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Issue Brief

India's Defence Budget 2019-20

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Summary

The Brief examines India's latest defence allocations, the distribution pattern of resources, shares of various stakeholders in the allocations and the possible impact on defence modernisation. It also looks at the Make in India initiatives announced in the budget that has an impact on defence production.

Finance Minister Nirmala Sitharaman, presenting her maiden budget on July 05, 2019, kept unchanged the allocation provided to the Ministry of Defence (MoD) in the interim budget on February 01, at Rs 4,31,011 crore ($ 61.96 billion).[1] Nonetheless, she changed the composition of the MoD's budget by shifting few of the elements from one head of expenditure to another. With the overall budget of the MoD remaining the same, the FM also changed the basic customs duties for certain defence imports, in an attempt to lessen the resource crunch facing modernisation of the armed forces.

This *Brief* examines India's latest defence allocations, the distribution pattern of resources, shares of various stakeholders in the defence allocation and the possible impact on defence modernisation. It also looks at the Make in India initiatives announced in the budget that have an impact on defence production. It begins with a brief survey of the heath of the Indian economy in order to appreciate the larger context of the defence allocation.

State of the Economy

Despite a slight moderation of gross domestic product (GDP) growth from 7.2 per cent in 2017-18 to 6.8 per cent in 2018-19, India remains the fastest growing major economy in the world. The *Economic Survey 2018-19*, presented to the Parliament on July 04, projects the GDP to grow even higher at seven per cent in 2019-20, on the "back of anticipated pickup in the growth in investment and acceleration in the growth of consumption." The higher growth trajectory of the Indian economy is particularly impressive especially when the world economic growth is on a constant fall. Further, the impressive forecast of the Indian economy comes with macro-economic stability with the headline inflation, as well as fiscal and current account deficits, remaining within manageable levels. With an average growth of 7.5 per cent in the last five years, the Indian economy is also set to 'shift gear' for a sustained growth of eight per cent per year for the country to become a five trillion dollar economy by 2024-25.

The robust GDP growth prospects notwithstanding, there are several challenges facing the economy, especially on the fronts of job creation, availability of liquidity, infrastructure spending, and also in view of the rural and agrarian distress and continuing crisis in both the banking and non-banking financial sectors. It is in this context that the latest Union budget attempts to spur economic activity by providing a host of measures for the affected segments. At the same time, the government has also decided to further contain the fiscal deficit target,[2] so as to limit the inflationary

[1] Conversion to US$ is based on average exchange rate ($1.0 = Rs 69.56) during the first three months of 2019-20. For an analysis of interim defence allocation 2019-20, see Laxman K Behera, "Interim Defence Budget 2019-20", *IDSA Issue Brief*, February 05, 2019, at https://idsa.in/issuebrief/interim-defence-budget-2019-20-lkbehera-040219.

[2] Fiscal Deficit amounts to Rs 7,03,760 crore in 2019-20. It is the amount that the government intends to borrow to meet its expenses.

pressure and allow greater flow of resources for the more productive private sector. As against the fiscal deficit of 3.3 per cent of GDP articulated in the interim budget, the target has further been squeezed to 3.2 per cent.

The twin effects of greater flow of resources to socio-economic sectors to spur economic activity and further squeezing of the fiscal deficit has constrained the FM from enhancing the overall allocations for the MoD. Though some leeway is provided by way of exempting certain defence imports from customs duty, it may not be enough, given the vast deficiencies existing across the defence services. Suffice to say that in 2018-19, the three armed forces together had projected a shortfall of Rs. 1,12,137 crore, or 30 per cent of their total requirement. This is exclusive of the shortfalls projected by the Defence Research and Development Organisation (DRDO) and others.

What is of greater importance for the defence establishment is that it is unlikely to see a major growth in its budget in the near-to medium-term. The Medium Term Fiscal Policy cum Fiscal Policy Strategy Statement, presented along with the Union budget, forecasts the revenue expenditure of the defence services to grow by 10 per cent per year for the next two years. Though there is no specific forecast for the capital expenditure of the defence services, it is unlikely to see a major jump, considering the limited space available in view of the government's focus on massive spending on infrastructure development. The MoD and the wider defence establishment would have to perforce learn to live with the limited growth in defence spending at least till 2021-22.

MoD's Total Budget: Civil, Pension and Defence

Table 1 provides the distribution of the MoD's total spending among three broad heads of expenditure: MoD (Civil), Defence Pensions and Defence Services. Though the MoD's latest budget has remained same as the interim allocation, there is a minor change of distribution between MoD (Civil) and Defence Services. The change is due to shifting out of two elements from the MoD (Civil) – Ex-Servicemen Contributory Health Scheme (ECHS) and Military Farms – to the fold of Defence Services which include the three armed forces and few other establishments, notably the DRDO and the Ordnance Factories (OFs). It is worth noting that the Military Farms and ECHS along with few others had been shifted to the MoD (Civil) in 2016-17. While others were brought back to their original place in subsequent years, these two are finally brought back in the latest budget. Further, they were brought back to the Army's fold from where they had been shifted out.

It is worth noting that, of the three major constituents of the latest MoD budget, the Defence Services, which conventionally constitute India's defence budget, amounts to 71 per cent, with Defence Pensions (26 per cent) and MoD (Civil) (three per cent) comprising the rest. What is of greater significance is that out of MoD's total budget, close to 60 per cent[3] is spent on salary and pensions of nearly 4.9 million personnel, of which 3.1 million are defence pensioners, 1.4 million uniformed and 0.4 million defence civilians. Owing to the periodic revision of salary and pension and the implementation of the One Rank One Pension (OROP), this segment has witnessed the highest growth. The arrears on OROP alone amounts to Rs 10,795 crore between 2015-16 and 2017-18. With the prospect of major growth in the defence budget being not so encouraging in the coming years, the MoD has an uphill task of managing its resources, especially for capital procurement.

Table 1. Distribution of MoD's Budget

	MoD (Civil) (Rs in Crore)	Defence Pensions (Rs in Crore)	Defence Services (Rs in Crore)	MoD's Total Expenditure (Rs in Crore)
2017-18 (Actual)	15143 (4)	92000 (24)	272560 (72)	379702
2018-19 (BE)	16206 (4)	108853 (27)	279305 (69)	404365
2018-19 (RE)	16318 (4)	106775 (26)	282100 (70)	405194
2019-20 (BE) (Interim)	17065 (4)	112080 (26)	301866 (70)	431011
2019-20 (BE)	13635 (3)	112080 (26)	305296 (71)	431011
Difference between 2019-20 (BE) and 2019-20 BE (Interim)	3430	0	3430	0

Note: Figures in parenthesis represent the percentage share in MoD's total expenditure. MoD (Civil) includes MoD Secretariat, Border Roads Organisation, Defence Accounts Department, Coast Guard Organisation, Defence Estate Organisation, Jammu and Kashmir Light Infantry, Armed Forces Tribunal, etc. BE and RE represent Budget Estimate and Revised Estimate.

3 For an analysis of major components of the defence budget, see Laxman K Behera, "Defence Budget 2018-19: The Imperative of Controlling Manpower Cost", *IDSA Issue Brief*, February 02, 2018,at https://idsa.in/issuebrief/defence-budget-2018-19-controlling-manpower-cost-lkbehera-020218

Defence Budget

With the return of Military Farms and the ECHS to the fold of the Defence Services, the defence budget has marginally increased over the interim allocation (see Table 2). The increase is, however, largely on the revenue expenditure front, as the new entrants have very little capital expenditure. Of the total increase of Rs 3430 crore in the budget of Defence Services, Rs 3145 crore is on account of the ECHS, whereas the Military Farms have contributed Rs 285 crore.

With respect to the actual expenditure of 2018-19, the latest allocation is a modest increase of six per cent (or Rs 17,896 crore). Of the total increase, the Revenue expenditure contributes Rs 9,440 crore and the Capital expenditure Rs 8,456 crore.

Table 2. Defence Budget, 2018-19 and 2019-20

	Revenue Expenditure	Capital Expenditure	Total
2018-19 (BE) (Rs in Crore)	185323	93982	279305
2018-19 (RE) (Rs in Crore)	188118	93982	282100
2018-19 (Actual) (Rs in Crore)*	192462	94938	287400
2019-20 (BE) (Interim) (Rs in Crore)	198486	103380	301866
2019-20 (BE) (Rs in Crore)	201902	103394	305296
Increase in 2019-20 (BE) over 2018-19 (Actual) (Rs in Crore)	9440	8456	17896
% Increase in 2019-20 (BE) over 2018-19 (Actual)	5	9	6

Note: *: Unaudited provisional actual expenditure

Key Defence Parameters

Table 3 provides the key defence parameters for 2018-19 and 2019-20. As can be seen, there has been a further decline in the share of defence expenditure in both the Central Government Expenditure (CGE) and the GDP. It is, however, important to note that even though the MoD's budget constitutes a little over two per cent of the GDP, it still accounts for 15.5 per cent of the total CGE. The wide disparity in the shares is largely due to the small percentage of the GDP forming part of the government's revenue,[4] as much of the economic activity in the country does not translate into tax collection, the major source of government's revenue.

4 The Central Government Expenditure in 2019-20 amounts to a mere 13 per cent of the estimated GDP.

In fact, India's tax-GDP ratio is one of the lowest among the comparable countries.[5] Unless the tax base of the country increases substantially in the coming years, defence's share in the CGE will remain high.

Table 3. Key Defence Statistics, 2018-19 and 2019-20

Parameter	**2018-19**	**2019-20**
Defence Budget (Rs in Crore)	2,79,305	3,05,296
Growth of Defence Budget (%)	7.7	9.3
Revenue Expenditure (Rs in Crore)	1,85,323	2,01,902
Growth of Revenue Expenditure (%)	7.3	8.9
Share of Revenue Expenditure in Defence Budget (%)	66	66
Capital Expenditure (Rs in Crore)	93,982	1,03,394
Growth of Capital Expenditure (%)	8.7	10.0
Share of Capital Expenditure in Defence Budget (%)	34	34
Share of Capital Expenditure in Central Government Capital Expenditure (%) #	31	31
Capital Acquisition (Rs in Crore)	74,116	81,009
Growth of Capital Acquisition (%)	6.7	9.3
Share of Defence Budget in GDP (%)*	1.48	1.45
Share of Defence Budget in Central Government Expenditure (%)	11.4	11.0
Defence Pension (Rs in Crore)	1,08,853	1,12,080
Growth of Defence Pension (%)	27	3.0
MoD's Budget (Rs in Crore)	4,04,365	4,31,011
Growth in MoD's Budget (%)	12.4	6.6
Share of MoD Budget in GDP (%)*	2.15	2.04
Share of MoD Budget in Central Government Expenditure (%)	16.6	15.5

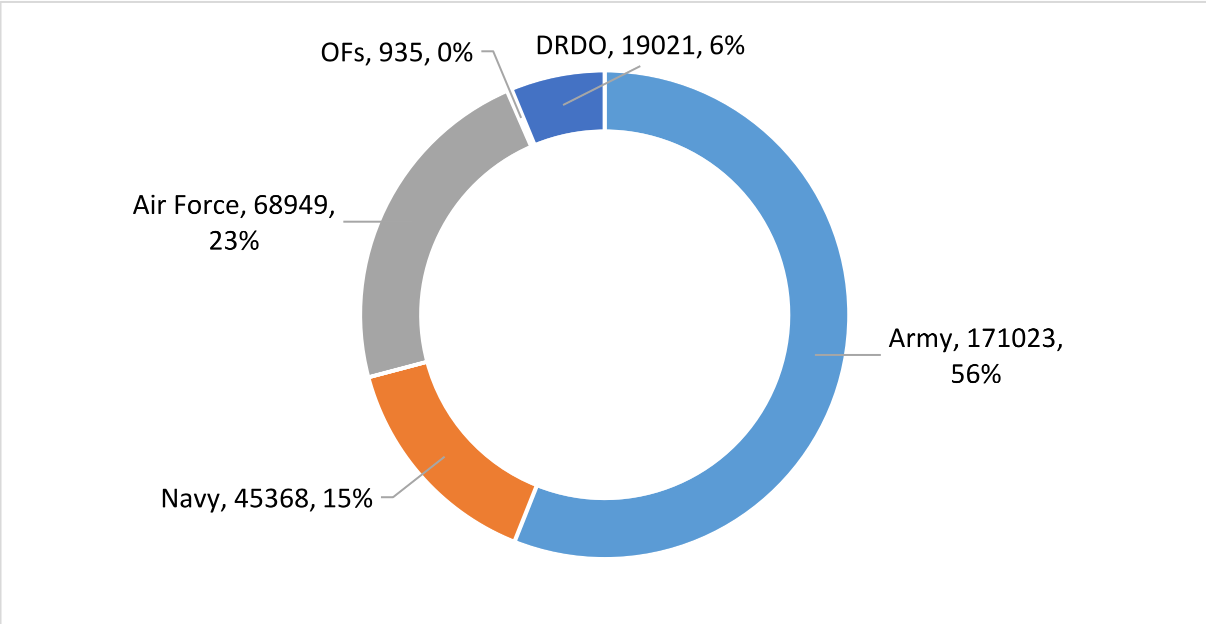
Note: *: Based on GDP's revised estimate for 2018-19 and budget estimate for 2019-20; #: The share is with respect to the capital segment of the defence budget. If the MoD's total capital expenditure is taken into accounts, the share increases to 33 per cent and 32 per cent in 2018-19 and 2019-20, respectively.

5 For an objective discussion on defence-GDP debate, see Laxman K Behera, "Examining the Feasibility and Affordability of Raising the Share of Defence Expenditure to Three Percent of GDP", *IDSA Issue Brief*, August 20, 2018, at https://idsa.in/issuebrief/feasibility-and-affordability-defence-expenditure-gdp-lbehera-200818.

Share of Defence Services

With the inclusion of Military Farms and ECHS in the Army's budget, the latter's allocation has increased by Rs 3,430 crore from the interim allocation. As in the past, the Indian Army with a budget of Rs 1,71,023 crore accounts for the biggest share in the defence budget, distantly followed by the other defence services (see Figure 1). However, unlike its sister services, the Army's budget is largely revenue expenditure-driven (see Table 4).

Figure 1. Share of Defence Services in Defence Budget 2019-20



Note: Army includes Military Firms, Ex-Servicemen Contributory Heath Scheme, Directorate General of Quality Assurance (DGQA) and National Cadet Corps (NCC).

Table 4. Revenue and Capital Expenditure of Armed Forces, 2019-20

	Army	Navy	Air Force
Revenue Expenditure (Rs in Crore)	141501	22212	29602
Capital Expenditure (Rs in Crore)	29522	23156	39347
Total (Revenue and Capital) (Rs in Crore)	171023	45368	68949
Revenue Expenditure as % of Total	83	49	43
Capital Expenditure as % of Total	17	51	57

Note: Army includes Military Firms, Ex-Servicemen Contributory Heath Scheme, Directorate General of Quality Assurance (DGQA), National Cadet Corps (NCC).

Impact on Modernisation

The Indian armed forces are currently in the midst of a huge modernisation process. However, owing to the resource crunch, their ability to pay for it has come under a great deal of stress. The resource crunch has been so intense that they are finding it difficult to even pay for the past contracts. In 2018-19, as against a requirement of Rs 1,10,044 crore to meet the Committed Liabilities, the total budget (including for New Schemes) was Rs 74,116 crore. If the requirement of the New Schemes is added, the shortfall on modernisation front was a staggering Rs 67,363 crore or 48 per cent.

As against a huge shortage on modernisation budget in the previous year, the latest budget has allocated an additional amount of Rs 6,893 crore, the same amount provided in the interim allocation (see Table 5 and Annexure). The additional amount is grossly inadequate, to say the least. However, partial relief is provided in the form of exemption of import of defence items not manufactured in India from the basic customs duty (CD). The MoD estimates the CD exemption will lead to a savings of Rs 25000 crore over the next five years.[6]

Table 5. Modernisation Budget of the Armed Forces

	2018-19 (BE)	2018-19 (RE)	2019-20 (BE) (I)#	2019-20 (BE)	% Increase in 2019-20 (BE) over 2018-19 (BE)
Army*	21211	21166	22951	22951	8.2
Navy	19927	20035	22106	22106	10.9
Air Force	33085	33100	36365	36365	9.9
Total	74224	74301	81422	81422	9.7

Note: *: Figures for Army are approximate; #: (I) stands for Interim Budget.

It is significant to note that even though the MoD has a severe resource crunch to fund capital procurement, it has not deterred the Ministry from signing new contracts. Since April 2018, the MoD has signed at least 30 contracts with a cumulative value of nearly Rs 1,17,000 crore. An outgo at the rate of 15 per cent per year would require an additional amount of Rs 17,550 crore to pay for these contracts. It does not look like the additional budget and CD relief would be enough to cater for that.

6 Press Information Bureau, "Defence Budget Allocation for 2019-20 at Rs 3.19 Lakh Crore, Excluding Defence Pension", July 05, 2019.

Make in India in Defence

Though the Finance Minister has not announced any defence specific measures, she has articulated a number of Make in India incentives which the MoD and the defence industry could take advantage of in driving the Make in India initiative in domestic arms production. Some of the initiatives articulated in the budget include:

- Lower corporate tax of 25 per cent for companies with an annual turnover of up to Rs 400 crore (earlier threshold was Rs 250 crore): The reduction of corporate tax from earlier 30 per cent to 25 per cent will improve the profit margin and act as a key incentive, particularly for private companies in the defence sector.
- Increase in minimum pubic shareholding in listed companies from 25 per cent to 35 per cent: This would pave the way for the government to raise additional resources by offering the shares of the listed Defence Public Sector Undertakings (DPSUs) which don't meet the new listing norm. The additional resources would augment the government's revenue which could be channeled for defence infrastructure development.
- Strategic Disinvestment of Central Public Sector Undertakings (CPSEs): The FM has categorically stated her government's unwavering commitment towards strategic disinvestment of government-owned companies. Some of the DPSUs, particularly the BEML, which was earlier identified for strategic disinvestment but held back for unspecified reasons, could now be taken to the logical conclusion. The MoD could also identity few other non-strategic DPSUs which could be offered for privatisation.
- Payment platform and ease of access to credit for Micro, Small and Medium Enterprises (MSMEs): This will greatly facilitate ease of doing business in defence for 8000-odd MSMEs who are involved in defence in some form or the other.
- Abolition of 'Angel-Tax' for Start-Ups: This would eliminate the threat from tax authorities in respect of valuation of share premiums. The start-ups and their investors would have greater freedom to focus on innovation and in operating their own business.

While the above steps are encouraging and would help the Make in India initiative in defence sector, the budget nonetheless falls short on a number of counts, especially in respect of the Defence Corridor and the scheme for funding defence attaches for export promotion. On each of these, the budget makes a token provision of Rs 100,000, which is grossly inadequate.

Conclusion: Funding Defence in an Era of Scarcity

With the latest Union budget keeping the MoD's interim allocation unchanged, the defence establishment has an uphill task in managing its resources. Though a partial relief is given in the form of customs duty exemptions for certain defence imports, it is unlikely to mitigate the severe resource constraints that the three armed forces have witnessed in recent years for their modernisation requirements. From the MoD's point of view, what is of greater concern is that a significant augmentation of its resources is unlikely in the near future, given the competing demands from other sectors, especially in view of the government's commitment to spend massively on infrastructure development.

Given the gloomy forecast of resource availability, the MoD has to find a way to fund its modernisation programmes. It is high time the MoD raised some resources by making best use of the vast assets it owns, rather than completely relying on the government funding. The Finance Minister's disinvestment commitment, including privatisation of CPSE, could be used by the MoD to raise some of the much needed resources by exposing all the DPSUs under its administrative control to the new listing norms.

Apart from the disinvestment, the MoD could also identify its vast unused or underused land parcel from its existing 1.73 million acres of land, which could be put to commercial use without compromising the security requirement. The resources generated could be used for the modernisation requirements.

Last but not least, the MoD also needs to rebalance its defence expenditure so as to contain the manpower cost and devote more resources for modernisation. Spending nearly 60 per cent of its budget on salary and pension is highly undesirable for a country which faces a two-front security threat. The MoD may like to review the existing 'colour service' for the entitlement of pension and also the possibility of lateral entry of retired uniformed personnel into the paramilitary forces.

Annexure

Army's Modernisation Budget

Modernisation Head	2018-19 (BE)	2018-19 (RE)	2019-20 (BE) (I)#	2019-20 (BE)	% Increase in 2019-20 (BE) over 2018-19 (BE)
Aircraft & Aero-Engine	1813	2369	2115	2115	16.7
H&MV	1972	1732	2128	2128	7.9
Other Equipment	17198	16993	18562	18562	7.9
Rolling Stock	128	2	50	50	-61.0
Rashtriya Rifles	100	70	95	95	-4.7
Total	21211	21166	22951	22951	8.2

Note: Figures for Amy are approximate; #: (I) stands for Interim Budget.

Navy's Modernisation Budget

Modernisation Head	2018-19 (BE)	2018-19 (RE)	2019-20 (BE) (I)#	2019-20 (BE)	% Increase in 2019-20 (BE) over 2018-19 (BE)
Aircraft & Aero-Engine	1900	1900	2400	2400	26.3
H&MV	20	60	45	45	125.0
Other Equipment	4863	3470	3500	3500	-28.0
Joint Staff	844	887	929	929	10.0
Naval Fleet	10300	11313	12182	12182	18.3
Naval Dockyard/Projects	2000	2405	3050	3050	52.5
Total	19927	20035	22106	22106	10.9

Note: #: (I) stands for Interim Budget.

Air Force's Modernisation Budget

Modernisation Head	2018-19 (BE)	2018-19 (RE)	2019-20 (BE) (I)	2019-20 (BE)	% Increase in 2019-20 (BE) over 2018-19 (BE)
Aircraft & Aero-Engine	24709	24812	24807	24807	0.4
H&MV	202	66	110	110	-45.6
Other Equipment	8174	8223	11448	11448	40.1
Total	33085	33100	36365	36365	9.9

Note: #: (I) stands for Interim Budget.

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