Tax nudges and tight fiscal math

Efforts to attract foreign inflows and steer investment are welcome, but revenue assumptions do not match GDP growth

MACRO PERSPECTIVE

R KAVITA RAO

In her Budget Speech for 2026-27, Finance Minister Nirmala Sitharaman has articulated a plan to encourage investment in a range of industries through tax and non-tax measures. Viewed in the context of global uncertainties and the emerging need to encourage and sustain foreign capital inflows, the Budget proposes support for agriculture, manufacturing as well as services with an eye on improving employment outcomes and broad-based participation in the labour market.

Here we focus mainly on two sets of issues: The changes in the income tax regime and the fiscal balance as presented in the Budget.

Changes in income tax: Part B of the Budget speech includes a number of important announcements in income tax rules. One significant announcement relates to the nudge to corporations to move from the old income-tax regime to the new regime. As reported in the revenue foregone statement, the share of corporate incomes reported in the old regime is not declining consistently over the years. Across all income categories reported, the share of incomes reported in the old regime has increased between 2022-23 and 2023-24. Nearly 38 per cent of total incomes in 2023-24 were reported under the old regime, compared with 34 per cent in the previous year. The introduction of the regime did not, *per se,* do enough to nudge adoption of the simplified regime with lower taxes and fewer exemptions and concessions.

To address this concern, the Budget proposes to change the format of the minimum alternate tax (or MAT). MAT is applicable in the old regime as a pre-payment of tax for which credit MAT is available in subsequent years. Going forward, partial MAT credit will be available only to companies that adopt the new regime. For companies that choose to remain in the old regime, MAT will become a final tax with a rate of 14 per cent, marginally lower than the current 15 per cent. With this change, it is expected that a number of companies will opt for the new regime, allowing for a gradual phase-out of the complexity of multiple regimes. A commendable change and a useful nudge.

The second set of changes in income tax is aimed at attracting foreign inflows into the country alongside improving the business environment for globally integrated activities. These include two sets of provisions. To make India an attractive destination for select forward-looking sectors, the Budget proposes a long-term tax holiday till 2047 to foreign companies providing Cloud computing services globally using Indian data centres. The long horizon of the tax holiday could provide an attractive incentive to encourage investment in Indian data centres. Safe harbour rules, with profit margins of 2 per cent of invoice value for the supply of components to electronics manufacturers and tax exemption for the supply of capital goods for toll-manufacturing in India up to 2030-31, are expected to encourage these activities in India.

Information technology (IT) and information technology-enabled services (ITeS) are major foreign exchange earners for the country. The rationalisation and reduction of profit margins under safe harbour rules for the IT and ITeS sectors, and the streamlining of advance pricing, are aimed at supporting the growth of this sector.

The selective process of identification of sectors and segments for incentives suggests considerable homework. However, the return to incentives within the tax regime might be a cause for concern and it could induce requests for expanding the scope of incentives to cover other sectors as well. Periodic review of the effectiveness of these interventions might be useful for ensuring the effectiveness of policies.

Fiscal equation: The finance minister has stood by her commitment to bring the fiscal deficit-to-gross domestic product (GDP) ratio down to 4.5 per cent or lower by 2025-26. Fiscal deficit for 2025-26 at 4.4 per cent of GDP matches the target set in the Budget. With the new fiscal anchor of debt-to-GDP and the objective to reduce the ratio to 50 per cent (+/-1 per cent) by 2030-31, the finance minister has chosen a modest target of reducing the debt-to-GDP by 0.5 per cent in the current fiscal, which translates into a fiscal deficit-to-GDP of 4.3 per cent for 2026-27 — almost the same level as in 2025-26. Given the uncertain global economic environment, this target does provide some fiscal space to address the country's short-term and medium-term goals. However, going beyond the headline number, there are some issues to consider. GDP for the year is projected to grow by 10.1 per cent, which could be broadly decomposed into 7 per cent real growth (following the Economic Survey) and 3 per cent inflation in the GDP deflator. There could be some modest downside risks to inflation, as in the last two years.

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The revenue forecasts, however, do not match up to the GDP forecasts. Gross tax revenue is forecast to grow by 8 per cent while the tax revenues net of transfers to states are growing at 7.2 per cent. Looking at the components, while direct taxes are growing at over 11 per cent, slower growth is reported for Central goods and services tax (CGST) and Customs. While the proposed changes in Customs tariffs could account for a slowdown in Customs revenues, there is no reason for CGST to register a moderation in growth. The impact of the GST rate cut should be incorporated into the prices during the current year. If no further rationalisation of rates is proposed, GST collections might provide an upside in revenues in 2026-27 if GDP growth rates hold.

The author is director, National Institute of Public Finance and Policy, New Delhi.
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