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Taxing Mobile Capital and the Limits of Domestic Absorption

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India's punitive capital gains tax on foreign portfolio investors compounds currency and market losses, driving out mobile capital in a globally discriminating environment. Domestic absorption through SIP flows has transferred risk to Indian households while creating a structural funding crisis in banking. India must abolish FPI capital gains tax immediately, phase down domestic capital gains rates, and equalise the tax treatment of savings instruments.

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Contents

1 Executive Summary	2
2 The Magnitude	2
3 Why Foreign Investors are Exiting	3
4 The Tax Outlier Problem	5
5 The False Comfort of Domestic Absorption	6
6 The Banking System Fallout	8
7 Policy Recommendations	9
8 Conclusion	10

1 Executive Summary

In the first four months of 2026, foreign portfolio investors withdrew approximately ₹1.92 trillion from Indian equities, which is more than the record outflow of all of 2025. The dominant explanation in public commentary blames external factors: a strengthening dollar, the West Asia conflict, and hawkish US monetary policy. This explanation is incomplete.

While capital fled India, it flowed into Korea and Taiwan in the same weeks.¹ This shows that the FIIs were not exiting following an emerging-market risk-off event. Instead, it is an exit from India specifically, occurring in a global environment where capital has become more discriminating. In such an environment, friction to capital matters more than ever. And India has imposed a particularly punitive set of frictions on foreign capital, most notably, a tax regime that places it among the very few major economies to tax foreign portfolio gains at material rates.

While “domestic absorption” of foreign outflows has occurred, it has come at a cost that is now visible in three places: in valuations maintained at unsustainable levels by mechanical SIP flows, in a banking system facing its tightest funding constraint in a generation, and in the suppressed real returns of older, deposit-dependent households who never participated in the equity boom but are now paying for its consequences.

This brief argues for five corrections: abolish capital gains tax for foreign portfolio investors as a matter of immediate competitive necessity; phase down domestic capital gains tax over the medium term; equalise the tax treatment of savings instruments to end the artificial subsidy of equity over deposits; and address the deposit-credit mismatch through bond market deepening rather than restrictions on equity flows; and introduce greater fiscal discipline that reduces the requirement for high taxes.

2 The Magnitude

The headline numbers are stark. Between January and April 2026, foreign portfolio investors withdrew approximately ₹1.92 trillion from Indian equities, exceeding in just four months the ₹1.66 trillion record outflow of calendar year 2025.² FPIs were net sellers in every month of 2026 except February, with a record monthly outflow of ₹1.18 lakh crore in March alone.³ The Nifty 50 fell 9.37 per cent in March 2026 on a close-to-close basis, its steepest monthly decline since the pandemic crash of March 2020.⁴

The structural picture is more striking than the flow data. Foreign institutional ownership of Indian equities has fallen to its lowest level in 12 years and now stands below domestic institutional ownership.⁵

The most analytically important fact, however, is comparative. While FPIs were heavy net sellers of Indian equities in April

2026, they were simultaneously net buyers of South Korean and Taiwanese equities in the same period.⁶ If this were purely a global risk-off episode, all emerging markets would be bleeding and FII would be returning to safe assets, such as US treasury bills. Korea and Taiwan are the principal beneficiaries of the AI capital expenditure cycle, especially Samsung Electronics, SK Hynix, and TSMC have become the dominant thematic destinations for emerging-market equity allocations.⁷ India lacks an equivalent listed proxy for the global semiconductor and AI buildout, and its consumption-led growth narrative has begun to unwind as earnings disappoint at peak multiples. The Nifty trades at roughly 21 times forward earnings, a level several analysts have described as expensive amid global uncertainty.⁸

This is not entirely an Indian policy failure. India's lack of a domestic semiconductor champion is a legacy of investment decisions made decades ago, and no current policy lever fixes it in the short run. However, in an environment such as this, where capital is trading carefully, the added frictions in the Indian market matter more than they did in the previous periods.

3 Why Foreign Investors are Exiting

The standard commentary treats FII outflows as a function of dollar strength and Federal Reserve policy. This is partly true, but incomplete analysis. From the perspective of a foreign investor evaluating Indian equities, the decision to exit reflects not one loss but three compounded losses.

1 The currency loss: The rupee has weakened substantially against the dollar since early 2025, depreciating roughly from 85 to 95 to the dollar.⁹ For a foreign investor whose returns are measured in dollars, currency depreciation directly subtracts from realised returns. A rupee-denominated capital gain is partially or fully offset by the corresponding currency loss when the position is repatriated.

This is a vicious negative feedback loop, where rupee weakening makes Indian investment less attractive, which leads to exit of foreign capital, which will further weaken the rupee.

2 The market loss: Indian equity markets have corrected meaningfully through 2025-26. The Nifty 50's near-double-digit fall in March 2026 was the headline event, but the broader picture is worse: substantial stretches of the mid- and small-cap markets have fallen 20 to 50 per cent from their 2024 peaks.¹⁰ The "growth premium" that justified Indian equities at premium multiples has been challenged by disappointing earnings reports across major sectors.¹¹ As mentioned earlier, the markets have also not been able to offer any unique value proposition to the foreign investors beyond India's large consumption driven markets, which has been saturated.

3 The tax loss: Even on whatever residual return remains after currency depreciation and market correction, the foreign investor pays a tax that is internationally anomalous. After Budget 2024, India raised short-term capital gains tax for listed equity from 15 per cent to 20 per cent, and long-term capital gains tax from 10 per cent to 12.5 per cent, applicable to FPIs.¹² The crucial subtlety is that this tax is computed on the *rupee-denominated* gain, not on the dollar-denominated economic gain.¹³ A foreign investor whose investment has lost money in dollar terms because of currency depreciation may still owe tax in India on a notional rupee gain. To be sure, the tax policy alone does not explain the outflows, but it compounds the effects of the other three pressures of a stronger dollar, a re-rated growth narrative, and a sectoral rotation India cannot participate in.

To illustrate the effect of these three losses, consider a foreign investor who deployed USD 100 (₹8,500) into Indian equities in January 2025. Twelve months later, the rupee position has appreciated 15 per cent to ₹9,775. The rupee has fallen to 95, so the dollar value of the position is approximately USD 103, a 3 per cent return before tax. India taxes the ₹1,275 nominal rupee gain at 12.5 per cent, deducting roughly ₹160. The post-tax dollar return collapses to approximately 1.3 per cent. The same investor could have held a US Treasury bill yielding 4 to 5 per cent with no due diligence costs, no foreign exchange risk, no General Anti-Avoidance Rules (GAAR) uncertainty, and no annual tax filing in a foreign jurisdiction.¹⁴ Faced with this arithmetic, the foreign investor has responded rationally and exited the country.

The Korea/Taiwan comparison should not be misread as a claim that India's tax regime is the dominant cause of outflows. The lack of a domestic semiconductor or AI-infrastructure listed proxy is what prevents India from participating in the principal thematic allocation of this cycle, which is a structural, long-term constraint that no near-term tax change can fix. What the tax regime does is drive out the marginal investor who came to India for the consumption and growth story, who already faces a roughly 11 per cent currency loss and a double-digit market correction, and for whom the additional 12.5 per cent rupee-denominated capital gains tax, levied on what may be a dollar loss, is the final friction that tips the decision.

Over the past decade, Indian equities have delivered above-EM-average dollar returns, and in such an environment marginal frictions are tolerated. In a globally discriminating environment, where every bit of friction is compared across competing destinations, this becomes decisive. The increase in both short term and long-term capital gains came precisely at the moment when global conditions began tightening and the AI capex rotation began drawing capital allocation away from just consumption-led economies. The structural problem (no AI proxy) and the policy problem (punitive tax on a uniquely elastic base) operate on different margins, and while there is no easy fix for the former, taxes can be reduced or eliminated in the next

budget.

The macroeconomic cost of imposing tax on foreign capital, which includes accelerating capital outflows, depreciating the rupee, depleting the Reserve Bank of India's forward intervention capacity, almost certainly exceeds the revenue raised. The Reserve Bank's net short position in the dollar forward market has grown substantially in recent months, reflecting the scale of intervention required to defend the currency in the face of the very outflows the tax regime is helping to accelerate.¹⁵

4 The Tax Outlier Problem

Beyond being uncompetitive, India's treatment of foreign portfolio gains is anomalous in global terms.

Among the major emerging markets that compete with India for portfolio allocation, the picture is consistent. Brazil generally levies no capital gains tax on non-resident portfolio investors trading on regulated exchanges.¹⁶ Taiwan has no separate capital gains tax on listed securities; the principal levy is a securities transaction tax of 0.3 per cent on sales.¹⁷ South Korea exempts foreign investors from capital gains tax on listed shares unless they hold 25 per cent or more of a company, a threshold that no portfolio investor crosses in practice.¹⁸ Singapore and Hong Kong have no capital gains tax at all, on residents or non-residents.¹⁹

Samir Arora of Helios Capital has argued publicly that of the world's roughly 200 jurisdictions, only India taxes foreign portfolio investors at material rates.²⁰ The precise count is rhetorical, but the substantive claim that India is a global outlier is correct.

The Budget 2024 increase in capital gains rates was, in this context, a self-inflicted wound delivered at the worst possible moment. It coincided with peak market valuations, the beginning of the AI capex rotation away from consumption-led emerging markets, and a hawkish Federal Reserve. The revenue gain from the increase, if any, must be weighed against the macroeconomic cost, which would be measured in the scale of incremental outflows, in rupee depreciation, in RBI forward exposure, and in the funding stress now propagating through the banking system.

The political case for the 2024 capital gains tax increase is straightforward: foreign investors have profited substantially from Indian equities through the post-2020 cycle, the Indian state has real revenue needs to meet, and taxing realised gains at modest rates is a legitimate source of that revenue. However, the marginal cost at which this revenue is raised must be carefully woven into the fiscal arithmetic. Capital gains tax on foreign portfolio investors is a small fraction of the overall tax base, and the additional revenue raised by the 2024 rate hike on FPIs, while not publicly disclosed in disaggregated form by the CBDT, is on any reasonable estimate a small fraction of overall direct tax collections.

Whereas the macroeconomic costs of accelerating the outflows that this tax helps produce, which are rupee depreciation, the depletion of the RBI's forward intervention capacity, the funding stress now propagating through the banking system, among others, almost certainly exceed that revenue by a substantial margin.

Foreign portfolio capital is the most mobile financial asset in existence; a marginal tenth of a percentage point on the rate produces orders-of-magnitude larger movements in allocation than the equivalent change would in any domestic tax.²¹ The global tax community has, with near-unanimity, settled on rates of zero or near-zero for this base. India's decision to move in the opposite direction in 2024 deserves explicit reconsideration.

5 The False Comfort of Domestic Absorption

The principal rebuttal to concerns about FII outflows has been that domestic institutional investors have absorbed the selling. The numbers back this up: domestic mutual funds and insurance companies have absorbed roughly ₹1.7 trillion of equity flows year-to-date in 2026, a substantial offset to FII selling.²² SIP contributions reached ₹32,087 crore in March 2026, with SIP AUM at ₹15.10 lakh crore.²³ Equity mutual funds have recorded net positive monthly inflows for 61 consecutive months, dating to March 2021.²⁴

This is presented as evidence of financial maturity, of "Atmanirbhar markets," of insulation from foreign capital whims. The markets are now dominated by domestic investors, but this has important analytical differences and implications.

First, the composition of "DII flows" is overwhelmingly retail household savings, channelled through mutual funds. This is not stable institutional capital in the way pension funds or sovereign wealth are; it is the aggregated discretionary savings of Indian households, most of whom have never experienced a sustained equity drawdown with their current allocation. The shift from deposits to equity has occurred entirely during a bull market, where the share of equity and mutual funds in household financial savings has risen from low single digits a decade ago to substantially higher levels today and much of that shift occurring during the post-2020 market rally.²⁵ The first real test of SIP discipline through a deep, multi-year correction has not yet happened.

Second, FII selling and DII buying are not occurring in the same securities. FIIs are predominantly large-cap, top-down investors, and have concentrated their selling in large-cap financials and IT services.²⁶ DII inflows, channelled through mutual fund mandates that require minimum exposures to mid- and small-cap segments, have disproportionately flowed into those segments.²⁷ The result

is that mid- and small-cap valuations have remained elevated despite the broader correction. The Securities and Exchange Board of India's chairperson explicitly warned of "froth" and "irrational exuberance" in mid- and small-cap segments in early 2024, and the underlying valuation concerns have not been resolved.²⁸

Third, the loss of foreign capital is also the loss of a particular kind of marginal investor. Foreign portfolio investors are, almost by definition, price-discriminating across countries. A fund evaluating Indian equities is continuously comparing them with Korean, Brazilian, and Indonesian alternatives, and reallocating when relative valuations get stretched. This cross-border comparison is what makes them agents of price discovery: they bring information from global markets into Indian price formation, and they discipline valuations by selling when prices detach from fundamentals. Domestic mutual funds operate under fundamentally different incentives. SIP flows arrive mechanically on the fifth of every month, regardless of whether stocks are cheap or expensive. Small-cap and mid-cap funds are required by SEBI mandate to hold at least 65 per cent of their assets in those segments, regardless of valuation. Fund managers are benchmarked against domestic indices, so the relevant question is whether they beat the Nifty rather than whether the Nifty is fairly valued against global peers. The result is that as foreign ownership has fallen, the marginal buyer in Indian equities has become structurally less price sensitive. Prices are increasingly determined by domestic flow dynamics rather than by competitive comparison with alternative investments. This is precisely what we observe in the mid- and small-cap segments today: valuations sustained at levels that a global investor would not accept, but that mechanical domestic flows continue to bid up. The IPO market of 2024-25, where a string of richly priced offerings still cleared comfortably on retail demand, is a good indicator of this effect. The deeper hidden cost is capital flowing to lower return uses than a more disciplined price regime would have permitted.

Fourth, and most consequentially, the substitution of foreign capital risk for domestic household balance sheet risk is not a neutral trade. When FII's lose money in India, the loss accrues to globally diversified institutional investors with limited political voice in India. When Indian households lose money in a sustained drawdown, the loss accrues to a politically salient middle class with high marginal propensity to consume, thin savings buffers, and substantial influence on policy. A 25 to 30 per cent small-cap drawdown sustained over 18 months would not be absorbed quietly. It would generate consumption shocks, calls for regulatory intervention, and can even slow down the capital market deepening. Given that households have shifted their basic bank savings into the equity market, a sustained drawdown can have macroeconomic impact on India's consumption and savings rate.

The risk has been transferred from global, diversified and mobile

capital to a middle-income household in India.

6 The Banking System Fallout

The savings shift that has cushioned equity markets has simultaneously created a structural funding crisis in Indian banking. Household allocation to bank deposits has fallen substantially as household financial savings have shifted toward equity-linked instruments.²⁹ Between FY2020–21 and FY2024–25, the share of bank deposits in total household financial savings fell from 40.9 per cent to 35.2 per cent, while the share of mutual funds, driven almost entirely by systematic investment plans, rose from 2.1 per cent to 13.1 per cent. The share of deposits in household savings was 58 per cent in 2012.³⁰

On the banking side, deposit growth has trailed credit growth for an extended period, pushing the credit-deposit ratio to multi-decade highs above the Reserve Bank of India's preferred range.³¹ India's credit-deposit ratio has risen secularly with financialisation, from approximately 53 per cent in FY2001 to 69 per cent by FY21, and to 82 per cent by December 2025, the highest in 61 years.³² The share of low-cost current account and savings account (CASA) deposits has fallen as households move from passive deposit balances into investment instruments like equity and mutual funds.

These structural shifts raise the weighted-average cost of bank funds and increase the liquidity risk of the system. Banks have responded predictably. Certificate of deposit and bulk deposit rates have risen, as banks compete more aggressively for term deposits and increasingly access wholesale funding markets. Between 2023–24 and December 2025, deposits increased 9 per cent against credit growth of 11.3 per cent. In the preceding two years — 2021–22 to 2023–24 — the gap was even wider, with deposits growing at 11.9 per cent while credit expanded at 17.6 per cent.³³ Both channels raise the cost of bank funds.

Higher funding costs translate directly into higher lending rates. They also translate into impaired monetary policy transmission. The Reserve Bank of India has cut the policy repo rate substantially over the past several quarters, but transmission to lending rates has been incomplete. Senior commercial bankers have publicly acknowledged that corporate loan rate transmission has been slower than expected because deposit costs are sticky. The savings shift is partially neutralising the central bank's policy stance: when the RBI cuts rates to support growth, but bank funding costs do not fall in step, the policy intent does not reach the small business taking a working capital loan or the household taking a mortgage. The high bank lending rates will directly increase the cost of borrowing for businesses who want to start or expand, which will impact the investment rate in India, which has already been falling. This decreased investment rate leads to lower job creation, lower innovation and a host of macro problems.

Even within the deposit base, the share contributed by households has declined from 64 per cent in FY20 to 60 per cent in FY25, with the gap filled by non-financial corporations. This means that banks have replaced stable, patient household deposits with corporate "hot money".

The state has not been a neutral observer of this shift but has shaped this change through tax policy. Equity capital gains are taxed at 12.5 per cent for long-term holdings and 20 per cent for short-term holdings.³⁴ Interest income on fixed deposits is taxed at the depositor's full marginal income tax rate, with TDS applied at source above modest thresholds.³⁵

Add to this the active campaign of household equity participation through "Mutual Funds Sahi Hai," through SIP-friendly platforms, through the regulatory architecture that has made equity participation frictionless while leaving the deposit saver with the same instruments she has had for decades.³⁶

7 Policy Recommendations

The diagnosis points clearly to five corrections, in order of urgency.

First, abolish capital gains tax on foreign portfolio investors.

The international evidence and the competitive arithmetic clearly indicate the need for India to change its course. India is a global outlier in taxing this base, and the costs of the outlier position, which results in capital flight, currency depreciation, RBI intervention burden, banking system funding stress, among others, substantially exceed any plausible revenue gain. The Budget 2024 increase should be reversed, and the rate should move toward zero in line with global practice. The political objection that this represents a "tax cut for foreigners" is real but manageable. Capital is mobile and will move to places with the least friction. The alternative is a continuing capital outflow that costs the rupee and the broader macroeconomy far more than the foregone revenue.

Second, phase down capital gains tax for domestic investors over the medium term.

The asymmetric treatment of foreign and domestic investors cannot be permanent, and the public finance principle that mobile capital should be taxed lightly applies to domestic capital too, perhaps less acutely, because domestic savers face higher exit costs, but in the same direction. The 2024 increases in domestic LTCG and STCG rates should be reversed, and the medium-term trajectory should be toward harmonisation with global emerging-market norms.

Third, equalise the tax treatment of savings instruments.

The current asymmetry, under which equity capital gains face a flat 12.5 per cent LTCG rate while fixed deposit interest is taxed at the saver's full marginal rate (which can be as high as 30 per cent), is not a defensible position for a state that claims to value financial inclusion. The solution is to extend tax-favoured treatment to long-term fixed deposits and small-saver bond holdings. This is consistent with broad-based household financial security and with maintaining a banking system that can fund the real economy.

Fourth, deepen the corporate bond market and allow banks to compete more freely for deposits. Another solution is to expand the menu of funding sources for banks through a deeper corporate bond market and through more flexible bank funding instruments, and to allow banks to compete more aggressively for deposits through rate deregulation at the margin.

Fifth, broader macroeconomic structural adjustments are needed. High government expenditure through its welfare programmes necessitates high borrowing from the government through banks and high taxes at every level. It's the insatiable appetite for government borrowings that results in fiscal dominance of monetary policy through the banking channels. Of the declining deposits that banks receive, they are forced to park 3 per cent of it as cash and 18 per cent as Statutory Liquidity Ratio, which is mostly G-secs. The fiscal appetite also explains the rapacious nature of the Indian tax system, which makes it a global outlier in taxing foreign capital.

8 Conclusion

The Indian state has, in effect, been running a policy experiment for a decade. It has taxed foreign portfolio capital aggressively, taxed bank deposit interest at full marginal rates, subsidised equity returns through preferential capital gains treatment and actively encouraged the migration of household savings from banks to mutual funds. The implicit bet was that domestic flows would absorb the consequences of taxing foreign capital, and that the broader financial system would adjust without disruption.

The bet has not paid off. Foreign capital has left at scale, the rupee has depreciated, and the consequences are now visible across the financial system: in mid- and small-cap valuations sustained at unsustainable levels, in a banking system facing its tightest funding constraint in a generation, and in weakening monetary policy transmission.

A state that has taxed mobile and immobile capital at the same rates, while the rest of the world has not done so, cannot hope to attract foreign capital. Singapore, Hong Kong, Brazil, Taiwan, and Korea did not arrive at near-zero taxation of foreign portfolio gains out of generosity to foreign investors. Instead, they arrived at it because they recognised that in a world of mobile capital and discriminating allocators, the country that imposes the lightest friction on the marginal investor wins, and the country that imposes the heaviest loses. India has been on the wrong side of this competition for a decade, and the 2024 budget moved further in the wrong direction at exactly the moment the global environment turned more selective.

The fix entails the correction of a set of policy errors: the tax treatment of foreign capital, the tax treatment of bank interest, the asymmetric encouragement of one savings vehicle over

another, and reducing SLR and freeing up banking capital. This will necessarily require far greater fiscal discipline by the government.

Endnotes

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