Push to modernize and create more opportunities for private players

The Union Budget was laid down by the Finance Minister (FM) on 1 February 2021. With almost 19% increase in capital outlay for defence expenditure, which is the highest ever increase in capital outlay for defence in the last 15 years, the Government of India has reiterated its focus towards defence modernization.

Defence has been characterized as one of the strategic sectors under the Disinvestment Policy of Government of India to minimize the presence of Central Public Sector Enterprises (CPSEs) and create further investment opportunities for private players in the sector.

Government’s aim of Atmanirbhar, i.e., self-reliance in defence is also reflected through the reduction in the custom duty rates for components and parts for manufacture of aircraft by Public Sector Units of Ministry of Defence.
How does the budget impact the defence sector?

- Defence allocation for 2021-22 is accounted under four demand for grants (same as last year):
  - Demand No 18 - Ministry of Defence (Civil)
  - Demand No 19 - Defence Services (Revenue)
  - Demand No 20 - Capital outlay on defence services
  - Demand No 21 - Defence Pensions

- Total defence budget (excluding defence pensions) in 2021-22 amounts to US$49.6 billion (INR 362,345.60 crores). Government’s budget allocation (in INR currency terms) has increased by 7.34% compared to the Budgeted Estimate (BE) of 2020-21 and 0.7% compared to Revised Estimates (RE) of 2020-21. Budgetary allocation towards capital and revenue expenditure stand at US$18.48 billion (INR 135,060.72 crores) and US$ 29.02 billion (INR 212,027.56 crores), respectively.

- Total defence expenditure (US$ billion)

- Brief on capital expenditure

  - Modernization of military forces is primarily driven by the capital outlay within each year’s budget. Budgetary allocation towards capital expenditure for this year is US$18.48 billion (INR 135,060.72 crores).

  - Current capital budget in INR terms is 18.75% higher than that of 2020-21(BE)
All three forces have shown an increase between 12-25% of their capital budget with the Army, Air Force and Navy registering 12.62%, 24.59% and 22.94% increase in allocations, respectively over 2020-21 (BE).

Closer examination of capital expenditure budget in INR terms for the Army suggests 68.18% increase in budget allocation for heavy and medium vehicles category when compared with 2020-21 (BE). For aircraft and aero engines, there has been an increase of 5.59% over the same period.

Aircraft and aero engines segment for Navy has witnessed 18.77% increase in allocation compared to 2020-21 (BE) while naval dockyards / projects witnessed 4.59% decline when compared with 2020-21 (BE).

The Air Force has witnessed ~104% increase in budget allocation for other equipment segment over 2020-21 (BE), while aircraft and aero engines segment has experienced a 9.81% decline as compared to 2020-21 (BE).

Breakdown of capital expenditure (US$ billion)
Brief on revenue expenditure

Revenue budget estimates for 2021-22 have only marginally increased as compared to 2020-21 (RE)

Revenue expenditure (US$ billion)

When measured in INR currency terms, Army has witnessed an increase of 2% in budget allocations compared to 2020-21 (RE). Navy has witnessed no change, whereas the Air Force has witnessed a reduction of 3% of allocation during the same period.

Breakdown of revenue expenditure (US$ billion)

Brief on miscellaneous expenditure

Demand of grant under Ministry of Defence (Miscellaneous) continues to be shown under Ministry of Defence (Civil) under Demand No 18.

Budget estimates for Demand No 18 for 2021-22 have been increased by 5.22% compared to 2020-21 (BE).

Notes and explanations

US$ amounts for 2020-21 have been computed at INR 71.49 whereas US$ amounts for 2021-22 have been computed at INR 73.05.
Key amendments

► Policy for strategic disinvestment in defence
  ▶ To increase investment from the private sector and minimize the presence of CPSEs, defence has been classified as one of the strategic sectors for disinvestment
  ▶ Strategic Disinvestment Policy to result in bare minimum presence of CPSEs in defence sector and remaining CPSEs to be privatized or merged or subsidiarized with other CPSEs or closed

► Tax incentives introduced to promote domestic aircraft leasing market
  ▶ Defence Acquisition Program (DAP) 2020 introduced “leasing: as an acquisition category in addition to “buy” and “make” category
  ▶ In 2020, Aircraft leasing was notified as an eligible financial product to be transacted in International Financial Services Centre (IFSC)
  ▶ Income-tax exemption has been proposed on royalty income received on aircraft lease by non-resident lessors from eligible IFSC units engaged in aircraft leasing subject to certain conditions

► Basic Customs Duty on import of components or parts, including engines by public sector units (under Ministry of Defence) has been reduced from 2.5% to nil for manufacturing of aircrafts or parts:

The above is subject to the below mentioned conditions:

► Importer is required to follow the procedure set out in the Customs (Import of Goods at Concessional Rate of Duty) Rules, 2017
  ▶ An officer not below the rank of Joint Secretary to the Government of India in the Ministry of Defence shall:
    (i) Certify the quantity, description and technical specifications of the imported goods
    (ii) Certify that the said goods are intended for manufacture of aircraft falling under heading 8802 or for manufacture of components or parts, including engines, of such aircrafts
    (iii) Recommend the grant of exemption to the imported goods

The above amendment is effective 2 February 2021.

► Custom duty rates of following commodities have been increased from 10% to 15% for:

<table>
<thead>
<tr>
<th>Tariff heading</th>
<th>Commodity</th>
<th>Effective date</th>
</tr>
</thead>
<tbody>
<tr>
<td>8544 3000</td>
<td>Ignition wiring sets and other wiring sets of a kind used in vehicles, aircrafts or ships</td>
<td>2 February 2021</td>
</tr>
<tr>
<td>9104 0000</td>
<td>Instrument panel clocks and clocks of a similar type for vehicles, aircraft, space craft or vessels</td>
<td>2 February 2021</td>
</tr>
</tbody>
</table>
► New tariff heading proposed for “unmanned aircraft” and parts thereof in order to align Indian Customs Tariff with changes introduced by World Customs Organisation (WCO) to the existing harmonized nomenclature
► Insertion of notes explaining the expression “unmanned aircraft” and few other notes related to unmanned aircrafts
► Insertion of the following tariff headings:

<table>
<thead>
<tr>
<th>Tariff heading</th>
<th>Description</th>
<th>Rate prescribed under tariff</th>
</tr>
</thead>
<tbody>
<tr>
<td>8806</td>
<td>Unmanned aircraft</td>
<td>10%</td>
</tr>
<tr>
<td>88071000 to 880730000</td>
<td>Parts of goods of Heading 8801, 8802 or 8806 (Specific parts)</td>
<td>3%</td>
</tr>
<tr>
<td>88079000</td>
<td>Parts of goods of Heading 8801, 8802 or 8806 (Others)</td>
<td>10%</td>
</tr>
</tbody>
</table>

Impact analysis

Significant increase in capital outlay (approx. 19%) from 2020-21 (BE) stage is a reflection of India’s current geo-political situation. From BE to RE stage, there was an increased expenditure due to emergency procurements. Amidst the pandemic, this increase in defence expenditure is sorely needed to solidify India’s resolve for an Atmanirbhar Bharat (self-reliant India).

For the Indian Army, a 68.18% increase in the budget allocation for heavy and medium vehicles suggests a strong focus on futuristic infantry combat vehicle (FICV)/ future ready combat vehicle (FRCV) and/or light tanks in Ladakh.

An increase of 104% in the budget allocation for “Other Equipment” in the Air Force segment over 2020-21 (BE) and series of missile tests by the DRDO in the last six months indicates an induction of more weapons. Allocation of US$3.32 bn (INR 24,268.20 crores) under “Aircrafts and Aeroengines-Air Force” head also includes 85% committed liabilities. The same indicated that the Air Force may either go ahead with the C-295 program and spend a major portion of allocated budget under this head or revalidate on the LAC and induct other systems/platforms as required.

For the Indian Navy also, there is a significant increase in budget allocations for the aircraft and aeroengines segment. This increase possibly suggests further progress on the MQ9 Sea Guardian program.

There is increase of US$58.18 m (INR 425.03 crores) under the special projects head of the Airforce. The Budget allocation of the Directorate General Quality Assurance (DGQA) has also increased to US$2.73 m (INR 20 crores) from US$1.65 m (INR 12.06 crores). This indicates further development on Defence Testing Infrastructure Scheme (DTIS) announced last year with an outlay of INR 400 crores.

This Budget is reflective of the various initiatives taken by the government for defence modernization, and therefore it envisages a continuation in the expenditure trend.
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