In Defense of Cash

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On the evening of November 2016, Indian Prime Minister Narendra Modi announced that 500-rupee notes (valued at about $8) and 1,000-rupee notes would become "worthless pieces of paper" at midnight, no longer recognized as legal tender. The stated goal of his demonetization plan: to catch criminals. The government offered a brief window in which old notes could be swapped for new ones, with the idea that everyone from human traffickers to tax cheats would have to show up at banks with vast sums of money and confess their sins or lose the value of their cash holdings altogether.

The costs of this scheme were large. At the time of the announcement, demonetized notes accounted for 86 percent of all currency in circulation. As George Mason economist Lawrence H. White has written, "A serious currency shortage immediately arose, with predictable consequences. Honest wage laborers in the huge cash economy went unpaid, honest construction projects came to a standstill, honest shopkeepers saw sales dry up, and honest businesses failed. Honest people wasted billions of hours waiting in queues to exchange old notes for the trickle of new notes."

Growth in the country's gross domestic product fell from an annualized rate of 7.37 percent in the quarter prior to the announcement to an average annualized rate of 6.06 percent in the first three quarters of 2017.

What's more, the program utterly failed to impose a levy on those conducting business in the underground economy. Lawbreakers did not find themselves stuck with worthless notes. Instead, the Reserve Bank of India reports that 98.96 percent of all demonetized notes were turned in during the months following the announcement. That is on par with redemption rates in Italy (99.15 percent) and France (98.77 percent) following the introduction of the euro—and in those cases users were given 10 years to convert their old money.

The Indian experiment was a failure. Yet a group of politicians, academics, and do-gooders continues to dream about a cashless world where black markets would shrink and tax coffers would grow.

Cash Is for Criminals

In his 2016 book *The Curse of Cash* (Princeton University Press), Harvard economist Kenneth S. Rogoff makes what is arguably the best case for demonetization in America. He estimates that more than a third of all U.S. currency in circulation is used by criminals and tax cheats in the domestic economy and suggests the proportion is even higher for large denomination notes. Rogoff concedes that "crime will continue with or without cash, but for very good reasons, cash is a medium of exchange highly favored by the underground economy, and the underground economy accounts for a significant share of the demand for cash."

Rogoff proposes eliminating $100 and $50 bills immediately. He claims few people use such large denominations in the domestic legal economy. As long as those who do are able to switch to lower denominations at little cost—and he says they would be—such a policy would be minimally disruptive.

But it doesn't stop there: In Rogoff's scheme, most lower denomination notes also must go. This would take place over a much longer period, a decade or more. To promote the transition, the government might subsidize deposit accounts—perhaps through rebates to customers or direct payments to financial institutions—or require all paychecks to come via direct deposits. The smallest denomination notes could be left in circulation or, better still, replaced with coins—which are much heavier and hence less convenient for large transactions—to leave some limited scope for financial privacy.

This proposal promises to deliver significant gains from reducing crime and tax evasion while imposing few costs on those operating in the legal domestic economy. Who wouldn't want that? Indeed, the idea has launched a formidable coalition in the Better Than Cash Alliance, with the United Nations Capital Development Fund, the U.S. Agency for International Development, the Bill and Melinda Gates Foundation, Omidyar Network, Citi, Visa, and Mastercard all reportedly donating $1.5 million or more per year.

The Philosophical Case for Cash

The case for cash presumes that we should be free to go about our lives so long as our actions do not harm others. It maintains that governments are not entitled to the intimate details of people's lives.

Whether they realize it or not, Rogoff and other demonetization advocates hold a progressive view of government. They think that existing laws and regulations have been rationally constructed by enlightened experts or are the product of an enlightened electorate. Adjust the requisite policy levers and one can fine-tune the social system.

Demonetization advocates are not utopian, to be sure. They understand that the world is complicated, that bad rules are occasionally adopted and once-good rules can persist long after their usefulness ends. But that just means a little more adjusting is in order. Eliminating cash, in their view, patches the hole in an otherwise well-designed system.

There is, of course, an alternative view of government—one that is skeptical that laws and regulations are so rationally designed. It maintains that they are far more likely to be a hodgepodge passed down and amended over time. Some of these rules do promote just conduct between individuals. But others merely reflect existing power structures: They were constructed to benefit some at the expense of others or to bolster a set of values that are not universally shared.

Classical liberals believe an individual has the right to pursue her own ends up to the point where her actions violate the rights of another. In general, therefore, they think the power of the state should be limited. Sure, governments might be used for good. But both theory and experience show that they will not always make the right choices. It is more important to limit the harm such a powerful institution might cause.

It is easy to see how these two views can lead to opposite conclusions regarding the desirability of cash. Physical currency enables one to disobey the government. If the government is a force for good, efforts to circumvent its orders are generally bad for society. On the other hand, if the government must have a compelling interest before it can justifiably interfere in people's lives, a blanket ban on cash is too broad. Individuals should be more or less free to act privately. And governments should only invade those private spaces if there is sufficient reason to believe someone is being harmed by someone else. Call it a moral presumption of liberty.

The rule of law requires that we accept some limits even in the prevention and detection of indefensible crimes. Banning cash might make it more difficult to fence stolen goods, but it does so by preventing a host of noncriminals from engaging in legitimate transactions as they see fit.

Importantly, this argument for cash is not merely a defense of crime and tax evasion, as some on the other side might have you believe. It is a case for due process and financial privacy—bedrock jurisprudential principles in the West.

Now, you may be thinking, even if cash advocates are not motivated by a desire to promote crime or tax evasion, those outcomes might be side effects of their favored policy. And indeed, such side effects seem inevitable. But we must keep two things in mind.

First, some crimes are defensible. Hiring an undocumented immigrant might be illegal, but it is not morally wrong. The philosophy of liberalism is clear: It is beyond the legitimate scope of government to limit people's freedom to pursue their own ends when such pursuits do not harm others. Insofar as cash allows one to circumvent unjust laws, it is a bulwark of liberalism.

Second, the rule of law requires that we accept some limits even in the prevention and detection of indefensible crimes. Banning cash might thwart the occasional murder-for-hire or make it more difficult to fence stolen goods. But it does so by preventing a host of noncriminals from engaging in legitimate transactions as they see fit.

The Costs of Cashlessness

One need not resort to pie-in-the-sky philosophy talk to oppose demonetization proposals. There is a strong practical case to be made as well. In brief, the costs of banning cash probably outweigh the benefits.

Let's start with the benefits. Since cash enables quasi-anonymous exchange, it seems reasonable to suspect it is used by criminals and tax cheats. Banning cash, as demonetization advocates suggest, would almost certainly eliminate some crime and tax evasion. The question is: How much will that improve the well-being of the average person in society?

There is no doubt that some criminal activities make us worse off. Most of us would like to limit murder, human trafficking, and theft, for example. If eliminating cash reduced the frequency of these crimes, we would have to add that fact to the tally in favor of an anti-cash policy.

But the spillover benefits of eliminating other crimes are less obvious. Consider prostitution. Where exactly is the externality? What costs do those engaging in consensual adult sex work impose on others? One might find such transactions repugnant. However, it is hard to see how society as a whole would be much improved by preventing people from buying and selling some goods and services, especially if the offending transactions take place in private.

It seems reasonable to suspect that the bulk of criminal activities stamped out by the prohibition of cash would be of questionable benefit to society. The online marketplace Silk Road facilitated transactions largely involving illicit goods and services from February 2011 to October 2013. Transactions on the platform used bitcoin, which, like cash, allows for potentially anonymous transactions. Despite a few headline-grabbing accounts of hitmen being hired to protect the site's secrets (no murders were ever found to have taken place), the best available evidence reveals that Silk Road postings almost always involved controlled substances like narcotics. A 2013 paper by Carnegie Mellon researcher Nicolas Christin found that more than 20 percent were for weed or hash—goods that are legal for recreational use in eight states and have been decriminalized in 13 others.

As for tax evasion, it is certainly bad for government revenues. But that tells us little about its effect on society. When considering overall social welfare, one must be wary of mere transfers. The IRS estimates the tax gap—the difference between what taxpayers owe and what they actually pay—at around $458 billion per year before recovery efforts. The result is that government is worse off by $458 billion—but tax cheats are *better* off by the same amount.

One might argue that society is harmed as a result of this transfer—if the government would have spent the money better than the tax cheats, for example. But even if that is the case, it's worth noting two things: First, $458 billion is less than 2.5 percent of the United States' annual gross domestic product. And second, it is highly unlikely that society is worse off by the full amount. Surely some economic value needs to be attributed to the extra purchases that tax cheats make, even if one finds their behavior reprehensible.

Economists like Rogoff, who favor demonetization, point to the distortionary effects of tax evasion. If some people avoid paying taxes, the burden falls disproportionately on others. The evaders can offer their goods and services at lower prices than their law-abiding competitors. This results in a misallocation of resources, as some high-value ventures lose out to lower-value ventures that are more competitive simply because they are not paying everything they owe.

No disagreement there—market distortions can be costly. Still, the losses from misallocating resources are surely much smaller than 100 percent of the (already modest) tax gap.

Finally, Rogoff overestimates the extent to which cash is used by criminals and tax cheats. He essentially argues that *any*cash not declared in surveys must be held for nefarious purposes. But at least some of the observed underreporting is surely to preserve financial privacy or to keep cash holdings secure—think of the proverbial grandma who hides her life savings under the mattress—not because such holdings are being employed to purchase illegal goods and services or get out of paying taxes.

None of this is to deny that there would be some benefits to society from banning cash. My claim is only that those benefits are overwhelmed by the costs.

Many noncriminals use cash, too. Demonetization would inconvenience them right alongside the bad guys. Some transactions will be foregone. Financial privacy will be undermined. Mental accounting methods—like Dave Ramsey's system, where people distribute cash across envelopes marked "rent," "gas," "food," "recreation," etc., and then limit spending in each category to the cash in the relevant envelope—will be eliminated. Moreover, since poorer Americans go "unbanked" in higher numbers than rich Americans and therefore rely more heavily on cash, the costs of such a move would likely fall on many of society's least well-off.

Some demonetization advocates suggest law-abiding citizens would be better off on net if we forced everyone to have a bank account and adopt "superior" electronic payment technologies. That is unlikely. In a 2017 working paper titled "The Curse of the War on Cash," George Mason's White noted that "standard economic reasoning tells us that improving lives means adding attractive options, not removing what people currently consider their most advantageous options."

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Plus, there is at least one potential advantage of tax evasion: It may serve as a constraint on the extent to which a government can extract revenue from its citizens. Since levies eliminate some productive exchanges, this could improve social welfare. And since the state requires money to operate, giving citizens a way to rebel against climbing tax rates (and authoritarian behavior more generally) enables them to act as a nonviolent check on government power.

A Cautionary Tale: Venezuela

There's one last argument for forbearance: If an anti-cash policy is implemented in the U.S. or endorsed by respected intellectuals and powerful international organizations, it is likely to be invoked in places where it is wholly inappropriate.

Rogoff has made it very clear that his proposal "is not aimed at developing countries, where the share of people without effective access to banking is just too large." Unfortunately, subtlety is often lacking in the political sphere. Politicians use ideas like a drunk uses a streetlight: for support, rather than illumination.

Demonetization schemes will quite naturally appeal to financially strapped governments in low-income nations, where such efforts might be used as a one-time tax on note holders. By canceling the value of old notes and spending an equivalent value of new notes into circulation, kleptocrats are able to extract wealth from those holding cash without suffering the usual inflationary consequences.

We already saw how such a policy was taken up in India, and that country is not alone. Venezuelan President Nicolás Maduro employed similar rhetoric when announcing in December 2016 that 100-bolivar fuerte notes (valued at around 2 U.S. cents) would be removed from circulation. He claimed the nearly worthless currency was being hoarded by mafias. The exchange window in Venezuela was initially limited to a mere 72 hours but later extended into January.

In sharp contrast to Rogoff's plan, neither India nor Venezuela permanently removed large notes from circulation. Indeed, both countries ultimately introduced larger denominations—2,000 rupees in India and 100,000 bolivares fuertes in Venezuela. Given that the demonetized notes in both countries (but especially in Venezuela) were of relatively low value and larger denomination notes were later introduced, it is hard to believe rooting out crime was the primary motivation.

Venezuela's move was part of an effort to deal with hyperinflation. (Johns Hopkins University economist Steve Hanke estimates that nation's implied annual rate of inflation for February 2018 at roughly 5,454 percent. As economist Noah Smith put it at *Bloomberg* in December 2017, the country "has the world's largest oil reserves and should be fabulously wealthy. Instead, children are starving.") Carrying suitcases full of cash around to pay for basic goods is inefficient, but one way to make that problem less severe is to exchange lots of small denomination notes for fewer large denomination notes. Maduro understood that demonetizing old notes would make this transition less expensive for the government, because it pushes people into the new, larger notes without compensating them for the small notes they are unable to redeem before the window closes.

Indian politicians meanwhile probably hoped for a large windfall tax on note holders as a result of some people failing to convert their money within the designated window. Though that did not actually come to pass (since most notes were, in fact, redeemed), note holders nonetheless had to bear the costs of the government's attempt to levy such a tax.

In both countries, few if any of the arguments in favor of eliminating cash apply. Yet both found it politically expedient to invoke the anti-crime rhetoric of more respectable demonetization proposals while imposing enormous costs on their citizens.

Cash Is Still King

The case against cash is often presented as a sensible solution to an obvious problem. But the solution is not sensible and the problem is not obvious. Demonetization advocates show little respect for financial privacy and see nothing wrong with restricting personal liberty. It is unlikely that even the best demonetization proposals would improve matters. At the same time, supporters of those proposals provide intellectual ammunition for others who would introduce far worse schemes.

The misappropriation of demonetization arguments in places like India and Venezuela should, at a minimum, give one pause. It is perfectly reasonable to look forward to a day when cash is no longer king. Forcing such a result by restricting access to some people's preferred payment mechanism is a terrible idea.

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