

# Centre scraps capital gains, interest tax on FII govt bond investments to pull foreign funds

With the rupee under pressure and BoP deficit likely to be around \$50-60 billion, the move is expected to result in good foreign fund inflows.

Written by: [Siddharth Upasani](#) 7 min read New Delhi Updated: Jun 6, 2026 02:10 AM IST



A BoP deficit exerts pressure on the rupee to weaken. (File Photo)

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Amid pressure to attract foreign funds and also stabilise the rupee, the Centre on Friday scrapped the capital gains tax, both long-term and short-term, on investment by Foreign Institutional Investors (FIIs) in government bonds as well as the withholding tax they must pay on their interest income

from these debt instruments. At present, FIIs pay 12.5% tax on long-term capital gains, 30% on short-term capital gains, and around 20% withholding tax on interest income.

The decision, taken after at least two months of internal discussions, is expected to bring tens of billions of dollars in foreign fund into government debt over the coming years, and bridge to some extent the looming balance of payments (BoP) deficit that economists estimate could even touch \$60 billion in 2026-27.

In an ordinance promulgated to amend the Income Tax Act, 2025, after President Droupadi Murmu gave her assent, the government said the changes will come into effect from April 1, 2026. FII investment in government bonds stands at Rs 3.75 lakh crore, or just 3.34% of the available amount of Rs 112.42 lakh crore, under the so-called General Route and Fully Accessible Route (FAR). These are the two ways in which foreign investors invest in Indian government securities.

According to Axis Bank economists, no tax on FII investment in government debt could lead to \$45-50 billion inflows over two years.

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A BoP deficit exerts pressure on the rupee to weaken. While the rupee has gained some ground since nearly breaching the 97-per-dollar mark last month, it is down 5% since the war began on February 27 and has slumped 10.3% in the last one year. After closing at 95.79 per dollar on Thursday, it had strengthened to 95.45 at 1PM Friday. Meanwhile, yields on government bonds declined following the promulgation of the ordinance.

The tax exemption on “any interest on Government security, and any capital gains arising from the sale, exchange or transfer of such Government security” applies to FIIs as well as the Bank for International Settlements. The BIS is an organisation of central banks from around the world. It is yet to invest in India.

Until now, while foreign investors had to pay a long-term capital gains tax of 12.5% on listed stocks and bonds that they hold for more than 12 months, they also had to pay a withholding tax – akin to a tax deducted at source – on interest income from their holding of bonds. Non-residents paid a withholding tax of about 20% on their interest income from government bonds – one of the highest in the world – after a concessional rate of 5% ended in 2023. The tax on short-term capital gains was 30%.

Investors from countries with which India has double taxation avoidance agreements pay lower rates. Meanwhile, investors who don't have an Indian tax residency are at a further disadvantage because

the withholding tax must be paid on the gross amount and losses can't be set off against past gains.

The Indian Express had reported on May 15 the government and the Reserve Bank of India were considering multiple measures to attract foreign investment inflows, including a cut in the withholding tax rate on government bonds, if not completely eliminating it.

Timing with tax elimination, the RBI too said Friday it was “expanding the universe” of government securities that fall in the so-called Fully Accessible Route (FAR) to include all new issuances of 15-, 30- and 40-year bonds.

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“In addition, limits pertaining to short-term investment, concentration and individual securities on FPI investment under the General Route are being removed. These measures along with the tax benefits provided by the government this morning should help attract foreign capital for government borrowing,” Governor Sanjay Malhotra said while announcing a raft of other measures to boost foreign inflows into the country. While he did not specify how much foreign money could come into India because of the steps that have been taken, he said the hope was that a healthy amount would do so.

“The combined impact of these could help bridge the \$40-50 billion gap in the Balance of Payments that we had estimated for FY27. We see an appreciation bias likely for the rupee over the coming months as the actual flows on account of these measures start trickling in,” Sakshi Gupta, Chief Economist at [HDFC Bank](#), said.

Experts have long warned that the withholding tax is an obstacle to stronger foreign inflows, with Ananth Narayan, former Whole Time Member at the Securities and Exchange Board of India, saying last month the tax is the source of a lot of “friction”. “I am not saying that if you solve this tomorrow, money will come in. But this is definitely a barrier for money to come into the country,” he had said.

As such, the removal of the two taxes on Indian government bonds could boost inflows at a time when Foreign Portfolio Investors (FPIs) have pulled out \$28 billion from Indian stock markets so far in 2026.

“The whole world is fixated on foreign portfolio flows into equities, but FPI debt inflows are not insignificant,” DSP Mutual Fund said on Thursday.

Since the start of 2024, net FPI outflows from the equity market have been a massive \$47 billion. Meanwhile, debt has seen net FPI inflow of \$26 billion.

“At a time when the capital account has been pressured by weak equity FPI flows and FDI outflows, debt flows can help bridge the current account deficit, reduce pressure on the rupee and give policymakers one more useful external sector stabiliser,” DSP Mutual Fund further said, adding that the Fully-Accessible Route (FAR) – a category of government bonds that FPIs can invest in without any restrictions – could become a “quasi-open, tax-efficient window for global investors to buy Indian debt”.

As India is a net importer of goods, it suffers from a large merchandise trade deficit. While the surplus from India’s services trade can cover some of the merchandise trade deficit, it is not enough, resulting in what is called a current account deficit, or CAD. Until recently, India has been able to attract enough money from abroad in the form of Foreign Direct Investment (FDI) and FPIs to more than make up for the current account deficit. This results in a positive net number, or a BoP surplus, which is the difference between the money Indians send abroad to pay for imports and make investments and the money India receives from overseas for exports and in the form of remittances and what foreigners invest in India – be it in the [stock market](#) and bonds or direct investment in the form of factories on the ground.

However, foreign investments into India on a net basis have slowed down sharply in recent years as interest rates across the world have risen, with net FDI in 2024-25 and 2025-26 combined being under \$9 billion. This has led to the BoP being in deficit to the tune of \$5 billion in 2024-25 and \$31 billion in the first three quarters of 2025-26. Matters have come to a head due to the West Asia war, which has not only accelerated the exit of foreign investors from domestic financial markets but also increased India’s import bill on account of the sharp increase in energy prices. As a result, economists expect India’s BoP to be in deficit in 2025-26 as well as 2026-27.

