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IDSA
Issue Brief

Defence Budget 2017-18: What the Macro-Economic Factors Foretell

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Summary

The Union budget that will be presented on February 1 will be the first budget not linked to any five-year plan. The Niti Aayog's 15-year 'National Development Agenda' that will include aspects relating to internal security and defence as well has not yet been released. In the absence of any five-year plan document or the Niti Aayog's vision document as a reference point, an assessment of the macro-economic factors, as noted in key fiscal policy statements, would indicate that the budget estimate (BE) for defence expenditure for 2017-18 would be around Rs. 285,000 crores, against the current year BE of Rs. 249,099 crores.

The Union budget is being presented for the first time on February 1 instead of the last working day of February. 2016-17 was also the last year of the 12th Plan. With the five-year Plan process having been given a decent burial, this would be the first budget not linked to any plan. It therefore would not have two categories of expenditure i.e., plan and non-plan. The defence planning process has been historically linked to the five-year planning process. The first five-year defence plan (1964-69) was initiated during the third five-year plan, and the five-year defence plan period was synchronised with the five-year plans of the Planning Commission from the Fourth Plan (1969-74) onwards. Service HQs began drawing up the first 15 year perspective plans from 1979. Although the five-year defence plans ran concurrent with the five-year plans, these defence plans did not necessarily have any linkage with the five-year plans except that the Planning Commission had to indicate the resources available for defence, which constitutes a major item of the central government expenditure.

Five-year plans would now make way for a larger and more focused 15-year 'National Development Agenda' (NDA) that will include aspects relating to internal security and defence as well. Niti Aayog had planned to complete the preparation of the 15-year vision document by December 2016 as it was expected that the next general budget was to be guided by the long-term development strategy. It was expected that there would be subsets like a seven-year strategy to convert the vision document into an implementable policy and a three-year action plan (2017-20) as part of the NDA. However, all has been quite on the western front! It's not in the public domain as to whether the 15-year vision document is in fact ready and given to the government or it will be made public as part of the budget.

In the absence of any such document for reference, we will have to go by the macro-economic factors to foresee allocations for defence for the year 2017-18. Demands for Grants of Ministry of Defence (MoD) were rationalised in budget 2016-17 with the stated aim of 'a clear and consolidated depiction of defence expenditures'. It was stated that 'two fold action has been taken in this regard — reducing the number of Demands for Grants and shifting of certain provisions on non-core activities to Defence (Civil) Demand'. In this process of rationalisation, the revenue budget demands of the services and joint staff have been consolidated into a single demand (No. 22) and the capital budget demands under No. 23.

The revenue budget of the Military Farms (MFs), Ex-servicemen Contributory Health Scheme (ECHS), Inspection Organisation (IO), Rashtriya Rifles (RR), and National Cadet Corps (NCC), Defence Research and Development Organisation (DRDO) and Ordnance Factories have been moved to MoD (Civil Estimates) and the new demand is No. 20 MoD (Miscellaneous). This in addition caters for Border Roads, Coast Guard, Defence Estates Organisation (DEO), Jammu and Kashmir Light Infantry (JAKLI), Armed Forces Tribunal, Canteen Stores Department (CSD) and Housing (DAD/DEO/CSD). Similarly, the capital budget requirement of all these entities has also been moved to new demand No. 20 (this has two components, revenue and capital). Defence pensions are now No. 21. However, what constitutes defence expenditure for benchmarking as percentage of central government expenditure (CGE) and more importantly as percentage of gross domestic product (GDP) has not been explicitly changed (see table below).

Table No. 1

Fiscal Indicators - Rolling Targets as Percentage of GDP						
	2014-15	**Revised Estimates**	**Provisional Actual**	**Budget Estimates**	**Targets For**	
		2015-16	2015-16	2016-17	2017-18	2018-19
Total Defence Expenditure	1.76	1.66	1.66	1.65	1.6	1.6
Fiscal Deficit	4.1	3.9	3.9	3.5	3	3

Source: Table 17: Fiscal Indicators - Rolling Targets as Percentage of GDP, Monthly Economic Report, Economic Division, Department of Economic Affairs, *Ministry of Finance*, November 2016, p. 14, at http://dea.gov.in/sites/default/files/MER_November%202016_0.pdf (accessed January 21, 2017).

Macro-Economic Factors and Fiscal Policy Statements

Given below are some macro-economic indicators as mentioned in key fiscal policy statements:

a. **Medium Term Fiscal Policy Statement 2016-17:**

   The revenue component of defence expenditure is estimated at Rs. 1,62,759 crores in BE 2016-17. During the projection period of 2017-18 and 2018-19, it is estimated to increase by 10 per cent over previous years. Total defence expenditure (revenue and the capital heads) is estimated at about 1.6 per cent of GDP in 2017-18 and 2018-19.

b. **The 14th Finance Commission, in its February 2015 report, had stated the following:**

   'Recognizing that revenue expenditure is critical for defence preparedness and maintenance, we have kept the defence revenue expenditure-GDP ratio constant during our projection period, instead of allowing growth to decelerate as was the case in the past. In other words, the rate of defence revenue expenditure has been allowed to increase at the same rate as the GDP, which is substantially higher than the past growth of defence revenue expenditure.'[1]

Inflation measured in terms of Consumer Price Index (CPI) and Wholesale Price Index (WPI) has remained in comfort zone during the current Financial Year 2016-17. CPI (combined) inflation for 2015-16 declined to 4.9 per cent from 5.9 per cent in 2014-15. It averaged 5.2 per cent in 2016-17 (April-October) and stood at 4.2 per cent in October 2016.[2]

c. **Press note giving first advance estimates of national income 2016-17 stated the following:**

Real GDP or GDP at constant (2011-12) prices in the year 2016-17 is likely to attain a level of Rs. 121.55 lakh crores, as against the Provisional Estimate of GDP for the year 2015-16 of Rs. 113.50 lakh crores, released on May 31, 2016. The growth in GDP during 2016-17 is estimated at 7.1 per cent as compared to the growth rate of 7.6 per cent in 2015-16.[3]

Price indices used as deflators: The WPI in respect of the groups - food articles, manufactured products, electricity and all commodities, has risen by 6.9 per cent, 2.0 per cent, (-)1.4 per cent and 2.8 per cent, respectively during April-November 2016-17. The CPI has shown a rise of 5.0 per cent during the same period.

GDP at current prices in the year 2016-17 is likely to attain a level of Rs. 151.93 lakh crore, as against Rs. 135.76 lakh crore in 2015-16 showing a growth rate of 11.9 per cent.[4]

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[1] "Report of the Fourteenth Finance Commission", *Finance Commission India*, Vol. 1, Chapter 6, Para 6.36, p. 70, at http://finmin.nic.in/14fincomm/14fcreng.pdf

[2] "Year End Review – 2016", Department of Economic Affairs, *Ministry of Finance*, December 30, 2016, at http://dea.gov.in/sites/default/files/Year_End_Review_DEA30122016.pdf

[3] "Press Note on First Advance Estimates of National Income 2016-17", Central Statistics Office, *Ministry of Statistics and Programme Implementation*, January 06, 2017, p. 2, at http://www.mospi.gov.in/sites/default/files/press_release/nad_prn_6jan17.pdf (accessed January 16, 2017).

[4] Ibid., p. 5.

Defence Budget 2017-18

We need to first arrive at the expected revised estimates (RE) for 2016-17 based on the macro-economic and other parameters given above, as also the trend in the immediate past years, before we come to BE 2017-18:

Table No. 2

Defence Budget Allocation at BE, RE and Actual Expenditure Stage						
	BE		**RE**		**ACTUAL EXPENDITURE**	
	CAPITAL	**REVENUE**	**CAPITAL**	**REVENUE**	**CAPITAL**	**REVENUE**
2013-14	86741	116931	78872	124800	79125	124374
2014-15	94588	134412	81965	140405	81887	136807
2015-16	94588	152139	81400	143236	79958	145936
2016-17	86340	162759				
	Demand No. 23	Demand No. 22	Demand No. 20		TOTAL	
	CAPITAL	REVENUE	CAPITAL	REVENUE	CAPITAL	REVENUE
2016-17	78586.68	143869.46	7753.32	18889.54	86340	162759

Source: Union budget document. Actual expenditure for 2015-16 as per "Accounts at a Glance 2015-16", Controller General of Accounts, *Ministry of Finance*, at http://cga.nic.in/writereaddata/AccountAtAGlance20152016English.pdf (accessed January 27, 2017)

Union Budget RE 2016-17

The variables likely to affect the RE are the following:

Supplementary Grants

An amount of Rs. 56,120 crores has been passed by the Parliament during the monsoon and winter sessions as per details provided in the table below:

Table No. 3

2016-17	PLAN	NON PLAN	TOTAL
	550010	1428050	1978060
SUPPLEMENTARY DEMAND FOR GRANTS			
	Gross	Net	
August 2016	103000	20948.26	20948.26
December 2016	59978.29	35171.92	35171.92

Sources: The Appropriation Bills No. 3, No. 4 and No. 5 (2016), Lok Sabha.

Shortfall in Disinvestment of Government Equity Holdings/Strategic Disinvestment

As has been the pattern over the years, there is likely to be a shortfall of about Rs. 32,487 crores (unless some disinvestment is made during February-March 2017) in the amount realised on account of disinvestment of government equity holdings/strategic disinvestment as per details tabulated in table below:

Table No. 4

Disinvestment of Government Equity Holdings/Strategic Disinvestment			
	Target	**Achieved**	**Disinvestment Achievement as a % of Target**
2010-11	40000	22846	57.1
2011-12	40000	18088	45.2
2012-13	30000	25890	86.3
2013-14	55814	29368	52.6
2014-15	63425	37737	59.5
2015-16	69500	24738	35.6
2016-17	56500	24013	42.5
Disinvestment of Government's Equity Holdings	36000	21433	Actuals up to November 2016 as per CGA
Strategic Disinvestment	20500	2096	
An amount of Rs. 486.14 Crs is expected to be realised on shares of MOIL Limited on January 24-25, 2017 (as per NSDL) bringing the total to Rs. 24,013 crores.			

Source: Union budget documents and CGA website.

Revenue Buoyancy

Buoyancy has been reported in the tax collections. As per the recent statement of the Union finance minister, the direct tax collections increased 12.01 per cent and indirect tax collections rose by 25 per cent in the April-December period.[5] However, some increase in the tax revenue is already anticipated and catered for in the BE of the year. The incremental revenue based on the collection figures reported up to November 2016 suggests that it is 9.2 per cent over the BE figures (details tabulated in Table No. 5). Some moderation because of slow down post-demonetisation may get reflected from the collection during December 2016-March 2017, and the increase could get moderated to about 8.2 per cent. Since the budgeted amount of the centre's net tax revenue was Rs.1,054,101 crores, we may expect about Rs. 86,000 crores on account of additional tax revenue.

Table No. 5

TAX	% Increase factored in BE 16-17 over RE 15-16	Actual Increase over 15-16 till November 2016	Contribution as a % of Gross Tax Revenue	Weighted variation
Gross Tax Revenue	11.73	21.55		
Corporation Tax	9.04	8.96	30.29	-0.03
Income Tax	18.10	20.95	21.66	0.62
Customs	9.79	6.80	14.10	-0.42
Union Excise Duties	12.15	45.97	19.54	6.61
Service Tax	10.00	27.10	14.16	2.42
Less - State's share	12.67	2.81	35.01% of total tax revenue*	
OTHER TAXES			0.25	
Centre's Net Tax Revenue	11.25		Total	9.2

Source: Union budget document and CGA's website for collections up to November 2016.

*Major portion of states share is transferred in March.

GDP Increase and Fiscal deficit

[5] "Higher tax mop-up shows no slowdown post note ban: Finance Minister Arun Jaitley", *The Indian Express*, January 10, 2017, at http://indianexpress.com/article/business/economy/higher-tax-mop-up-shows-no-slowdown-post-note-ban-finance-minister-arun-jaitley-4467099/

The supplementary grants and the short fall in receipts on account of disinvestment would be offset by the tax buoyancy. The Union budget had reckoned GDP of Rs. 135.67 lakh crores for 2015-16 and it was expected to go up by 11 per cent and increase to Rs. 150.65 lakh crores for 2016-17. Accordingly, fiscal deficit target of 3.5 per cent of GDP at Rs. 533,904 crores was set in the Union budget. As per the press note on first advance estimates of national income, GDP at current prices in the year 2016-17 is likely to attain a level of Rs. 151.93 lakh crores, as against Rs. 135.76 lakh crores in 2015-16 showing a growth rate of 11.9 per cent. As has been the practice in the past, the deficit percentage target is extended to second and third place of decimal, which would indicate that the government may target it for 3.544 percentage. If the government chooses to do so, the fiscal deficit figure could go to about Rs. 538,440 crores giving additional resources of about Rs. 4,500 crores.

Table No. 6

Expenditure Trends (till November 2016) and Corresponding Figures of the Previous Year (till November 2015)

	Budget Estimates 2016-2017	**Actuals up to November 2016**	**% of Actuals to Budget Estimates**	
	Rs in crores		2016-17	2015-16
Non-Plan Expenditure	1428050	922492	64.60%	64.30%
Plan Expenditure	550010	364189	66.20%	64.10%
Total Expenditure	1978060	1286681	65.00%	64.30%
DEFENCE HEADS				
Ministry of Defence (Misc)	35683.18	15702.2	44%	**
Defence Pensions	82332.66	51232.09	62%	65%
Defence Services (Revenue)	143869.46	102618.77	71%	**
Capital Outlay on Defence Services	78586.68	49937.77*	64%	49%

This includes over Rs. 8,000 crores paid on signing of 36 Rafale fighters for which additional funds were to be provided. The percentage without that would be about 52-53 per cent.

** comparative percentage figures of last year not available due to restructuring of demand numbers

Source: "Union Government Accounts at a Glance", Controller General of Accounts, *Ministry of Finance*, as at the end of November 2016, at http://cga.nic.in/MonthlyReport/Published/11/2016-2017.aspx (accessed January 16, 2017).

The expenditure trends up to November 2016 are comparable to the trends last year. Hence, we may expect the trends to be similar in 2017 too. Last year, RE figures were substantially lowered both for capital and revenue portion of defence expenditure to make up for the likely extra expenditure in heads 'Other than defence'. The final position of the BE and actual expenditure also reflected the same trend as may be seen in table below:

Table No. 7

	Defence Expenditure		**Other than Defence**	
	Capital	Revenue	Non Plan	Plan
BE	94588	152139	1065473	465277
Actual	79958	145936	1093806	471083
	-14630	-6203	28333	5806

Source: "Accounts at a Glance 2015-16", Controller General of Accounts, *Ministry of Finance*, at http://cga.nic.in/writereaddata/AccountAtAGlance20152016English.pdf (accessed January 27, 2017)

In view of the above, the RE figures for all the demands under defence i.e., both defence civil and defence services heads, may have to be marginally adjusted to keep it within the total of Rs. 340,922 crores.

Key Additional Factors Impinging on Budget 2017-18

Political Outlook

Elections to the Lok Sabha are due in April-May 2019. Hence the budget to be presented on the first working day of February 2019 will have to be an interim budget, similar to what happened in 2009 and 2014. The next two budgets may therefore be expected to have a political bias. It is hoped that realisation will also dawn on the political establishment that the defence budget as a percentage of GDP has reached around the levels of the late 1950s and early 1960s and any further neglect will erode the defence capability.

Economic Outlook

If the growth of the economy tides over the blip of the November-December 2016 slow down and is able to maintain the GDP growth rate of 11.9 per cent (at current prices), as given in the advance estimates released by the Central Statistical Organisation (CSO), the positive aspects of demonetisation and the planned rollout of goods and services tax (GST) from July 2017 (notwithstanding the implications of policy changes in the United States under the Donald Trump administration) could propel the growth rate of GDP at current prices. It is hoped that the finance minister too shares this optimism and have a relook at the defence expenditure-GDP ratio and does not reduce it further to 1.6 per cent as set in the rolling target. The GDP for 2017-18 in such a scenario would be Rs. 173 lakh crores, and if for 2017-18 the finance minister maintains the last year's defence expenditure relationship of 1.65 per cent of GDP, we may see a BE for defence expenditure of Rs. 285,000 crores against the current year BE of Rs. 249,099 crores.

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