A Post-Keynesian Approach to Understanding the Black Economy

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BOOK REVIEWS

Macroeconomics of the Black Economy by Saumen Chattopadhyay, *Hyderabad: Orient Blackswan, 2018; pp xx + 276, ₹795.*

The aftermath of demonetisation witnessed several books engaging with the black economy. However, the seminal work on the black economy in the Indian context is Arun Kumar's *The Black Economy in India* (1999). Saumen Chattopadhyay's *Macroeconomics of the Black Economy* is an extension of his PhD thesis which significantly draws on Kumar (1999).

Chattopadhyay's book is divided into six chapters. After outlining key concepts and definitions in Chapter 1, Chapter 2 undertakes a survey of the empirical literature on black economy. Chapters 3, 4, and 5 examine the effects of the black economy on the real sector, monetary sector, and open economy respectively. Chapter 6 appraises policies such as demonetisation, the goods and services tax (GST), and education. It ends with a discussion on the necessary features of a macro model for the Indian economy, perhaps in lieu of a concluding chapter.

The author favours the post-Keynesian approach to macroeconomics and is critical of the dominant neoclassical approach. In terms of accounting, Chattopadhyay employs the stock-flow consistent modelling proposed by Godley and Lavoie (2007). The core argument is based on the principle of the circular flow of income. In a two-sector economy with just households and firms, the equilibrium condition is given by equality between planned saving and investment and in general, it is given by the equality between injections (investment, exports) and leakages (saving, imports). But, note that the consumption and investment out of black incomes are injections. Indeed, Chattopadhyay is correct in pointing out that "the black economy is not a parallel economy," but is intertwined with the white economy (p 77) and that this fact receives inadequate attention in macroeconomic debates and policy. To put it differently, black incomes are generated endogenously alongside white incomes (p 96). Moreover, "the leakage of foreign exchange reserves and investment in gold remain trapped in unproductive investment" and consequently having an adverse impact on the expenditure multiplier and therefore on employment (p 160). Chattopadhyay's key point is that in an open economy, the "adverse impact of black investment can outweigh the positive impact of black consumption" and therefore negatively impact output and employment levels (p 170); this is because black investment, unlike white investment, is a leakage from the circular flow of income (also see p 183).

Since the tax is deducted at source (TDS) for wage incomes, Chattopadhyay argues that the main source of black income in India is profits (which evade taxes). He highlights the role of transfer payments in contributing to the black economy because it generates money flows without any corresponding commodity flows. Another chief route of black income generation is via transfer pricing, the "manipulation of prices charged for international transactions between the subsidiaries" (p 33). In the discussion of such illicit capital flows in an open economy (Chapter 5), Gabriel Zucman's (2015) work on tax havens is conspicuously absent.

The author endorses Kumar's estimate of the black economy which is "around 60 per cent of the reported size of the economy, that is, the GDP" (p 68). According to Chattopadhyay, black incomes are "mostly concentrated in businesses and self-employed tax paying individuals" through the "under-reporting of output" and "over-reporting of costs" (pp 73–74). Other channels of black investment are "informal sector saving," "holdings of gold, silver and gems," "mis-invoicing of exports and imports," "speculation in non-reproducible goods," and "illegal activities such as smuggling and drug trafficking" (pp 86–87). And, illegal activities generate the demand for and supply of foreign exchange (p 150), an estimate of which is important for the management of foreign exchange, thus pointing to the importance of understanding the black economy for monetary policy.

A key point which Chattopadhyay highlights is the frequent conflation of black money, a stock variable with black income, a flow variable by the policymakers. In an introductory economics class, this would be seen as an elementary mistake. Therefore, the author criticises demonetisation because it only targeted the stock, and that too, unsuccessfully. However, he notes that the move towards GST was in the right direction because it has the capacity to curtail the generation of black income and, therefore, its flow (p 190).

Chattopadhyay points out that a 30%–40% tax on half of the estimated black income would yield 6%–7% of gross domestic product (GDP) as additional tax revenue (p 178). Given the significance of public expenditure on education, health, and the environment, such additional revenues are paramount and this is all the more reason for targeting both black incomes and money. In a way, alongside monetary disincentives to curb black incomes, Chattopadhyay also highlights the importance of good "moral sentiments," to use Adam Smith's term (p 195).

Theoretical Issues

The analysis in the book, according to the author, "is derived from Keynesian and post-Keynesian perspectives of the economy as a whole, i e, both the white and the black" (p xiv). The key features of this theoretical standpoint are the following: (i) there exists no real-monetary dichotomy, (ii) aggregate demand determines aggregate output and employment, and (iii) money is endogenous.

Chattopadhyay is critical of the mainstream approach to macroeconomics, and in the context of analysing the black economy, notes that most of the empirical literature adopts a "micro-theoretic" perspective. Mainstream neoclassical macroeconomics is rightly criticised for its adherence to methodological individualism (where the fundamental unit of analysis is an individual), use of the production function, and belief in Say's law (p 80). And consequently unemployment is explained by recourse to rigidities and imperfections in the system and not treated as a permanent feature of a competitive economy.

Although Chattopadhyay explicitly adopts the Keynesian approach, when he discusses black savings and white investment, he implicitly assumes an anti-Keynesian causation which runs from saving to investment (p 53). This could partly be due to the focus on macroeconomic accounting (or macrobalance) which accounts for the investment-saving gap in terms of sectoral (households, firms, banks, rest of the world) balances (pp 139–46). But, this provides an answer to the what-question and not the why-question, although there are some important pointers: white saving is invested in the illegal sector via chit funds and black profits is invested in the real estate sector via *benami* accounts (pp 144–45). Therefore, it would have been good had there been a section on how black and white saving and investment are brought into equilibrium in the neoclassical and Keynesian approaches. Similarly, a longer discussion on the determination of the rate of interest in both the approaches is warranted. The book contains only half-a-page of discussion on endogenous money (p 133), an aspect which is central to post-Keynesian macroeconomics. The history of endogenous money is much older and begins with the work of Thomas Tooke in the 19th century (see Smith [2014] for a detailed account).

Given Chattopadhyay's dissatisfaction with neoclassical economics, it is very odd to see him taking the assistance of an "educational production function" when discussing corruption in education. In fact, the inclusion of corruption in education in the final chapter (pp 210–17) appears out of place.

Methodological Considerations

The book has a rich assortment of methodological points which deserve separate mention because they can enrich both economics research as well as teaching. Chattopadhyay rightly notes that "exogenous preferences are better treated as endogenous as people evolve through their experiences in their interaction with the people, the institution and the society" (p 7). He also criticises the Laffer Curve hypothesis since it is based on the neoclassical "microtheoretic framework" (p 187). While discussing the measurement of the black economy, the author points out that although "household production [and] gathering of nature produce for household production … add to the well-being of the household [they] cannot be valued because of the absence of market" (p 26). The question of valuation is central to economics. However, it is important to debate whether the market is the only institution which is capable of valuation. Given the recent surge of experiments in economics, Chattopadhyay's words of caution are pertinent: "In experiments, social pressure and stigma are absent, and results would vary depending on who is included in the population" (p 49).

With the advent of powerful computing, quantitative data analysis has become easier and this has resulted in the proliferation of empirical papers in economics. The empirical turn in economics has led concepts and definitions to be determined by the available data and methods of estimation. Chattopadhyay argues that the "definitions of the underground economy" should precede the "method of estimation" (p 62). It is true that mainstream macroeconomics is yet to satisfactorily incorporate a stock-flow consistent accounting framework; in assessing the macroeconomics of the black economy, the author calls for analysing the changes in stock and flow together (p 82). Owing to the presence of a significantly large black economy, when employing the quantity theory of money in empirical work, it should be noted that "the transaction velocity may actually be unstable as well as higher than the income velocity of circulation" (p 119). Moreover, "to capture the true velocity of circulation, the appropriate database should be weekly or monthly" and not annually (p 132). In a way, this underscores the fact that specific demands on data come from theory. While discussing the level of money supply in the presence of black money, Chattopadhyay prefers to focus on the "potential" than the "actual" level (p 121). It is important to point out that while the latter is calculated based on past data, the former is a theoretical position and, therefore, *any* estimation of potential values should be critically assessed.

Attention to Black Economy

While the book explicitly adopts a post-Keynesian framework, a greater theoretical engagement would have been beneficial, especially with respect to the saving-investment dynamics and endogenous money. In terms of macroeconomic accounting, Chattopadhyay's book makes an important contribution not only to the macroeconomic aspects of the Indian economy, but also to the teaching of macroeconomics and Indian economy (especially the tables on pages 91 and 141, and in Chapter 6). The readers obtain a good understanding of the nature of black incomes, especially its sources and uses, in the Indian economy. While most of the policy discussion is around taxation, the last chapter engages briefly with demonetisation and GST. The book has been successful in conveying to us that more attention to the black economy is warranted in macroeconomics teaching and research so that appropriate policies can be formulated.

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