

Rationalization of Capital Gains Tax in India: Implications for Equity Market Participation and Investment Decisions

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ABSTRACT

Capital gains tax (CGT) is also a significant part of the fiscal system that has impacts on the investment behavior, capital formation, and general development of equity markets. The capital gains taxation in India has been subject to periodic rationalization, simplification and stability of revenues. Nonetheless, its implication on the participation of equity market and investment decision-making are an area to subject to further analytical scrutiny. This research aims at exploring the effects of capital gains tax rationalization on equity market participation in India through a combination of theoretical underpinnings of taxation as well as behavioral finance lenses. The research is based on Haig-Simons net accretion principle which takes income as growth in economic power and also covers the theoretical explanation of why capital gains should be taxed and also discusses issues like inflation gains, realization based tax and lock in effect which distort allocation of capital.

The research design is descriptive and analytical in that it will be based on the use of secondary data such as trend in the growth of the demat accounts, special participation of investor and the proportion of retail ownership of market capitalization in recent years. The results indicate that there is immense growth in the participation of the equity markets even with the existence of capital gains taxation. The fact that the level of retail investors and the proportion of ownership have sharply risen is an indication that capital gains tax did not serve as a form of prohibition to the entry into the stock markets. Rather, a greater impact on growth in participation seems to have been delivered by broader structural factors, which include financial inclusion and digital trading platforms, increased awareness, and investor confidence.

The paper, however, observes that capital gains taxation has more subtle impacts on the behavior of investors by interfering with the expected after-tax returns, risk perception, the choice of holding period and the portfolio allocation strategies. Capital gains tax rationalization, achieved by simplification of the rates, good transparency in classification of holding periods, and by enhancing better neutrality can be used to minimize distortions, lock-in effects, and promote long-term investment orientation. The research findings end by asserting that capital gains tax is not only a revenue-generating tool but it is a policy tool that can influence financial behavior and sustainable development of capital markets. Proper and fair taxations can boost the depth of the market, consumer involvement, and promote the greater goals of India of financial inclusion and economic development.

Keywords: Capital Gains Tax (CGT), Tax Rationalization, Equity Market Participation, Behavioral Finance, After-Tax Returns, Digital Trading Platforms, Tax Policy and Investment Behavior

JEL classification: H24, H21, G11, G18, D14, O16

1. INTRODUCTION

Capital Gains Tax (CGT) is very instrumental in determining investment behavior, capital allocate on and equity market development. Capital gains in India are as a result of transfer of capital asset and are taxed under Section 45 to 55A of the Income Tax Act, 1961. Capital gains are not similar to ordinary income since they signify the increase in the value of the assets over time and not the common periodic income (Akhtar, 2010).

The amount of taxes which one pays on the capital gains is theoretically determined by the Haig-Simons net accretion principle, which describes income as the net growth of an economic power of an individual within a

timeframe. Under this principle, capital gains amount to a growth of wealth and hence should be included in taxable income (Akhtar, 2010). Nevertheless, the capital gains taxation is still debatable because of its issue of inflationary gains, determination of taxation by realization, lock-in phenomena, and how it may affect the decisions made by investors in a distortive manner.

Capital gains tax has direct implications on the post-tax returns of investors, risk perceptions, decision to maintain their holdings and choice of portfolios in equity markets. The empirical evidence indicates that stock market participation has been low across the globe something commonly known as the stock market participation puzzle (Christelis et al., 2010; Guiso et al., 2003). Among the explanations that do not participate is fixed costs of participation which consist of transaction costs and taxation (Calvet et al., 2007; Vissing-Jorgensen and Attanasio, 2003).

The literature on behavioral finance also states that awareness, trust, education, and herding behavior determine stock market participation (Banyen and Nkuah, 2015). The more aware and trusting investors in financial institutions would be interested in equity markets. Likewise, risk aversion plays a major role in the choice to participate with investors having higher financial risk having low chances to participate in stocks (Langat, 2019).

Other areas that are highly influential in increasing stock market participation are financial literacy, social inclusion, and digital inclusion (Parvin and Panakaje, 2022). Better informed investors who have access to information are more comfortable making decisions in equity investment. Moreover, cognitive

Other abilities, including financial planning, and risk perception, are important in moderating investor intentions to engage in stock markets (Akhter and Hoque, 2022).

All these behavioral dimensions are affected by taxation by modifying the expected after-tax returns and perceived investment risk. The tendency to raise the net returns by net losses in capital gains tax can raise perceived risk, deter long-run investment, and decrease the participation in equities. Rationalization of capital gains tax, on the other hand, by simpler rates, benefits of indexation and a clearer definition of the holding period can raise the efficiency of investments and wide-scale participation.

India has been conducting regular capital gains tax reforms which aim to achieve rationalization and stability of revenues. Nevertheless, there is scarce literature on the direct influence of such rationalization on the participation and investor behavior in the Indian equity market.

This paper thus aims at examining the effects of rationalization of capital gains taxation in India on participation and investment choices of equity markets through the combination of both the theory of taxation and the view of behavioral finance.

2 LITERATURE REVIEW

The theory of capital gains taxation lies in the principle of net accretion of income that explains income as the growth of the economic power of an individual during a given period. In this framework, capital gains are appreciation of wealth, and hence they are classified as taxable income base (Akhtar, 2010). Taxation of capital gains has however been controversial with some of the concerns being inflationary gains, taxation based on realizations and lock-in effects. Taxation can be on the basis of realizations which can make investors unwilling to sell their realized asset, hence disrupting the capital allocation decisions (Akhtar, 2010). These hypothetical issues show the need to rationalize capital gains tax frameworks in order to achieve neutrality and economic efficiency.

Financial economics has extensively examined stock market participation especially as applied to the stock market participation puzzle, in which the comparatively low household participation rates in equity markets are contrasted with their historically higher returns (Guiso et al., 2003; Christelis et al., 2010). The presence of fixed costs of participation such as transaction costs, information costs and tax-related costs are one of the reasons behind the lack of participation (Calvet et al., 2007; Vissing-Jorgensen and Attanasio, 2003). The expected after-tax returns are also decreased by capital gains tax, thus it can be considered an implicit cost of participation, which can deter investment in equities.

Literature of behavioral finance also provides the fact that the psychological and social factors play a role in the participation decisions. According to Banyen and Nkuah (2015), level of awareness on stock markets, trust on financial institutions, education level, and herding behavior have a significant effect on stock market participation. The more informed and trusted investors tend to be the more they are willing to participate in the

equity investments and the less the information and mistrust they have the lower the participation level. These results indicate that the behavioral variables can be influenced by the policy variables like taxation to determine the investment behaviour.

Another determinant which is vital in the participation of the stock market is Risk aversion. The study by Langat (2019) has investigated the correlation between risk aversion and the decision to participate and discovered that risk averse consumers are unlikely to invest in equity. Because capital gains tax lowers net returns and could also elevate the perceived risk, it can enhance risk-averse behavior and deter stock market investment.

There is also financial literacy and cognitive ability that is relevant in decisions that pertain to

investment. According to Parvin and Panakaje (2022), financial literacy, social inclusion, and digital inclusiveness have been important in having a role to play in stock market participation. People who have more information about finance and access to online platforms have a better chance of investing in equities. Equally, Akhter and Hoke (2022) established that the attitudes of investors, financial planning capacity, perceived financial risk, and financial satisfaction have an impact on their behavioral intentions to join stock markets. These mental and attitude variables moderate the reaction of the people to the change in financial rewards such as taxation.

Market environment and forecasted returns also affect the decision making process of investment. Kazimoto (2016) identified that the portfolio selection decisions depend greatly on the expectations of returns, the benefits of diversification, and access to the degree of equity investment information. The taxation of capital gains has direct implications on the expectation of returns and hence a shift in taxation can have an impact in the portfolio allocation and holding period plans.

Also, risk-sharing arrangements, which are developed into equity participation models imply that low levels of financial distortions can lead to increased investment levels (Bashir and Darrat, 1992). The policies allowing risk-sharing and lowering structural burden on investors can stimulate the increase in the capital formation. In this aspect, capital gains tax rationalization can lead to the realization of a better level of efficiency in investments and participation in the market.

Despite great body of literature on stock market participation and behavioral determinants of investment decision making, however, there is less work that attempts to directly correlate capital gains tax rationalization in India with behavior of the equity market participation. Majority of research analyses the taxation either with a revenue perspective or theoretical stand point or researches on behavioral finance alone. Thus, the research gap is in the integration of the tax policy analysis and behavioral finance to comprehend the impact of the capital gains tax rationalization on investment decisions and participation in the equity markets.

3. METHODOLOGY

The research design used in this study is the descriptive and analytical research design that entails theoretical analysis and synthesis of the literature to determine the implication of capital gains tax rationalization on the equity market participation and investment decisions in India.

The main aim of the study is to explore the theoretical and practical concepts of the capital gains taxation in India and to investigate the effect that the rationalization of capital gains tax has on equity market participation.

The research also seeks to determine the role of taxation in investment choices with special consideration to risk-taking behaviour, portfolio allocation policy and holding policy. Also, the study incorporates both behavioral finance and the analysis of tax policies in an attempt to comprehend the way investors react to changes in capital gains taxation.

The methodology of the research is based on the study of doctrines and the synthesis of the literature. The doctrinal analysis entails a close study of capital gains taxation theory and the Indian taxation system, the conceptual basis of income taxation and structural aspects of capital gains tax provisions.

The literature synthesis part will assess the available empirical research on the subject of stock market participation, risk aversion, financial literacy, cognitive skills, and awareness and other behavioral factors that can

dictate whether an individual invests or not. The study uses previous studies about the cost of participation and behavioral finance to put capital gains taxation as a structural variable that transforms expected after-tax returns and the behavior of investors.

The study conceptualizes the analytical framework of a causal relationship where the expectations of the after-tax returns due to the rationalization of capital gains tax result in alteration of the expected risk of returns that will result in risk perception by the investors which subsequently determine the decisions regarding equity market participation and portfolio allocation. By this classification, the tax system is perceived not just as a source of revenue but as one of the policy variables that are able to influence the level of financial decision-making and participation in the market.

Solution-wise, this research would suggest that rationalization of capital gains tax, by simplification, reduction in complexity, and enhanced neutrality, can lessen bias in investment decisions, enhance tax efficiency, encourage long-term equity participation, mitigate the strengths of lock-in, and ensure depth of the capital market and financial inclusion.

The paper puts its conclusion by suggesting policy changes which would provide equilibrium, efficiency and revenue factors and encourage more retail investor involvement in the equity markets of India.

3.1 Research Gap

Despite the wide amount of literature on the participation and the behavioral determinants of investment decisions in stock markets, there is little literature that directly associated capital gains tax rationalization in India and equity market participation behavior. The literature before this mainly dwells on the theoretical elements of the capital gains taxation, or on other drivers of behavioral finance, including risk aversion, financial literacy, and investor psychology. Nevertheless, there is a paucity of studies that combine the analysis of taxation policy and behavioral reactions in the Indian environment. This gap identifies the necessity of a general framework that can investigate the effects of varying capital gains tax structure on their predicted after-tax returns, risk perception, and participation choices. The current research paper tries to fill this gap through the integration of doctrinal tax analysis and market participation data and behavioral observations.

3.2 Limitations of the Study

The study has limitations, in as much as it has been contributing to the field of analysis. To begin with, it depends mostly on secondary data and theories that can restrict the possibility of having direct cause-effect links of capital gains tax reforms and investor behavior. Second, the research fails to use primary survey data to gain perceptions of taxation at the individual level. Third, the analysis is narrowed down to equity market participation and not to other assets, e.g. real estate, bonds or derivatives. Also, market cycles, interest rates and world economic conditions are other external macroeconomic indicators which could also affect the participation trends but are not independently isolated in this study. Such limitations imply that the future study can be based on empirical modelling and primary data to be stronger validated.

4 DISCUSSION

The sub-section examines equity market participation trends in India in the light of capital gains tax (CGT) rationalization especially following the reintroduction of the 10% Long-Term Capital Gains (LTCG) tax on listed equities in 2018 in the Union Budget.

In order to be consistent and prevent instances of overlap of data, the year upon which analysis shall be conducted is considered 2020 as consolidated and similar data regarding demat accounts, unique investors and retail ownership share have always been available since 2020.

4.1 Growth of Demat Accounts

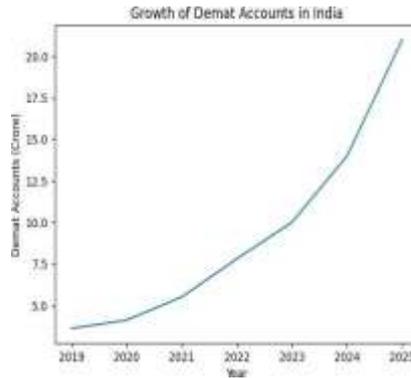


Figure 1: Growth of Demat Accounts in India (2019–2025)

Source: NSE, NSDL, CDSL Annual Reports (2019–2025).

The growth of demat was seen to grow by around 21 crore in 2025 compared to about 4.1 crore in 2020, which is over five times the growth in five years.

Interestingly, this growth has been massive since it follows the reinstatement of the 10% LTCG tax in 2018. Had taxation of capital gains served as a potent discouragement to the participation in equities, the following years would have anticipated a sluggish or a stagnant increase in the number of accounts opened. Nevertheless, the demat accounts were steadily increasing in the period between 2018 and 2020, and in the period after 2020, the rates speeded up.

This growth implies that the capital gains taxation did not have a strong negative effect on the entry level by reducing the entry into equity markets.

The influence of structural factors including digital trading sites, fintech growth, lenient KYC requirements, escalated smart phone accessibility and wider a financial inclusion efforts seem to have created a more influential impact on participation patterns.

This implies that CGT as a determinant of net returns is more of a cost driver of the market as opposed to an aspect of market access-barrier.

4.2 Growth of Unique Investors

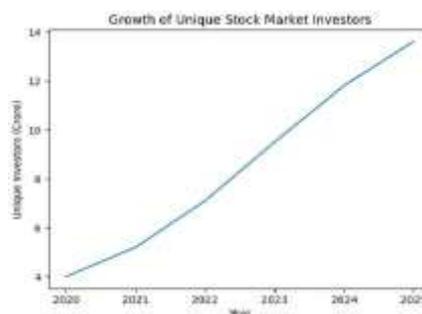


Figure 2: Growth of Unique Investors (2020–2025)

Source: SEBI and NSE Investor Data Reports.

There was an increment of unique investors by around 4 crore in 2020 to 13.6 crore in 2025. This increase is equivalent to real growth in the number of investors and not numerous account openings done by the current members.

The rise in special investors shows an increase in the demographic involvement and the awareness of the investor.

The information indicates that taxation did not deter first-time investors to join the equity markets.

Nevertheless, entry has been expanding, but CGT can possibly affect the magnitude, frequency and time

duration of investment activity. The investor can change the magnitude of portfolio, the rate of turnover and the holding period based on the expectations of after-tax returns.

This finding is consistent with the participation-cost theories which state that taxation influences the intensity of investment and the allocation decisions instead of whether a firm enters the market.

4.3 Retail Share of Market Capitalization.

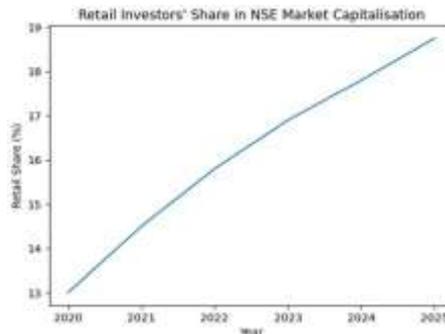


Figure 3: Retail Investors’ Share in Market Capitalisation (2020–2025)

Source: NSE Ownership Pattern Reports; SEBI Statistics.

The proportion of retail investors in the total market capitalization rose by 13% in 2020, to about 18.75% by 2025. It is one of the highest levels in recent decades, which must be verified also with the help of SEBI and NSE ownership statistics.

The retail investors are also getting into the market at an alarming rate, besides taking up a larger percentage of shares.

The increase in retail ownership shows the interest being more engaged, market confidence, and capital market depth.

Long-term orientation to investment may have been encouraged by the capital gains tax rationalization, which includes better classification of holding period and comparatively stable rate structure, which lowered the uncertainty about treatment under taxation.

Nevertheless, any assertion on the highest levels in history has to be appropriately backed by official data sources to uphold academic integrity.

4.4 SUMMARY OF KEY INDICATOR

Indicator	2020	2025	Growth Pattern	Implication	Indicator
Demat Accounts	4.1 Cr	21 Cr	Very High Growth	Increased market access	Demat Accounts
Unique Investors	4 Cr	13.6 Cr	Strong Growth	Broader participation	Unique Investors
Retail Market Share	13%	18.75%	Steady Increase	Rising ownership confidence	Retail Market Share

4.5 OVERALL DISCUSSION

The observed empirical patterns indicate that there was a massive increase in the participation of equity markets in India even with the availability of capital gains taxation. The capital gains taxation has not been a detriment to joining equity markets, with participation growing faster in the following years than it had in 2018 when the 10% Long-term capital gains (LTCG) tax was reintroduced, which did not reverse and suppress growth in participation. The results indicate that investors still take part despite post-tax returns being slightly lower meaning that CGT acts as a moderating variable rather than restrictive. Whereas taxation seems to have no effect on the first-time participation, it seems to have an effect on the holding period decisions, strategies of portfolio allocations, and the perceived risk-reward trade-offs. Such structural and behavioral motivations as the enhancement of financial literacy, the inclusion of the digital component, the penetration of fintechs, access to simplified trading, and market awareness appear to peer out a potential threat of tax disincentives in the participation patterns. Behaviorally, capital gains taxation can have implications on short-term and long-term investment choices, investment choices in terms of lock-in, post-tax return predictions, and rebalancing actions of the portfolio. To that end, the result is indicative of a subtle conclusion: capital gains tax rationalization does not invariably boost the participation rates as such, simplification, predictability, and impartiality in tax structure contribute to the minimization of distortions and augments efficiency in the equity market. Nevertheless, although aggregate data show no direct adverse correlation between capital gains taxation and participation increase, this research is not asserted to have causal inference because it relies on descriptive analysis which is secondary.

5 CONCLUSION

This paper has explored the reason why capital gains tax rationalization has implications on the participation of the equity market and on investment decisions in India by using a combination of the taxation theory and behavioral finance frame of reference assessments and the secondary market data. The results show that the equity market has become increasingly active in India over the past few years and this has been evident in the fact that the number of demat and unique investors as well as retail ownership share in the total market capitalization have significantly increased. Retail participation has been on the rise even after capital gains taxation has been introduced and reintroduced implying that taxation has not been a significant obstacle to joining equity markets.

Nevertheless, capital gains tax does not necessarily deter investors to enter the market, but there are more subtle effects of the policy. Tax structure influences expected after-tax returns which in turn influence holding period decisions, risk perception, portfolio allocation strategies, and timings of realization. The facts are that rationalization, which is simplification, predictability and neutrality of tax provisions may decrease distorting factor like lock in effect and excessive short term speculation and enhance long term orientation towards investing. An effective tax system that will reduce complexity without impacting on revenue goals seems to be agreeable to long term capital market growth.

This paper finds that capital gains tax cannot be considered only as a revenue-generating tool, but it can also be a powerful policy tool that can influence financial market behavior. Well-considered and reasonable tax reforms have the potential to enhance capital markets, financial inclusion, and retail involvement and sustain equity and efficiency in the taxation system. Policy interventions must therefore be targeted at ensuring that there is a transparent, stable, and investor-friendly capital gains tax regime in relation to the long term goals of the Indian economy in terms of economic development and the development of its capital markets.

The analysis can be furthered in future studies by using primary surveys to investigate the micro level perception of taxation by investors and using econometric modeling to determine the causal effects of certain types of tax reforms on levels of trading and levels of participation. The interaction of capital gains tax with other market taxes like securities transaction tax and the taxation of dividends through comparative cross-country analysis and examination can further enhance the knowledge on policy. This kind of research would be more empirically validated and it would facilitate more expansive policy formulation

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