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Issue Brief

Defence Modernisation: A Silver Lining in the Dark Clouds?

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Summary

The presentation of the Union budget on February 1 is expected to ensure full utilisation of allocated funds and will ensure that 'New Schemes' can be processed, approved and contracted from April 1, 2017. This would aid defence modernisation which has seen bad times in the recent past due to a range of factors, including declining share of capital expenditure as a percentage of GDP and defence expenditure and under-utilization of the capital budget. Further, it is hoped that the recommendations of the Fiscal Responsibility and Budget Management (FRBM) Review Panel which submitted its report recently would enable the Ministry of Finance not to be constrained to tap the 'Defence Capital Budget' to meet the fiscal deficit target.

For defence modernisation that has seen bad times in the recent past, some new developments have kindled hopes for better times. First came the news on January 23, 2017 of the Hon'ble Supreme Court's go ahead for the presentation of the Union Budget on February 1.The Election Commission, in response to the demand from opposition parties for staying the presentation of the budget on February 1 in the interest of free and fair elections in the five poll-bound states, only advised the Union Cabinet Secretary that 'no state specific schemes' shall be announced in the budget and that the government's achievements in the five states must also not be highlighted. And finally, it was reported on January 24 that the Fiscal Responsibility and Budget Management (FRBM) review panel had submitted its report. These developments have to be seen in the context of issues which have been ailing defence modernisation in recent times.

Modernisation Expenditure

Defence expenditure has two major components, viz., capital and revenue. The capital budget caters for two heads. The first is modernisation of the three services and the joint staff, which includes acquisition of new platforms, weapons systems and major mid-life upgrades of platforms. The second includes land acquisition and capital works for the services and capital expenditure (both plant and machinery and capital works) of the Defence Research and Development Organisation (DRDO) and Ordnance Factories, among others. Modernisation constitutes about 82 to 83 per cent of the capital expenditure and as a first charge, caters for 'committed liabilities', i.e., milestone-related stage payment due in respect of contracts signed in the past. Only the residual amount is available for 'New Schemes', i.e. for making the first stage payment due on signing of contracts. (See Table No. 6 below).

As seen in Table No. 1, the share of capital expenditure from 2004-05 as a percentage of GDP and as a percentage of defence expenditure is declining.

Table No. 1

Defence Capital Expenditure relationship as percentage of GDP and Defence Expenditure (Rs. in Crores)

Year	Capital Expenditure	Revenue Expenditure	GDP	Capital Expenditure as % of GDP	Revenue Expenditure as % of GDP	Capital as a % of Defence Expenditure
2016-17 (BE)	86340	162759	15065010	0.573	1.080	34.66
2015-16	80117	145928	13567192	0.591	1.076	35.44
2014-15	81887	136807	12488205	0.656	1.095	37.44
2013-14	78872	124800	11272764	0.700	1.107	38.73
2012-13	70499	111277	9951344	0.708	1.118	38.78
2011-12	67902	103011	9009722	0.754	1.143	39.73
2010-11	62056	92061	7784115	0.797	1.183	40.27
2009-10	51112	90669	6477827	0.789	1.400	36.05
2008-09	40918	73305	5630063	0.727	1.302	35.82
2007-08	37462	54219	4987090	0.751	1.087	40.86
2006-07	33826	51669	4294706	0.788	1.203	39.56
2005-06	32338	48211	3693369	0.876	1.305	40.15
2004-05	31994	43862	3242209	0.987	1.353	42.18

Source: Defence Expenditure figure as per DSE Vol I (Except 2015-16 figures as per CGA website, at http://cga.nic.in/MonthlyReport/Published/3/2015-2016.aspx (accessed on January 24, 2017). GDP as per market prices are figures are based on CSO's National Accounts 2004-05 series/2011-12 onwards-national Accounts 2011-12 series and for 2015-16 & 2016-17 as per Union Budget Document.

Compounding Factor

The constraints of reducing share of capital expenditure got further aggravated by the Ministry of Defence (MoD) in 2007.[1] In a policy letter, the MoD identified items of expenditure which until then booked to the revenue budget, would henceforth be met by using the capital budget. To ensure that the elaborate capital acquisition process specified in the Defence Procurement Procedure (DPP) does not delay this prescribed activity, the policy letter specified that:

> (a) The expenditure will be booked to capital budget heads but the procedure to be followed should be as per Defence Procurement Manual (DPM). The list prescribed in 2007 was modified more than once subsequently. This came to be called Capital Budget Revenue Procedure (CBRP).
>
> (b) Offsets will not be applicable in respect of such procurements.

The annual expenditure figures under the CBRP category are not available in any document in the public domain. The extent of its usage is illustrated in Table No. 2 below by taking only one minor head for the navy (repair and refits) and one sub-head under minor head 'stores' for the air force, i.e., air frame and engines, and comparing the amount allotted at the budget estimate (BE) stage in 2005–06 prior to the introduction of CBRP and the current financial year, 2016–17.

Table No. 2

	AIR FORCE			**NAVY**		
Rupees in Crores						
	Total Revenue Budget	**Air Frame & Aero Engines**	**Percentage of Revenue Budget**	**Total Revenue Budget**	**Repair & Refits**	**Percentage of Revenue Budget**
2016-17	23656	1251	5.29	17425	865	4.96
2005-06	9005	2011	22.33	6027	1206	20.01

Source: DSE Vol I

The expenditure under these heads, which used to be upwards of 20 per cent of their respective revenue budgets, has come down to 5 per cent because a major part is being booked to the capital budget. By conservative estimates, the expenditure under CBRP would be of the order of Rs. 20,000 crore in 2015–16 (+/–

[1] Government of India, MoD letter No. PC-11(1)/Bud1/2007, dated September 25, 2007, available at http://cgda.nic.in/ifa/orders/cir_25_09_07. pdf (accessed on July 15, 2016).

5 per cent). This figure is about 9 per cent of the defence expenditure for 2015–16, which stood at Rs. 226,045 crores. Assuming that this figure has progressively come to 9 per cent, the allocation used for capital expenditure looks worse:

Table No. 3

	04-05	**05-06**	**06-07**	**07-08**	**08-09**	**09-10**	**10-11**	**11-12**	**12-13**	**13-14**	**14-15**	**15-16**
Share as per table no 1	42.18	40.15	39.56	40.86	35.82	36.05	40.27	39.73	38.78	38.73	37.44	35.44
Less CBRP				1	2	3	4	5	6	7	8	9
Actual Share	42.18	40.15	39.56	39.86	33.82	33.05	36.27	34.73	32.78	31.73	29.44	26.44

Impact of FRBM

The Government had constituted a five Member Committee[2] headed by N.K. Singh to comprehensively review and give recommendations on the FRBM roadmap for the future. The Terms of Reference (ToR) of the Committee were as under:

(a) To review the working of the FRBM Act over the last 12 years and to suggest the way forward, keeping in view the broad objective of fiscal consolidation and prudence and the changes required in the context of the uncertainty and volatility in the global economy;

(b) To look into various factors going into determining the FRBM targets;

(c) To examine the need and feasibility of having a 'fiscal deficit range' as the target in place of the existing fixed numbers (percentage of GDP) as fiscal deficit target; if so, the specific recommendations of the Committee thereon; and

(d) To examine the need and feasibility of aligning the fiscal expansion or contraction with credit contraction or expansion respectively in the economy.

FRBM Act 2003 was notified with effect from July 5, 2004. It required a reduction in two ratios, i.e., revenue deficit and fiscal deficit as a percentage of GDP, and the target was to wipe out the revenue deficit and bring down the fiscal deficit to 3 per cent by 2007–08, which was later deferred to 2008–09. However, given the

[2] Press Information Bureau, Government of India, Ministry of Finance releases dated May 17, 2016 and January 23, 2017, at http://pib.nic.in/newsite/PrintRelease.aspx?relid=145416 and http://www.pib.nic.in/newsite/erelease.aspx?relid=157603 (accessed on January 24, 2017).

international financial crisis of 2007, the deadlines for the implementation of the targets in the Act were suspended. While presenting the budget for 2012–13, the finance minister had introduced amendments to the FRBM Act as part of Finance Bill 2012. As per the amendments in 2012, the government was to take appropriate measures to reduce the fiscal deficit, revenue deficit and effective revenue deficit (effective fiscal deficit excludes from fiscal deficit those revenue expenditures [or transfers] in the form of grants for creation of capital assets) in order to eliminate the effective revenue deficit by March 31, 2015.

Finance Act 2015 extended the target dates for achieving the prescribed rates of effective deficit and fiscal deficit. The effective revenue deficit, which had to be eliminated by March 2015, now needed to be eliminated only after three years, i.e., by March 2018. The three per cent target of fiscal deficit, which was to be achieved by 2016–17, was now shifted by one more year to the end of 2017–18. In the FRBM period, when the economy did better than expected (2004–05 to 2007– 08), the actual total expenditure could exceed the BE figures, yet the fiscal deficit target would be met. But when the economy did not perform as well as expected, the government had to curtail its expenditure below the BE figure and as Table No.4 below illustrates, defence capital budget was a major contributor.

Table No. 4

Year	Defence Capital Budget (BE)	Actual capital Expenditure	Capital Budget Amount Under Utilised	BE Fiscal Deficit	Actual Fiscal Deficit	Change in Amount of Fiscal Deficit	Defence Capital budget Underutilisation as a Percentage of the Amount by which Fiscal Deficit Figure had to be Reduced to Meet FRBM Target
Rupees in Crores							
2011-12	69148	67902	1296	412817	516269	103452	Non FRBM Year
2012-13	79579	70499	9080	513590	490190	-23400	38.8
2013-14	86741	79125	7616	542499	502863	-39636	19.21
2014-15	94588	81887	12701	531177	510817	-20360	62.38
2015-16	94588	80117	14471	555649	532351	-23298	62.11

Source: Defence Capital Budget & expenditure figures as per DSE Vol and Fiscal deficit figures as per Union Budget documents

Silver Lining

Budget Presentation on February 1

The Parliament normally has three sessions, beginning the year with the Budget session, which is the longest and extends from the last week of February to the second week of May, followed by the Monsoon session covering a period of one month between August and September and the Winter session for one month between November and December. The budget is presented in the budget session of the parliament and traditionally it has been presented on the last working day of February. The prescribed procedure of general discussion for four to five days followed by detailed examination of Demands for Grants of various Ministries/Departments by concerned Standing Committees and submission of their reports takes time.

After the reports of the Standing Committees are presented to the House, the House proceeds to the discussion and Voting on Demands for Grants, of all ministries and departments. Since Parliament is not able to vote on the entire budget before the commencement of the new financial year, the necessity to keep enough finances at the disposal of the government in order to allow it to run the administration of the country remains. A special provision is therefore made for 'Vote on Account' by which government obtains the Vote of Parliament for a sum sufficient to incur expenditure on various items for a part of the year.

Normally, the Vote on Account is taken for two months only**.** In accordance with the provisions of Article 116 of the Constitution, funds made available under Vote on Account are not to be utilized for expenditure on a 'New Service'. This binding constraint means that the Government including by Competent Financial Authorities (CFAs) at the MoD and Service Headquarters can approve no new modernisation schemes. This means the precious loss of two months. Since the capital acquisition is a meandering process, very few schemes can get processed. This is illustrated below by noting the percentage of BE utilised up to December is the past six financial years.

Table No. 5

	2015-16	**2014-15**	**2013-14**	**2012-13**	**2011-12**	**2010-11**
April	5	(*)	3	2	2	1
May	10	12	19	8	7	4
June	18	17	26	*18*	12	12
July	25	23	32	21	18	17
August	29	28	37	26	25	*26*
September	35	37	46	*35*	35	37
October	42	42	55	40	37	42

November	49	47	61	50	46	49
December	60	58	75	64	65	59

Source: CAG websitehttp://cga.nic.in/index.aspx (accessed on January 24, 2017).
(*) Details not available

It becomes a double whammy because at a time when the revised estimates (RE) discussions start in end-December, not many contracts would have been signed. Because of low expenditure under new schemes, the amount allocated for 'New Schemes' is scaled down at RE stage. This accounts for the underutilisation of capital budget which has been a recurring phenomenon (except in two financial years) as can be seen from Table No.6 below.

Table No.6

Fin Year	Capital BE	Actual Expenditure	Underutilisation	Underutilisation as a percentage of BE	Fin Year	Capital BE	Actual Expenditure	Underutilisation	Underutilisation as a percentage of BE
	Rupees in Crores					Rupees in Crores			
15-16	94588	80117	14471	15.30	05-06	34375	32338	2037	5.93
14-15	94588	81887	12701	13.43	04-05	33483	31994	1489	4.45
13-14	86741	78872	7868	9.07	03-04	20953	16863	4090	19.52
12-13	79579	70499	9080	11.41	02-03	21411	14953	6458	30.16
11-12	69148	67902	1246	1.80	01-02	19959	16207	3752	18.80
10-11	60000	62056	-2056	-3.43	00-01	17926	12384	5542	30.92
09-10	54824	51112	3712	6.77	99-00	12230	11855	375	3.07
08-09	48007	40918	7089	14.77	98-99	10360	10036	324	3.13
07-08	41922	37462	4460	10.64	97-98	8907	9104	-197	-2.21
06-07	37458	33826	3632	9.70	96-97	8944	8508	436	4.87

Source: DSE Vol I

The current financial year (2016-17) would be no different. The BE allocated is given in Table No.7 below. During the discussion of the Parliament Standing

Committee on Defence, on a query from the committee on 'the amount earmarked for the purchase of the aircraft in the budget of the year 2015-16 and 2016-17', the MoD submitted:

> 'A separate proposal will be moved for additional funds in FY 2016-17 to procure the 36 Rafale aircraft after details regarding cost and delivery timelines are finalized.'[3]

Table No.7

	CAPITAL BE 2016-17 (Rs in Crores)					
Sl No		2016-17		Committed Liabilities	New Schemes	Total
1	Capital (Acquisition including DGOF Supplies)	70000.00	Army	19449.26	2086	21535.26
	Capital (other than Acquisition)		Navy	18763.77	1600	20363.77
2	Land & Works of 3 Services (including Married Accommodation Projects)	7923.25	Air Force	22871.05	4684.97	27556.02
3	DRDO, DGOF and Other Defence Departments	8416.75	Joint Staff	325.55	219.4	544.95
	Total Capital	86340.00		61409.63	8590.37	70000

Source: Para 1.20 of the 22nd report of the parliament Standing Committee on Defence of the 16th Lok Sabha

As per the expenditure booked under head 'Capital Outlay on Defence Services', Rs.35,190.13 crores was spent till October 2016 and Rs. 49,937.77 crores has been spent till November 30, 2016.[4] This expenditure of November includes upwards of Rs. 8,000 crores paid on signing of the 36 Rafale aircraft contract. If we exclude this expenditure as this was to be allocated in addition, the expenditure in the first eight months of the year has been Rs. 41,000 crores out of an allocation of Rs. 78,000 crores i.e., 52.6 per cent. The RE figures would be known on February 1, 2017. The trend is expected to continue and RE figure would be the BE figure or may be even less. With Rs. 8,000 plus crores already spent on a scheme for which additional funds were to be allocated, once again only contracts for some minor

3 Para 1.25 of the 22nd Report of the Parliament Standing Committee on Defence, 16th Lok Sabha, available at http://164.100.47.193/lsscommittee/Defence/16_Defence_22.pdf (accessed on July 15, 2016).

4 As per CGA website http://cga.nic.in/MonthlyReport/Published/3/2015-2016.aspx (accessed on January 24, 2017).

schemes, which may utilize the slippages in committed liabilities, would get concluded. The presentation of the Union budget on February 1 is expected to ensure full utilisation of allocated funds and will ensure that 'New Schemes' can be processed, approved and contracted from April 1, 2017.

FRBM Act Review

Although not timed with any knowledge of the impending global crisis, the FRBM Act and its implementation have enabled the governments of the day to navigate the economy through a tough period of financial crisis and ensured that challenging 'fiscal deficit' targets set by the FRBM Act are achieved. This however has also come at a cost, one of which has been the constraints in building up of the defence capability. Hopefully, a range-bound target giving the government of the day some freedom to meet the essential expenditure will replace the binding constraint of the specified percentage.

The recommendation of the committee would enable the Ministry of Finance not to be constrained to tap the 'Defence Capital Budget' to meet the fiscal deficit target. It is also hoped that in addition to the above, a larger and compliant tax base as a result of the disruptive changes made in November 2016 and the planned and much awaited roll out of the Goods and Services Tax (GST) regime will be the catalyst to catapult the economy to a higher growth trajectory enabling the government to make much needed higher budgetary allocation for defence.

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