Economic Research | India

No tax on FII debt may lead to USD 45-50bn of bond inflows over 2Y

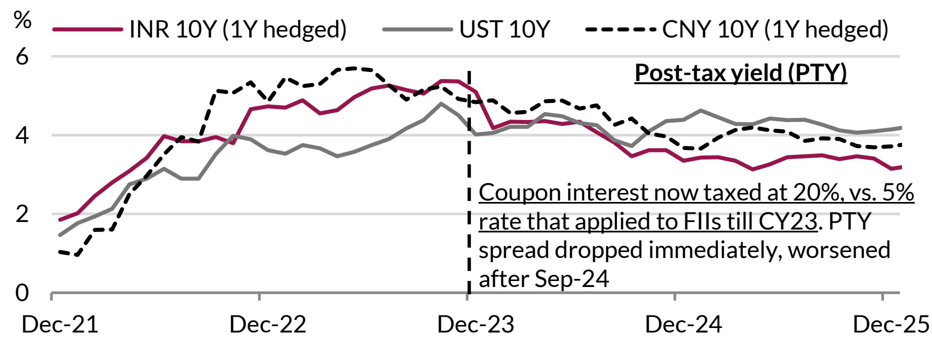
Despite FPI purchases of GSecs being the cheapest form of foreign capital, ownership is <3% due to i) non-inclusion in benchmarks like Global Agg & FTSE WBGI; and ii) low hedged post-tax yields. Progress has been made on market infra and operational concerns, tax reforms before the mid-2026 review could speed up India's inclusion, opening up US$45-50bn of inflows over two years and pave the way for participation from global pension and endowment investors. 20% tax on coupon interest is also well above most peer jurisdictions (some like China give special dispensation/exemption to index-inclusion-led flows), and limits participation, as relative returns are unattractive.

14 May 2026

Capital Flows

FII taxation

Exhibit 1: After-tax INR yield weak; 0% tax→ better returns & inflows→lower hedge cost



Source: Bloomberg, Axis Bank Research; data intentionally stopped in Dec-25

Foreign investments in GSecs are the cheapest form of foreign capital

India needs steady inflows of foreign capital. Its quality matters too: cost, stability, and other benefits (e.g., FDI comes with technology). Inflows from PE/VC funds, while productive, are also expensive: their exits at implied high IRRs pushed FDI repatriation to US$55bn last year, negating gross inbound FDI. FPIs buying GSecs, on the other hand, are the cheapest form of capital, but their ownership remains low at 3% (Fig 4) despite attractive gross yields (no SIP-led valuation distortions). Two reasons i) Not yet part of benchmarks like Bloomberg Global Agg; FTSE WBGI, Fig2); and ii) hedged post-tax yields in India are unattractive (Fig1).

Inclusion in global bond indices delayed by taxation & process-related issues

Factors in favour of India' inclusion: 1) India's size: by 2030 it could be ~5% of global GDP; 2) Fiscal stability when nearly all developed markets (DMs: US, UK, JP) have fiscal stress; 3) Several DMs now show policy volatility and institutional failings earlier attributed to EMs; and 4) Low yields in China (Fig 5). However, decision deferral in Jan-2026 was due to "settlement & post-trade tax process delays, lack of automated workflows, and repatriation… for FPIs". We understand progress has been made on these, like in repatriating proceeds faster, extension of settlement hours and entry of Exchange-Traded Products.

Tax reforms could unlock large bond inflows, support INR

Both Global Agg and FTSE WBGI (AUM ~USD 4.5tn, Fig 2) seek clarity or exemption on taxes (govt. considering reducing taxes on FPI debt investments). Inclusion could imply 45-50bn of inflows over two years, and greater allocation from pension funds/endowments not using these as benchmarks but taking comfort from inclusion and the clarity on taxation. Several major nations do not tax bond investments, and even those that do, like China, gave a special dispensation to investors that entered after index inclusion (tax exemption granted has so far been extended repeatedly). Further, coupon interest tax of 20%, higher than in most peer jurisdictions (Fig 7), reduces the relative attractiveness of Indian debt (Fig 1).

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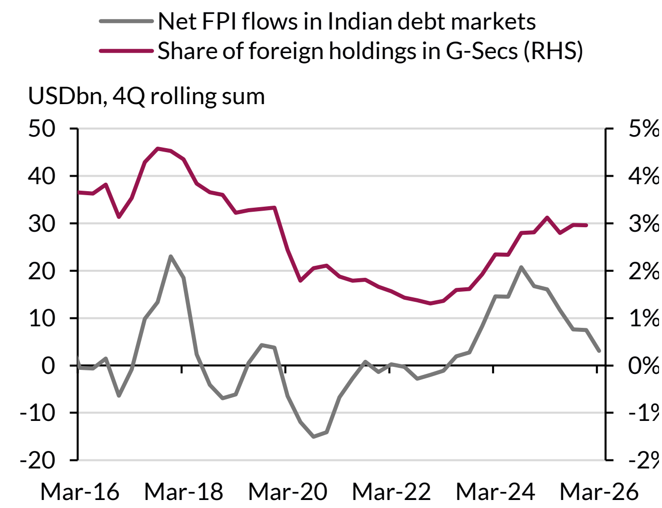
Exhibit 2 - Inclusion in Global bond benchmarks would be a gamechanger

	Global Bond Benchmarks		EM Bond Benchmarks
Index	**Bloomberg-Barclays Global Aggregate Index (Global AGG)**	**FTSE World Government Bond Index (WGBI)**	**JP Morgan Government Bond Index-Emerging Markets (GBI-EM)**
EM Relevance	HC and LC Sov and Corp	HC and LC Sov	LC Sov
Min. issue size	YES		YES
Weighting*	Market Capitalization		Modified market cap.
Rating criteria	Investment grade rating required		More liberal
Other key criteria	More demanding criteria that EM indices on local market investability criteria including settlement and clearing, capital controls and tax regimes.		Bespoke criteria to determine EM status. Less demanding investability criteria
Liquidity criteria	YES		YES
Min. Maturity criteria	At least 1Y remaining		2.5Y; exit when less than 13 months to maturity
AuM benchmarked to the index (USD)	Approx. 2 tn each		236 bn
Taxes	Clarity on tax regime	No taxes	Taxes are ok if it doesn't impair index replicability
Capital controls and investment restrictions	No capital controls, quotas, investment restrictions	No capital controls, quotas; sustainable issuance; transparent monetary policy	No capital controls, quotas, investment restrictions

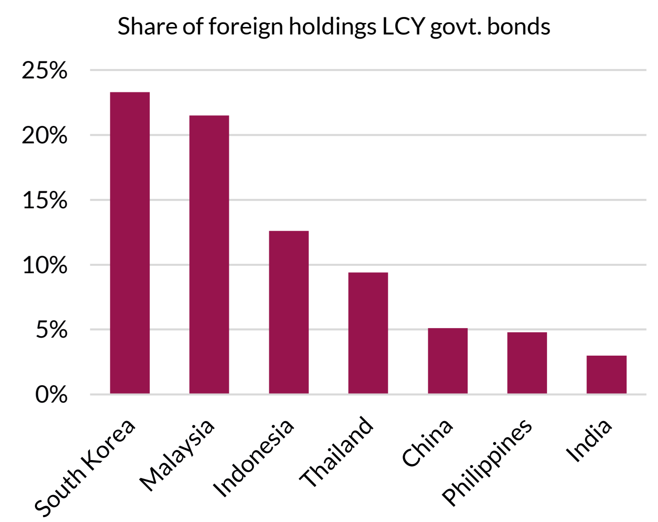
Source: IMF Working Paper (2020): Benchmark driven investments in EM bond markets, Axis Bank Research; LC = Local Currency; HC = Hard Currency

Exhibit 3 - FPI inflows picked up sharply post JPM GBI inclusion, weak now; another index inclusion to help



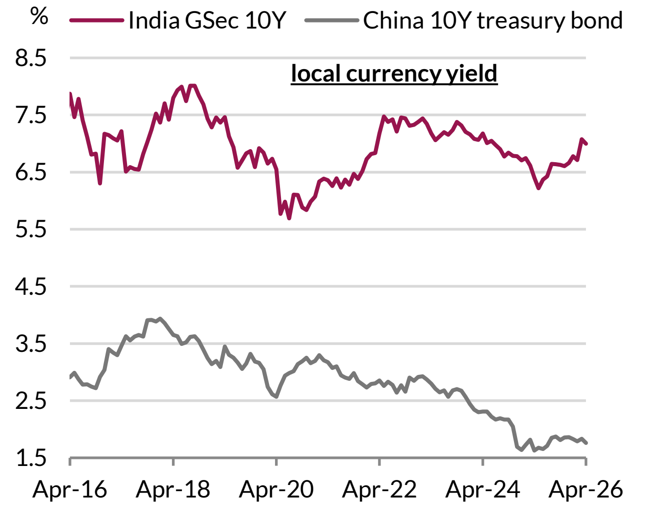
Source: CEIC, Axis Bank Research

Exhibit 4 – Record low FII participation in India debt: tax reforms needed to attract FII debt flows and index inclusion



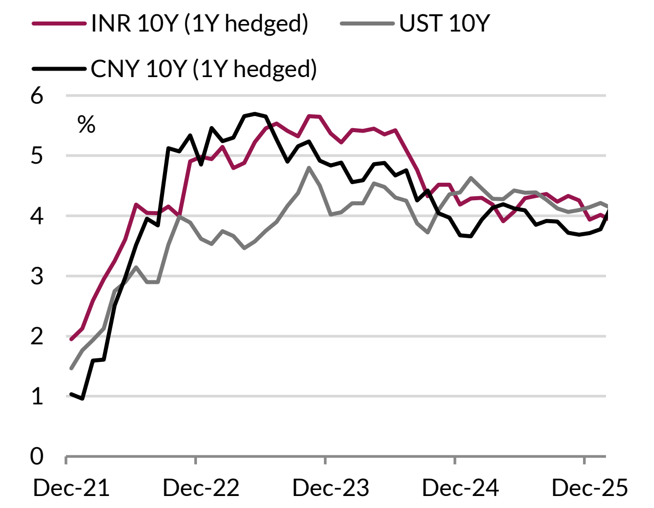
Source: CEIC, Axis Bank Research

Exhibit 5 – Unhedged investors would want to diversify CN bond gains and G-Sec yields more attractive vs. CN bonds LT



Source: Bloomberg, Axis Bank Research

Exhibit 6 – Assuming zero taxation, 1Y USD hedged coupon returns in India weren't too low vs. US and China



Source: Bloomberg, Axis Bank Research

Exhibit 7 - A look at how FIIs are taxed across important jurisdictions

Country	Tax rate applicable on Interest	Reduced tax rate applicable to eligible US tax resident investor	Notes
Brazil	15% to 22.5%	NA	Tax applicable depending on the holding period. Non-tax-haven investors should be subject to a 15% WHT rate.
China	10%	10%	**Circular 108 temporary exemption for interest is now extended to December 31, 2027. Interest on certain government debt are exempt.**
France	Exempt	Exempt	
Germany	Exempt	Exempt	
Indonesia	20%	10%	
Korea	Exempt or 15.4%	13.2%	Interest from bonds issued by the Korean government and interest from Monetary stabilization bond exempt from taxes. Interest on local government bonds at 15.4%
Malaysia	Exempt	NA	
Mexico	Exempt		
Singapore	15%	NA	Possible exemption on interest derived from qualifying debt securities issued within a specific time range
South Africa	15%	Exempt	Certain portfolio interest, incl. that arising from government bonds and listed debt instruments, may be exempt
Thailand	Exempt		
UK	20%	Exempt	Interest on Quoted Eurobonds and QPPs should be exempt from withholding tax.
US	Exempt	NA	
India	**20%**	**10% or 15%**	

Source: Global Withholding taxes report, KPMG (link), Axis Bank Research

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