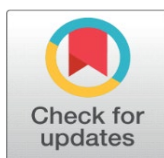


THE ROLE OF TAX DEDUCTIONS IN SHAPING INDIVIDUAL FINANCIAL BEHAVIOR IN INDIA

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DOI

[10.29121/shodhkosh.v5.i7.2024.6111](https://doi.org/10.29121/shodhkosh.v5.i7.2024.6111)

Funding: This research received no specific grant from any funding agency in the public, commercial, or not-for-profit sectors.

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ABSTRACT

Tax deductions are a key fiscal tool that influences how individuals in India manage their finances, save, and invest. By allowing taxpayers to reduce their taxable income through specific expenditures and investments, deductions encourage financial behavior aligned with both personal goals and national economic objectives. Under the Income Tax Act, 1961, various sections—such as 80C for investments in provident funds and life insurance, 80D for health insurance premiums, and 80E for education loans—provide structured incentives that shape financial decisions. These provisions not only offer immediate tax relief but also motivate long-term financial planning, contributing to capital formation, social welfare, and economic stability.

The impact of tax deductions is particularly significant in guiding savings behavior. Many individuals start investing primarily to avail tax benefits, gradually building habits of disciplined saving. Instruments like the Public Provident Fund (PPF) and Equity Linked Savings Schemes (ELSS) gain popularity because of the dual advantage of returns and deductions. Similarly, deductions on home loan interest and principal repayment encourage home ownership, while those on health insurance premiums promote better risk management. Furthermore, deductions under 80G stimulate charitable donations, reflecting how fiscal policies can promote social responsibility. However, the benefits of tax deductions are unevenly distributed, favoring individuals in formal employment with higher taxable incomes, while informal workers and low-income households often fail to utilize these provisions fully. The recent introduction of the new tax regime without deductions has also altered financial behavior, as taxpayers now weigh simplicity against the benefits of deductions.

The Study concludes that tax deductions serve as more than just a means of reducing taxes; they actively influence individual choices related to savings, investments, and consumption. This interplay highlights the power of tax policy as a driver of financial behavior in India.

Keywords: Role, Tax Deductions, Individual Financial Behaviour, India

1. INTRODUCTION

Tax deductions refer to specific amounts that taxpayers are allowed to subtract from their gross income to arrive at their taxable income. In India, these deductions are provided under various sections of the Income Tax Act, 1961, such as Section 80C, 80D, and 80E, among others. They act as financial incentives offered by the government to promote certain expenditures or investments, such as contributions to provident funds, health insurance premiums, education loans, and charitable donations. By reducing the taxable income, tax deductions lower the overall tax liability, encouraging individuals to channel their money into areas that align with government policies and long-term personal benefits.

Financial behavior refers to the patterns and decisions individuals make in managing their financial resources, including earning, spending, saving, investing, and borrowing. It is influenced by a combination of personal goals, risk appetite, income levels, cultural norms, and external factors such as economic policies and tax incentives. In the Indian

context, financial behavior often reflects a balance between traditional saving habits—such as investing in gold and property—and modern financial planning that includes mutual funds, insurance, and retirement schemes.

The interaction between tax deductions and financial behavior is significant. Tax deductions motivate individuals to adopt disciplined saving and investment practices, influencing choices like purchasing insurance or investing in tax-saving schemes. Therefore, they serve not only as tools for reducing taxes but also as mechanisms that shape financial habits and contribute to broader economic objectives.

1.1. OBJECTIVE OF THE STUDY

This study explores the Role of Tax Deductions in Shaping Individual Financial Behavior in India.

2. RESEARCH METHODOLOGY

This study is based on secondary sources of data such as articles, books, journals, research papers, websites and other sources.

2.1. THE ROLE OF TAX DEDUCTIONS IN SHAPING INDIVIDUAL FINANCIAL BEHAVIOR IN INDIA

Tax deductions play a critical role in shaping individual financial behavior in India, influencing decisions related to savings, investments, consumption, insurance, education, and health expenditure. These deductions act as financial incentives embedded in the tax system, encouraging individuals to allocate their income in ways that align with broader economic and social objectives. The Indian tax regime, especially under the old tax regime that allows for various deductions, significantly affects the way individuals plan their finances, demonstrating the government's ability to steer economic behavior through fiscal policy tools.

In India, tax deductions are primarily governed by the Income Tax Act of 1961, which provides a framework of exemptions and deductions to encourage certain forms of economic behavior. Section 80C is perhaps the most well-known among taxpayers, offering deductions for investments and payments such as Life Insurance Premiums, Public Provident Fund (PPF), Employee Provident Fund (EPF), National Savings Certificates (NSC), Equity Linked Savings Schemes (ELSS), tuition fees for children, and repayment of home loan principal. These instruments and expenditures not only allow taxpayers to reduce their taxable income but also guide them toward future-oriented financial planning. The policy rationale behind such deductions is twofold: first, to incentivize individual savings and investment that support capital formation in the economy; and second, to support sectors deemed socially beneficial, such as housing, education, and health.

The influence of tax deductions on savings is particularly noteworthy in a country like India where financial literacy and planning habits are still evolving among a large section of the population. Before the wide availability of digital financial tools, many taxpayers were largely dependent on the guidance of financial advisors, family traditions, or employer recommendations when making financial decisions. The presence of tax-saving incentives provided a straightforward reason to invest in specific schemes, often acting as the first introduction to long-term saving and investment for many salaried individuals. Instruments like the Public Provident Fund have become household names largely due to the tax benefits associated with them. PPF, with its attractive interest rate and tax-free status, remains a preferred investment vehicle for risk-averse individuals who seek guaranteed returns and safety of capital, bolstered by the deduction it offers under Section 80C. Thus, tax policy has successfully nudged people toward adopting better saving habits through such instruments.

The importance of tax deductions becomes even more pronounced when observed through the lens of investment behavior. In a developing economy like India, where investment in financial instruments is still catching up with traditional asset classes like gold and real estate, tax deductions provide a strong motivation to explore diversified investment options. ELSS mutual funds, for example, have gained popularity as a tax-saving tool offering potential for higher returns through equity exposure, coupled with the shortest lock-in period among the 80C options. This has encouraged many individuals to enter the stock market ecosystem, often initiating their equity investment journey through ELSS. In this sense, the role of tax deductions transcends mere tax planning and ventures into the realm of promoting capital market participation, thereby contributing to market depth and financial inclusion.

The interplay between tax deductions and housing choices is another area where financial behavior is visibly shaped. The deductions available under Sections 24(b) and 80EE/80EEA for home loan interest and principal repayment have provided strong incentives for individuals to invest in residential property. These tax benefits reduce the effective cost of borrowing, making home ownership more accessible and attractive, especially for middle-income families. The real estate sector, being a major contributor to employment and economic activity, indirectly benefits from such individual financial behavior. Furthermore, the government's efforts to promote affordable housing through additional deductions for first-time home buyers under specific provisions demonstrate the alignment of tax incentives with broader policy goals. Tax deductions not only shape the timing and size of home purchases but also influence choices between renting and owning a property, often tipping the scales in favor of ownership due to the financial advantages conferred by tax relief.

Health-related expenditures also fall within the ambit of tax deductions and significantly influence household budgeting and insurance planning. Under Section 80D, deductions are available for premiums paid toward health insurance policies for self, spouse, children, and parents. With rising healthcare costs and growing awareness about medical risks, tax deductions provide a timely push for individuals to secure health coverage. This is particularly important in India, where out-of-pocket health expenditure is still a major concern. By making insurance more financially viable through tax incentives, the government encourages wider adoption of health insurance, contributing to better risk management at the individual level and reduced burden on public healthcare systems. Additional deductions for preventive health check-ups and treatment of specified diseases under Sections 80DDB and 80U also promote proactive health planning and social security for differently-abled individuals.

Education and skill development are crucial for national progress, and the Indian tax system recognizes this through deductions under Section 80E for interest on education loans. This provision plays a significant role in enabling access to higher education for students and families across income groups. By allowing interest payments to be deducted from taxable income, the tax system lowers the effective cost of financing education. It is particularly impactful for families considering foreign education or pursuing expensive professional degrees, where interest liabilities can be significant. The availability of such a deduction may be the deciding factor in opting for higher studies, highlighting how tax incentives can influence life-altering decisions. The indirect benefits of this provision include a more skilled workforce, higher employability, and greater potential for income growth, all of which contribute positively to the economy.

Another significant area where tax deductions shape financial behavior is charitable giving. Section 80G offers deductions for donations made to approved charitable institutions and relief funds, which not only encourages philanthropy but also fosters a culture of social responsibility among taxpayers. Whether it is contributing to disaster relief efforts, supporting education of underprivileged children, or donating to temples, mosques, or NGOs, the tax benefit provides an additional motivation to give. Although altruism may be the primary driver in many cases, the financial incentive acts as a reinforcing factor that makes giving more attractive. The process of claiming these deductions also brings individuals into closer contact with organized charitable institutions, potentially leading to deeper civic engagement and sustained support.

The role of tax deductions extends to shaping consumption patterns as well. For example, the benefits associated with electric vehicles under Section 80EEB, which allows deductions on the interest paid on loans taken to purchase EVs, incentivizes environmentally responsible consumer behavior. In a country grappling with severe air pollution and climate challenges, such provisions indicate a policy-level attempt to influence purchasing decisions through fiscal levers. Similarly, deductions under Sections related to contributions to the National Pension Scheme (NPS) not only promote long-term retirement planning but also provide a way for the government to channel household savings into national development priorities. The additional deduction of ₹50,000 over and above the 80C limit for NPS contributions has made it a more competitive product, especially for individuals looking to optimize their tax planning beyond traditional avenues.

While the impact of tax deductions on individual financial behavior is profound, it is also essential to recognize the behavioral economics aspect at play. Many individuals, especially in the salaried segment, tend to back-load their investment decisions toward the end of the financial year, often prompted by employer reminders or social cues. This seasonal behavior around tax-saving deadlines creates a spike in investments in February and March, a phenomenon well-documented in the financial services sector. While the tax system does succeed in directing funds toward desirable areas, the timing and quality of investment decisions can sometimes suffer due to last-minute rushes. This points to the need for greater financial literacy and planning discipline, alongside the structural incentives offered by the tax system.

Despite their benefits, tax deductions also raise concerns regarding equity and efficiency. The availability and extent of deductions often favor the salaried and formal sector workers who have better access to financial products and information. Self-employed individuals, informal workers, and low-income households may not be in a position to fully utilize these provisions, either due to low taxable income or lack of awareness. This creates a skew in the distribution of tax benefits, with better-off individuals able to avail a larger share of the tax-saving pie. Additionally, some critics argue that deductions distort economic decisions by channeling funds into tax-saving instruments that may not always align with the individual's risk profile or life goals. For example, an individual might invest in a low-return tax-saving fixed deposit merely for the sake of claiming a deduction, even when a better alternative might exist outside the tax-saving bracket. This underlines the need for tax policy to strike a balance between guiding behavior and preserving individual choice.

The introduction of the new simplified tax regime without deductions further illustrates the trade-offs inherent in tax policy design. The new regime, offering lower tax rates without exemptions and deductions, aims to simplify compliance and reduce distortions. However, its uptake has been mixed, with many taxpayers opting to remain in the old regime to continue availing deductions. This divergence indicates the deep-rooted influence of deductions on financial decision-making. For some, the simplicity of the new regime is appealing, but for others, especially those who already invest in tax-saving instruments, the old regime continues to offer greater tax efficiency. The very fact that taxpayers compare and calculate the financial implications of both regimes before choosing reflects the rational yet incentive-sensitive nature of individual financial behavior.

Financial institutions and product manufacturers also align their offerings around tax-saving themes. Banks, mutual fund houses, insurance companies, and fintech platforms market their products aggressively during the tax-saving season, using the appeal of deductions as a selling point. This shapes consumer choices not only in terms of what to buy but also when to buy. For example, insurance is often viewed through the lens of tax benefit rather than pure risk coverage, leading to suboptimal choices such as over-insurance or the purchase of high-premium policies with low coverage. The tax-driven product selection can sometimes compromise on utility, an issue that underscores the importance of integrated financial advice that considers both tax and personal goals.

Moreover, tax deductions have intergenerational implications, influencing how families plan for their children's education, health, inheritance, and asset transfers. The use of instruments like Sukanya Samriddhi Yojana, eligible for deduction under Section 80C, not only encourages saving for the girl child's future but also promotes gender-sensitive financial planning. Similarly, deductions on senior citizen health insurance premiums and fixed deposit interest income cater to the needs of an aging population, guiding households to allocate resources across life stages. The tax system, therefore, acts as a subtle but powerful planner embedded within family financial strategies, helping to institutionalize savings, protection, and provision across generations.

Tax deductions in India also intersect with the country's federal structure, with state and central governments often using deduction-linked schemes to promote specific social and economic outcomes. For instance, tax exemptions for contributions to certain state-run relief funds or pension schemes incentivize participation in government welfare programs. This coordination between fiscal incentives and welfare delivery enhances the efficiency and reach of public policy. At the same time, it also poses challenges of monitoring, misuse, and complexity, requiring robust governance and simplification efforts.

3. CONCLUSION

Tax deductions in India play a pivotal role in shaping how individuals approach financial decisions, from savings and investments to insurance and philanthropy. By reducing taxable income, they create a clear incentive for taxpayers to channel funds into specific instruments and expenditures that not only benefit them personally but also support national economic objectives such as capital formation, housing development, and improved healthcare coverage. These incentives have successfully encouraged many individuals to adopt disciplined financial practices, particularly in the middle-income segment where tax planning is a priority. However, the effectiveness of deductions is not uniform across all sections of society. Low-income groups and informal sector workers often cannot take advantage of these benefits due to limited taxable income or lack of awareness. Moreover, the over-reliance on tax-saving motives can sometimes lead to suboptimal financial decisions, where individuals invest in products without considering their overall financial goals. With the introduction of the new tax regime that minimizes deductions, individual behavior is evolving, forcing

taxpayers to make strategic choices between lower tax rates and deduction-led investments. Nevertheless, the old regime continues to influence a significant portion of taxpayers, illustrating that tax deductions remain a strong behavioral driver. Thus, they continue to be an essential element in aligning individual financial actions with broader economic growth.

CONFLICT OF INTERESTS

None.

ACKNOWLEDGMENTS

None.

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