
— black marketing of price-controlled commodities;
— bribes to alter land use zoning or to "regularise" unauthorised structures;
— bribes to obtain and maintain scarce public goods and services such as electricity, telecommunications, irrigation water and rail wagon allotments;
— various kinds of frauds in banks and other financial institutions;
— "leakages" from various public expenditure programmes;
— bribes to obtain public contracts;
— "contributions" to political authorities at various levels, ostensibly to finance elections and post-elections manipulations.

These simple illustrations help to emphasize a few points. First, any falsification of accounts usually leads to the evasion of more than one tax. Hence, logically, any explanations of tax evasion in terms of a single tax are likely to be flawed. Second, the links between particular transactions and the national accounts estimate of income in that sector are often weak. This, in turn, implies that the links between tax evasion and underestimation of national income are likely to be quite unsystematic, except in a few sectors. Third, the same level of productive income (or national income) can be associated with quite different levels of corruption, and hence, quite different levels of illegal incomes in the form of illegal transfer payments from one economic agent to another. In a purely *accounting sense*, such transfer payments do not alter the real *size* of the economy, but they can clearly have a very powerful influence on the final distribution of income. Furthermore, if one goes beyond "pure accounting" it is clear that bribes, kickbacks etc. can have significant consequences for the allocation of productive resources in the economy and their effective productivity, and hence, on the real size of national output. Finally, it should be obvious that the estimates of black income according to the broader version of Definition A (that is, including all illegal source incomes) are likely to be extremely difficult, if not impossible. Even the "narrower" version, limited to legal source incomes, will, as we shall see, pose very considerable problems.

3. The Extent of Black Income in India: A Qualitative View

Before we come to quantitative estimates, it is useful to offer an initial judgement on the extent of the phenomenon. Based on the available literature and a large number of interviews with people in varied walks of life we cannot escape the conclusion that the making and spending of black incomes has become quite pervasive in society.

The available official reports on taxation certainly support this view. The much-cited Wanchoo Committee Report painted the black economy as a pervasive and growing phenomenon as far back as 1971. The Venkatappiah Committee Report (Government of India, 1974) on the self-removal procedure in Union excisesfelt "free to confess that we were not prepared for, and are, therefore, painfully surprised at the range, diversity, and, in certain segments of production, almost the universality of the evasion which is practised by those who produce the goods" (p. 55). More recently, commodity-wise studies of excise evasion by this Institute have found evidence of large-scale evasion in copper (NIPFP, 1982) and cotton fabrics (NIPFP, 1984a) and, to a lesser degree, in plastics (NIPFP, 1983 b).

Studies of State sales tax systems also tend to find rampant evasion. For, example, as far back as 1963, Lokanathan (1963) estimated that for 10 agricultural commodities in Andhra Pradesh in 1960-61 and 1961-62, some 68 per cent of the turnover escaped tax. Using a similar methodology a much more recent evaluation of the Bihar sales tax system by the NIPFP (1981) found that in most years revenue collection from motor parts was less than half of the estimated tax potential. In Kerala, the Report of the Committee on Commodity Taxation (Government of Kerala, 1976) estimated that tax realisation from coconut and copra were often only a third or so of the estimated tax potential. Similarly, the Uttar Pradesh Taxation Enquiry Committee (Government of Uttar Pradesh, 1974) had estimated that in 1965-66 and 1969-70 sales tax receipts were only 42 and 60 per cent respectively of the estimated tax potential.

Tax evasion on legal economic activities has been only one, though probably the most important, source of black income. Pervasive and detailed regulation of economic activity through industrial licensing, import licensing, controls on prices and distribution channels of goods and services (including housing), credit controls and various other means has been another major source of black incomes reaped in different forms of illegal scarcity premia and bribes. Such economic regulations have been a permanent feature of post-1950 Indian economic history, though their nature, scope and intensity have varied from time to time. The Dagli Committe Report (Government of India, Ministry of Finance, 1979) provides the best single compendium of the awesome edifice of controls governing the Indian economy and their history.

Quantitative estimates of black incomes spawned by the system of controls are few and piecemeal. For example, a NCAER (1978) study of price control in selected commodities estimated that Rs 840 crore of black incomes (in the form of scarcity premia) were reaped in just six commodities (urea, cement, tyres, paper, vanaspati and steel) during the period 1965-66 to 1974-75. But the paucity of empirical studies should not detract from the judgement of virtually all knowledgeable observers who credit the extension and institutionalization of economic controls with a major responsibility in the generation of black incomes. Full twenty years ago the Santhanam Committee Report (Government of India, Ministry of Home Affairs, 1964) identified the "large armoury of regulations, controls, licenses and permits", as providing new and expanded opportunities for corruption.

There is every indication that those opportunities have been fulfilled. Generally, controls have given a fillip to black incomes in two distinct ways: first, by creating (illegal) scarcity premia between the controlled price of the good, service or asset and its market clearing price; and second, by vastly augmenting the discretionary authority of functionaries at all levels of government. As the Wanchoo Report (p.9) notes, "Since considerable discretionary power lay in the hands of those who administered controls, this provided them with the scope for corruption—'speed money' for issuing licenses and permits, and 'hush money' for turning a blind eye to the violation of controls." In fact, the use of discretionary authority to extract or levy illlegal tolls has spread far beyond the area of economic controls. Particularly at the lower levels of the State apparatus it has become quite common for illegal payments to be demanded in return for the *regular* public services, such as the registration of a document, repair of a telephone, the issue of a tax assessment order, the admission of a student in an educational institution, or decisions on postings and transfers in the public services.

The Santhanam Committee Report had also pointed out that "the rapid expansion of Governmental activities afforded to the unscrupulous elements in public service and public life unprecedented opportunities for acquiring wealth by dubious methods" (p. 9). The Committee "were told by a large number of witnesses that in all contracts of construction, purchases, sales, and other regular business on behalf of the Government a regular percentage is paid by the parties to the transaction, and this is shared in agreed proportions among the various officials concerned" (p. 10). There is little reason to believe that these practices have changed for the better in the past two decades. In fact, our interviewees were virtually unanimous in maintaining that this form of corruption had greatly worsened over time. What *has* changed is that the absolute and relative scale of government spending has increased dramatically. So the scope for making black incomes through kickbacks, cuts and commissions on government projects, programmes and purchases is today far greater. Furthermore, there are strong indications that political involvement in such transactions has grown enormously. In earlier years the need for political finance was largely met through discretionary control over licenses and permits, with "contributions" being made by private industrialists and traders either as direct *quid pro quos* or in exchange for explicit or implicit assurances of generally easy access to licenses and permits. Today, we were told, a great deal of political finance is raised from purchases. sales and contracts awarded by different levels of government and public sector agencies, with orders placed abroad being particularly lucrative propositions.

To sum up this brief preview, our qualitative judgement is that the making of black incomes has become a very integral even "routine" dimension of Indian society, encompassing pervasive tax evasion on legal source economic activities and widespread corruption and abuse of all forms of public discretionary authority.

Notes

1. See, for example, the collection of papers edited by Tanzi (1982b).
2. It is sometimes suggested that if we know the amount of black income accruing to an individual it should be easy to estimate his

black wealth by cumulating his "black savings" over time. This is easier said than done. Consider an individual who earns Rs 100,000 in a year, half in white and half in black (the black part may represent legal source income which is not disclosed to the tax authorities or it may represent illegal source income, say, from smuggling. Suppose he consumes goods and services worth Rs 80,000 during the year. Now he has a very considerable degree of freedom in how he chooses to hold his savings of Rs 20,000. The total amount of the savings is unambiguous. But the amount of *black savings* cannot be determined unambiguously. It depends entirely on how the individual chooses to allocate his savings. At one extreme he could hold all of it in declared financial assets, with the implication that there was no saving from his black income. At another extreme it could all be in undeclared forms, if, for some reason, the individual does not wish to add to his stock of white (or declared) wealth. All intermediary situations are, of course, possible.

3. We should note, in passing, that while income tax evasion is typically associated with underreporting and non-reporting of incomes, sometimes evasion is accomplished through *misclassification* of incomes; for example, by showing non-agricultural incomes as agricultural incomes.

4. As the nomenclature suggests, such payments simply transfer purchasing power from one economic agent (or set of agents) to another; there is no increase in the economy's national income.

5. Whether item (4), incomes from current *illegal* economic activities, *should* be excluded from national income is a real, and separate, issue. There may even be some question as to whether the current practice is based on *principle* (of excluding activities which produce social "bads" not social "goods") or on *expediency* (because reliable data cannot be had).

6. This need not always be the case. If the understatement of profits is accomplished solely through fictitious inflation of the wage-bill, then total value-added would not be reduced from what it would have been in the absence of this particular act of evasion.

7. The inflation of expenditures may not only be at the expense of declared profits, but may also lead to higher (than otherwise) output prices.