

## FIRM ON MODERNISATION: INDIA'S DEFENCE BUDGET 2021-22

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*The Union Budget 2021-22, presented to the Parliament on February 01, 2021, earmarked Rs 4,78,196 crore to the Ministry of Defence or some 14 per cent of the total central government's budget. Representing an increase of just 1.4 per cent, the increase in the MoD's latest allocation is one of the lowest in recent past. What has caused such a paltry increase in the defence budget? How does it impact the modernisation of the Indian armed forces, which has drawn increasing attention because of the Chinese aggression on India's borders? This issue brief examines the MoD's latest allocations along with the recommendation of the 15th Finance Commission which was specifically tasked to find a solution to the perennial shortage of funds for India's defence and security modernisation.*



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## INTRODUCTION

Presenting her third and the Modi government's eighth consecutive regular budget on February 01, the Finance Minister Nirmala Sitharaman allocated Rs 4,78,196 crore (\$ 65.6 billion<sup>1</sup>) to the Ministry of Defence (MoD). Representing an increase of Rs 6,818 crore, or 1.4 per cent, the hike in MoD's budget is one of the lowest in the recent past. Is the meagre increase in defence allocation due to India's once-in-a-century economic crisis precipitated by the Covid-19 pandemic? How does the new budget fare on the country's defence modernisation front which has drawn increased attention due to the Chinese military aggressiveness in the eastern Ladakh, leading to the worst military standoff in decades? This issue brief examines the defence budget 2021-22 and its critical components to decipher the larger picture. It also looks at the recommendations of the 15th Finance Commission that was tasked to address the severe resource constraints being faced by the defence and security establishments of the country. The brief, however, begins with a broad survey of the Indian economy and the state of public finance, both of which have a direct implication on the MoD which accounts for the highest allocation among all central government ministries.

### State of the Indian Economy and Public Finance

The Union Budget 2021-22 comes in the backdrop of a severe economic crisis induced by the Covid-19 pandemic. The Indian economy, which was already slowing down prior to the crisis, was hit hard by the stringent lock-down following the pandemic's outbreak. The disruption that followed caused a massive contraction of the economy, with the first quarter of the gross domestic product (GDP) contracting by a record 23.9 per cent. Though a degree of normalcy has returned since then, the economy is nevertheless expected to decline by 7.7 per cent in 2020-21 (compared to 4.2 per cent growth in 2019-20) - the sharpest negative growth since 1960-61.<sup>2</sup>

However, owing to the resilience of the Indian economy and a host of monetary and fiscal measures taken by the central bank and the union government, the economy is all set to rebound to the growth trajectory. The *Economic Survey 2020-21*, presented to the Parliament on January 29, estimates the GDP to increase by 11.0 per cent in real terms (or 15.4 per cent in nominal terms) in 2021-22 - the highest since Independence.

The expected rebound of the Indian economy notwithstanding, the economy will take nearly two years to regain the previous high. The pandemic-induced crisis has necessitated a massive stimulus programme amounting to 13 per cent of the GDP,<sup>3</sup> leading to fiscal profligacy hardly seen before. The fiscal deficit (FD), or the amount of money that the government borrows to meet all its expenditure ballooned from the initial 3.5 per cent of the GDP to 9.5 per cent in 2020-21. In absolute terms, the estimated fiscal deficit of 6.8 per cent of GDP for 2021-22 amounts to a whopping Rs 15,06,812 crore or 43 per cent of the total central government expenditure (the corresponding share for 2020-21 was 26 per cent). The massive borrowing to fund public expenditure is partly due to the lack of buoyancy in revenue collection. The central government's total net tax revenue is estimated to decline by Rs 90,513 crore to Rs 15,45,396 crore in 2021-22.

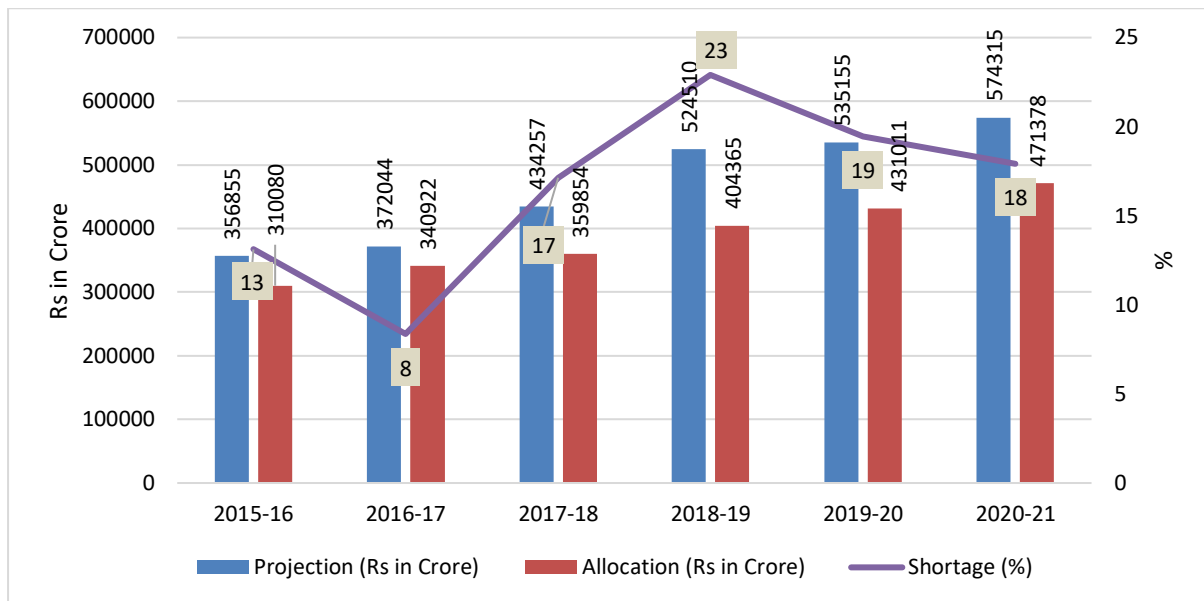
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<sup>1</sup> The conversion to US\$ is based on exchange rate of \$1.0 = Rs 72.8986

<sup>2</sup> Ministry of Finance, *Economic Survey 2020-21, Vol. II*, p. 42.

<sup>3</sup> Ministry of Finance, Government of India, "Budget 2021-22 (Budget Speech)", p. 2.

**Figure 1. MoD's Resource Projection and Allocation**



The meagre growth in the MoD's allocation has to be seen in the context of serious economic stress, a decline in tax revenue and high fiscal deficit. However, the defence establishment would not be a happy lot considering the urgency and necessity of modernisation primarily, because of the military standoff with the Chinese forces at the eastern Ladakh and the substantial resource constraints it is facing for the past several years. Figure 1 illustrates the gap between annual resource projection and the allocations has remained quite wide open with the shortage in 2020-21 alone amounting to nearly Rs 1,03,000 crore. Given that the fiscal space going forward will be limited (in view of the government's announcement to bring down the FD below 4.5 per cent by 2025-26), the scope for hefty growth in the defence allocation in the medium term is doubtful. It is, therefore, imperative to find innovative ways to mitigate resource constraints. Can the report of the 15th Finance Commission show the way?

### Defence Budget: The Big Picture

Of the total allocations for the MoD, defence services comprising the Armed Forces (Army, Navy and Air Force), the Defence Research and Development Organisation (DRDO) and Ordnance Factories (OFs), constitute the most significant component, followed by the defence pension and MoD (Civil) (see Table 1). The defence services also account for the biggest growth in allocations, compared to both the previous budget and its revised estimate. The total allocations earmarked for the MoD represents 13.7 per cent of the total central government expenditure and 2.15 per cent of the GDP. The MoD's total capital expenditure amounts to 29 per cent of its budget (Table 2) and accounts for 25 per of the total central government's capital outlays (See Annexure 1 for defence budget indicators).

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**Table 1. Component of MoD's Budget 2021-22**

	MoD (Civil)#	Defence Pension	Defence Services*	Total MoD
2020-21 (BE) (Rs in Crore)	14,500 (3)	1,33,825 (28)	3,23,053 (69)	4,71,378
2020-21 (RE) (Rs in Crore)	15,914 (3)	1,25,000 (26)	3,43,822 (71)	4,84,736
2021-22 (BE) (Rs in Crore)	15,257 (3)	1,15,850 (24)	3,47,088 (73)	4,78,196
% Increase in 2021-22 (BE) over 2020-21 (BE)	5.2	-13.4	7.4	1.4
% Increase in 2021-22 (BE) over 2020-21 (RE)	-4.1	-7.3	0.9	-1.3

*Note. \*: Include Army, navy, air force, ordnance factories and Defence Research and Development Organisation (DRDO). Figures in parentheses represent percentage share in total MoD.*

**Table 2. Revenue-Capital Expenditure of MoD's Budget 2021-22**

	Revenue Expenditure	Capital Expenditure	Total Expenditure
MoD (Civil) (Rs in Crore)	10,084	5,173	15,257
Defence Pension (Rs in Crore)	1,15,850	---	1,15,850
Defence Services (Rs in Crore)	2,12,028	1,35,061	3,47,088
Total (Rs in Crore)	3,37,961	1,40,234	4,78,196
% of Total	71	29	100

The noticeable feature of the MoD's allocation is the sharp 13.4 per cent (Rs 17,975 crore) decline in pension budget. While a part of the decline could be explained due to the freezing of Dearness Relief, the big drop does not seem to be realistic. Considering that the nearly 60,000 new retirees add to the existing pool of nearly 3.2 million defence pensioners every year, and the increasing life-span of average Indians, the pension budget is unlikely to drop. The budgeted amount for 2021-20 is Rs 1,960 crore less than Rs 1,17,810 crore that the MoD incurred on pension in 2019-20, indicating that the new pension budget is underestimated.

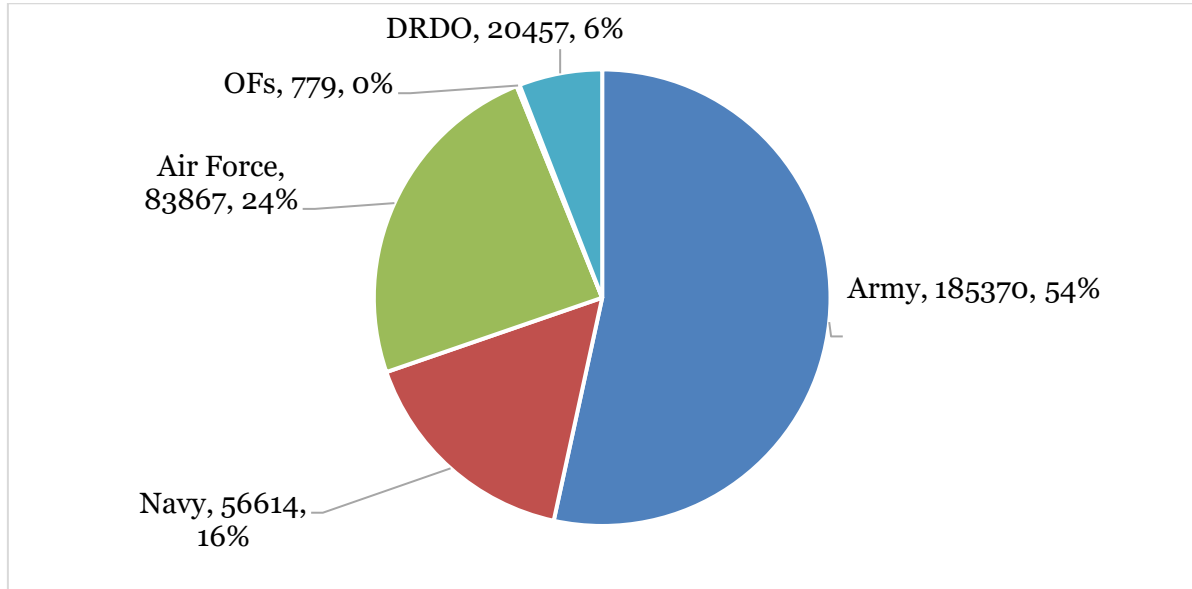
Keeping the inexplicable big drop in the pension budget aside, the hike in the MoD's budget amounts to Rs 24,793 crore or an increase of 7.3 per cent. What is significant in this growth is that it is almost entirely driven by the hike in capital expenditure which has increased by 18 per cent (Rs 21,679 crore). This is a marked departure from the past several budgets characterised by hefty growth in manpower cost.

### Share of the Defence Services, 2021-22

The Indian army with a personnel strength of near 1.2 million (or 85 per cent of the total uniformed personnel) has a commanding share of 54 per cent in the MoD's latest budget (see Figure 1). However, its share in the budget has declined marginally, from 56 per cent in the

previous budget.<sup>4</sup> Among the three forces, the army is, however, least capital intensive, with 80 per cent of its budget going to pay for salary, ration and other revenue expenses (see Table 3).

**Figure 2. Distribution of Defence Services Budget 2021-22**



**Table 3. Revenue-Capital Ratio of Armed Forces, 2021-22**

	Army	Navy	Air Force
Revenue Expenditure (Rs in Crore)	1,48,819	23,361	30,653
Capital Expenditure (Rs in Crore)	36,552	33,254	53,215
% Share of Revenue Expenditure	80	41	37
% Share of Revenue Expenditure	20	59	63

### Modernisation Expenditure

Notwithstanding a meagre growth in the MoD's overall allocations, the modernisation budget, has seen a 23 per cent increase (Rs 21,042 crore), with double-digit growth in the allocation for each of the three services (see Table 4 and Annexures 2-4).

However, the hefty 23 per cent hike in the modernisation budget is unlikely to satiate the needs of the MoD, considering the huge shortages in the allocation over the last several years. As Table 5 shows, the deficits in 2020-21 were over 53,600 crores or over 52 per cent of the MoD's total shortages in that year. This means the government must provide additional allocation at the revised estimate stage, like it has done for 2020-21, to speed up procurement. Otherwise, the pace of the modernisation would necessarily be curtailed.

<sup>4</sup> For a discussion share of defence services in previous defence budget, see Laxman Kumar Behera, "India's Defence Budget 2020-21", *IDS.A Issue Brief*, February 04, 2020, <https://idsa.in/system/files/issuebrief/def-bgt-2020-21-040220.pdf>.

**Table 4. Modernisation Expenditure of Armed Forces**

	2020-21 (BE) (Rs in Crore)	2020-21 (RE) (Rs in Crore)	2021-22 (BE) (Rs in Crore)	% Increase in 2021-22 (BE) over 2020-21 (BE)
Army*	25,999	25,999	30,587	18
Navy	25,620	36,478	32,235	26
Air Force	39,031	51,804	48,870	25
Total	90,649	1,14,280	1,11,691	23

*Note. \*: Figures for army are approximate*

**Table 5. Shortages on Modernisation, 2020-21**

	Projection (Rs in Crore)	Allocation (Rs in Crore)	Shortages (Rs in Crore)	Shortages (%)
Army	41,531	26,069	15,462	37
Navy	40,928	24,598	16,330	40
Air Force	60,840	39,031	21,809	36
Total	1,43,299	89,698	53,601	37

*Note. Navy excludes Joint Staff*

### 15th Finance Commission, Non-Lapsable Defence Modernisation Fund and Defence Reforms

In July 2019 the Modi government had tasked the 15th Finance Commission to address severe resource constraints being faced by the Defence and Home Affairs ministries in their modernisation efforts. Also, to examine if whether a "separate mechanism for funding of defence and internal security ought to be set up and if so, how such a mechanism could be operationalised."<sup>5</sup> In view of the charter, the Commission has made several vital recommendations that would, if implemented, go a long way in mitigating the shortages of resources required for security sector modernisation and make the defence expenditure, in particular, sustainable.

The Commission in its report has asked the government to create in the Public Account of India Rs 2,38,354 crore non-lapsable Modernisation Fund for Defence and Internal Security (MFDIS) to bridge the gap between projected requirement and budget allocations for the MoD and the Ministry of Home Affairs. The proceeds of the fund would accrue over five years from 2021-22 to 2025-26. The Commission has suggested the following three broad sources to generate resources for the non-lapsable MFDIS:

1. Transfer from the Consolidation Fund of India at the rate of one per cent of the central government's annual gross revenue receipts (Rs 1,53,354 crore or 64 per cent in five years)
2. Disinvestment proceeds of Defence Public Sector Undertakings (DPSUs) (Rs 40,000 crore or 17 per cent)
3. Monetisation of defence land (Rs 45,000 crore or 19 per cent)

<sup>5</sup> Press Information Bureau, Ministry of Finance, "Cabinet approves Amendment in the Terms of Reference for the Fifteenth Finance Commission", July 17, 2019.



It is worth noting that while suggesting the creation of a dedicated non-lapsable fund, the Commission has been categorical in stating that any under-utilised capital budget from the annual budgets of MoD and the MHA would not be part of the proposed fund. The Commission has suggested any under-utilised amount would be returned to the Consolidated Fund of India as is the case now. This ensures that these two ministries that oversee India's internal and external security do not show complacency in utilising their respective allocated budget and park their under-used money in the fund for use in the future at their convenience.

The Commission has also recommended that of the total amount, the MoD would be entitled to Rs 1,88,354 crore or 79 per cent of the MFDIS. The remaining amount will be under the MHA's disposal to fund capital expenditure related to internal security.

While suggesting the creation of the non-lapsable fund, the Commission has also urged the MoD, the bigger beneficiary of the proposed MFDIS, to "take immediate measures to innovatively bring down the salaries and pension liabilities". Suffice it to say that the manpower cost, the major elements of which are salaries and pension, has increased significantly from less than 50 per cent of the MoD's budget to over 60 per cent in a time span of 10 years ending 2020-21. During the same period, the share of modernisation expenditure has declined from 27 per cent to 19 per cent.<sup>6</sup> While urging the MoD to reduce its manpower cost, particularly on account of pension, the Commission has taken note of its various options being contemplated by the MoD. These include:

- Bringing service personnel currently under the old pension scheme into the New Pension Scheme (NPS) or a separate NPS for the armed forces
- Increasing the retirement age of personnel below officer ranks to a reasonable level
- Transfer of retired personnel to other services, like the paramilitary forces, after active service of a certain duration
- Resettlement of ex-servicemen through skill development courses

The 15th Finance Commission has also urged the MoD to reduce dependence on defence import. In this respect, the Commission has recommended to the Ministry of Finance (MoF) to incentivise the MoD to work on a time-bound action plan for progressive increase in the share of indigenous arms in India's defence procurement. The Commission hopes that a calibrated roadmap should enable the MoD to source not more than 30 per cent of its arms requirement from the foreign vendors by the end of 2025-26.

## CONCLUSION

The meagre hike of 1.4 per cent in the defence budget 2021-22 could only be explained by a sharp but inexplicable contraction in the pension budget, the worst economic crisis that the country has faced in a century downturn in the revenue collection. Excluding the pension, the defence budget has grown by a modest 7.4 and, more importantly, is driven by a hefty 18 per cent increase in capital expenditure. However, given the resource shortages facing the defence establishment, particularly on the modernisation front, even this 18 per cent hike in the capital expenditure does not look enough.

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<sup>6</sup> Laxman Kumar Behera and Madhulika Baniwal, "Bang for the Buck: India's Defence Expenditure in a Wider Context", *MP-IDSA Special Feature*, July 10, 2020, <https://idsa.in/system/files/comments/sf-india-defence-expenditure-100720.pdf>.

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Going forward, the non-lapsable modernisation fund, suggested by the 15th Finance Commission, could play a vital role in supplementing funds for the modernisation of the Indian armed forces. Given the urgency of capability build-up, especially in view of the Chinese aggression along the international border, this vital piece of recommendation needs to be implemented at the earliest. Simultaneously, other recommendations by the Commission, particularly those related to curbing of manpower cost, also need to be acted upon without losing any time. Suffice it to say that reform in the manpower cost is long overdue and any further delay will squeeze modernisation and adversely affect India's defence preparedness. The Finance Commission has given the roadmap. It is time for the MoD, particularly the Department of Military Affairs headed by the Chief of Defence Staff (CDS), to act on it.

**ANNEXURE: 1  
Defence Budget Indicators**

<b>Indicator</b>	<b>2020-21</b>	<b>2021-22</b>
Defence Services Budget (Rs in Crore)	3,23,053	3,47,088
Growth of Defence Services Budget (%)	5.8	7.4
Revenue Expenditure of Defence Services (Rs in Crore)	2,09,319	2,12,028
Growth of Revenue Expenditure of Defence Services (%)	3.7	1.3
Share of Revenue Expenditure in Defence Services Budget (%)	65	61
Capital Expenditure of Defence Services (Rs in Crore)	1,13,734	1,35,061
Growth of Capital Expenditure of Defence Services (%)	10.0	18.8
Share of Capital Expenditure in Defence Services Budget (%)	35	39
Share of Capital Expenditure of Defence Services in Central Government Capital Expenditure (%) #	28	24
Capital Acquisition (Rs in Crore)	90,048	1,11,691 <sup>^</sup>
Growth of Capital Acquisition (%)	11	24
Share of Defence Services Budget in GDP (%) *	1.66	1.56
Share of Defence Services Budget in Central Government Expenditure (%)	10.6	9.96
Defence Pension (Rs in Crore)	1,33,825	1,15,850
Growth of Defence Pension (%)	19.4	-13.4
MoD (Civil) (Rs in Crore)	14,500	15,257
Growth in MoD (Civil) (%)	6.3	5.2
MoD's Budget (Rs in Crore)	4,71,378	4,78,196
Growth in MoD's Budget (%)	9.4	1.4
Share of MoD Budget in GDP (%) *	2.42	2.15
Share of MoD Budget in Central Government Expenditure (%)	15.49	13.73

*Note. \*: Based on GDP's revised estimate for 2020-21 and budget estimate for 2021-22; #: The share is with respect to the capital segment of the defence services. If the MoD's total capital expenditure is taken into account, the share increases to 29 per cent and 25 per cent in 2020-21 and 2021-22, respectively. ^: Approximate figure*



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**ANNEXURE: 2  
Modernisation Expenditure of Army**

Modernisation Head	2020-21 (BE) (Rs in Crore)	2020-21 (RE) (Rs in Crore)	2021-22 (BE) (Rs in Crore)	% Increase in 2021-22 (BE) over 2020-21 (BE)
Aircraft & Aero-Engine	4,000	3,809	4,224	6
H&MV	1,589	1,319	2,673	68
Other Equipment	20,209	20,650	23,490	16
Rolling Stock	100	150	100	0
Rashtriya Rifles	100	70	100	0
Total	25,999	25,999	30,587	18

*Note. Figures for the Army are approximate*

**ANNEXURE: 3  
Modernisation Expenditure of Navy**

Modernisation Head	2020-21 (BE) (Rs in Crore)	2020-21 (RE) (Rs in Crore)	2021-22 (BE) (Rs in Crore)	% Increase in 2021-22 (BE) over 2020-21 (BE)
Aircraft & Aero-Engine	4,640	8,687	5,511	19
H&MV	30	30	30	0
Other Equipment	3,000	5,950	5,500	83
Joint Staff	1,022	762	1,204	18
Naval Fleet	12,746	17,394	16,000	26
Naval Dockyard/Projects	4,182	3,654	3,990	-5
Total	25,620	36,478	32,235	26

**ANNEXURE: 4  
Modernisation Expenditure of Air Force**

Modernisation Head	2020-21 (BE) (Rs in Crore)	2020-21 (RE) (Rs in Crore)	2021-22 (BE) (Rs in Crore)	% Increase in 2021-22 (BE) over 2020-21 (BE)
Aircraft & Aero-Engine	26,910	29,425	24,268	-10
H&MV	120	80	120	0
Other Equipment	12,001	22,299	24,481	104
Total	39,031	51,804	48,870	25



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*Views are author's own.*

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