1 February 2022

Union Budget 2022

Tax Alert – Defence Sector

Government committed to reducing defence imports and increasing self-reliance

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Digital signature

The Union Budget was presented by the Finance Minister on 1 February 2022. With ~12.82% increase in capital outlay for defence expenditure, the government has continued its effort towards defence modernization.

Reiterating its commitment to promote indigenization, 68% of the capital procurement has been proposed to be earmarked for domestic industry in 2022-23, up from 58% in 2021-22.

Further, 25% of the R&D budget has been earmarked for industry, start-ups, and academia. Private industry will be encouraged to take up design and development of military platforms and equipment in collaboration with DRDO and other organizations through SPV model. This step should incentivize industry led research towards development of military platforms and encouraging collaborative efforts in a PPP mode with DRDO and other research institutions in the country.

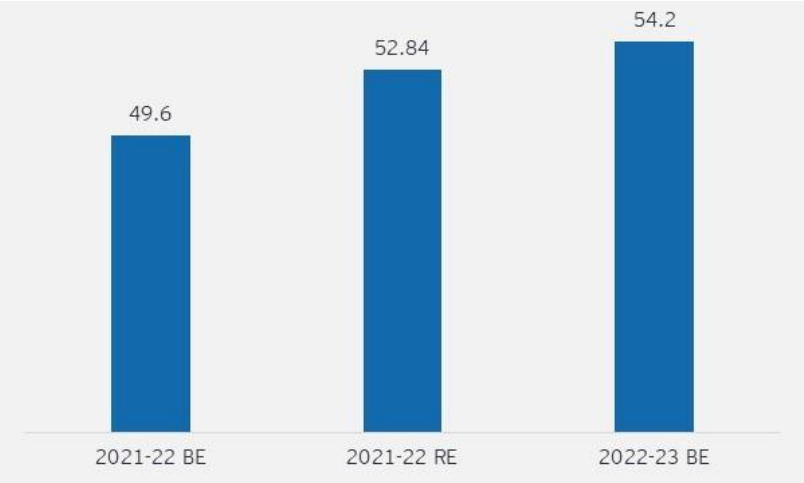
Prescribing sunset date of 31 March 2023 for existing exemption available on specific imports in relation to defence and internal security forces is a measure to promote the domestic industry and reduce reliance on imports.

How does the budget impact defence sector?

- Defence allocation for FY 2022-23 is accounted under four demands for grants:
  - Demand No 19 – Ministry of Defence (Civil)
  - Demand No 20 – Defence Services (Revenue)
  - Demand No 21 – Capital outlay on defence services
  - Demand No 22 – Defence Pensions

The total defence budget (excluding defence pensions) for FY 2022-23 amounts to USD54.20 billion (INR4,05,470.15 crores). Budgetary allocation towards capital and revenue expenditure stands at USD20.36 billion (INR1,52,369.61 crores) and USD31.14 billion (INR2,33,000.54 crores), respectively.

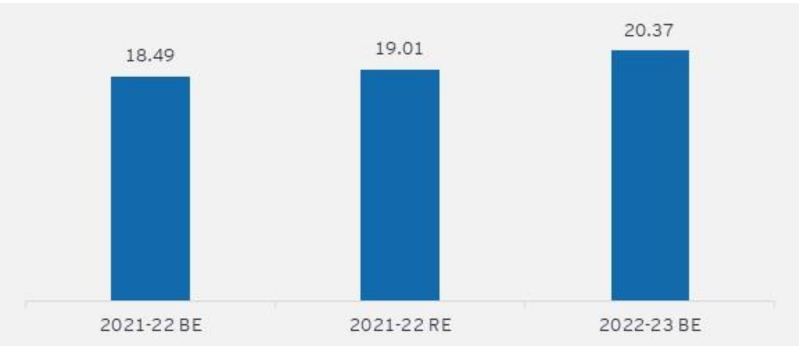
Total defence expenditure (excluding defence pensions) (US$ billion)



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$20.36 billion (INR 1,52,369.61 crores).
- Current capital budget in INR terms is 12.82 % higher than that of 2021-22 (BE).

Capital expenditure (US$ billion)



Highlights

12.82% increase in Capital outlay allocation

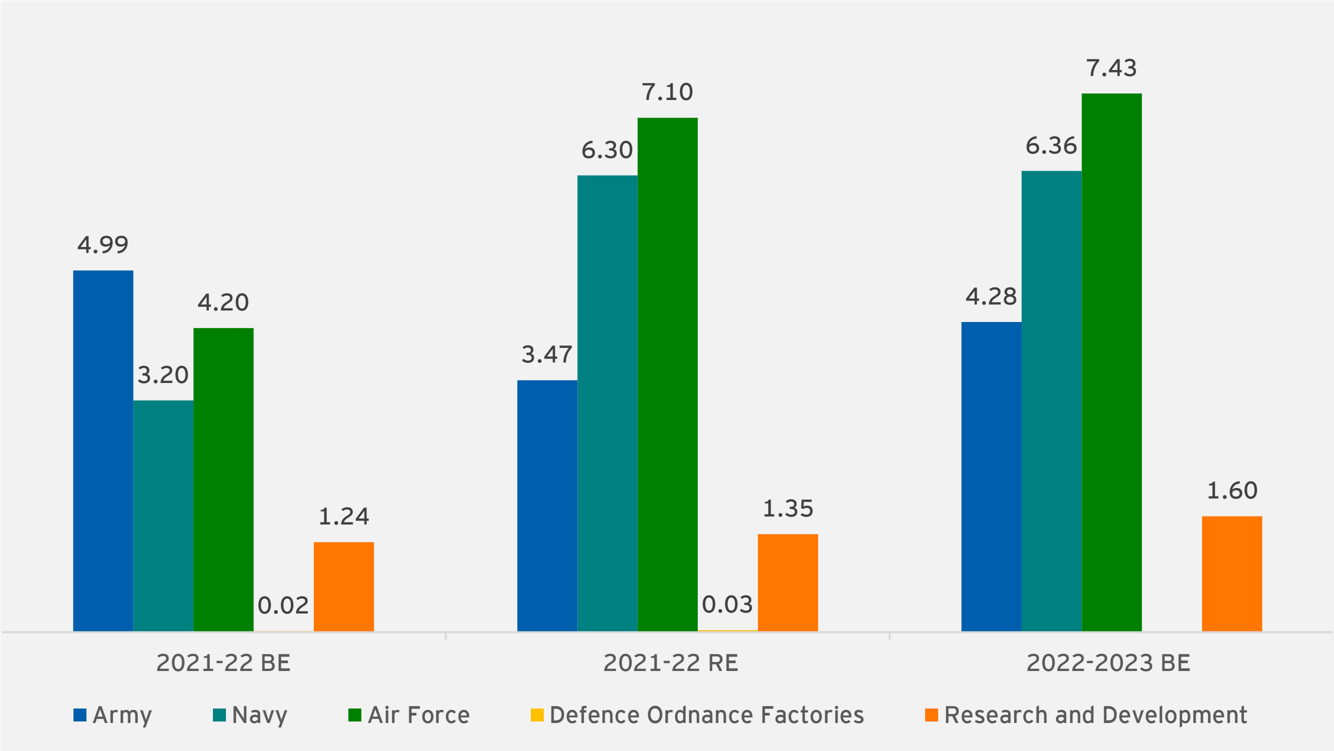
Nodal Body – testing and certification

Continuing the focus on reduction of defence imports and private participation

Encouraging private sector to collaborate with DRDO

- Indian Navy and Indian Air Force have witnessed an increase of ~43% and ~4% of their capital budget respectively over 2021-22 (BE), whereas Indian Army's allocation has reduced by ~12%.
- Closer examination of capital expenditure budget in INR terms for Aircraft and Aeroengines shows almost ~50% reduction in case of Army, whereas there is an increase of ~21% and ~7% for Indian Air Force and Indian Navy respectively under this head.
- At the RE (2021-22) stage, both Indian Navy and Indian Air Force utilized more than what was allocated at the BE (2021-22) stage. Indian Army had spent ~69% of its allocation at the RE (2021-22) stage.

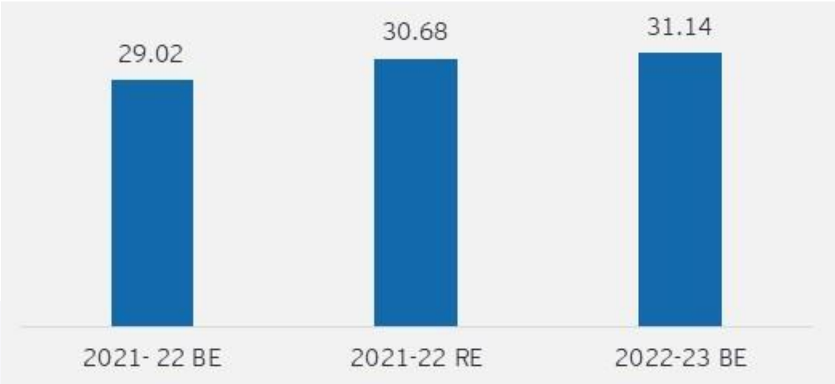
Breakdown of capital expenditure (US$ billion)



Brief on Revenue Expenditure

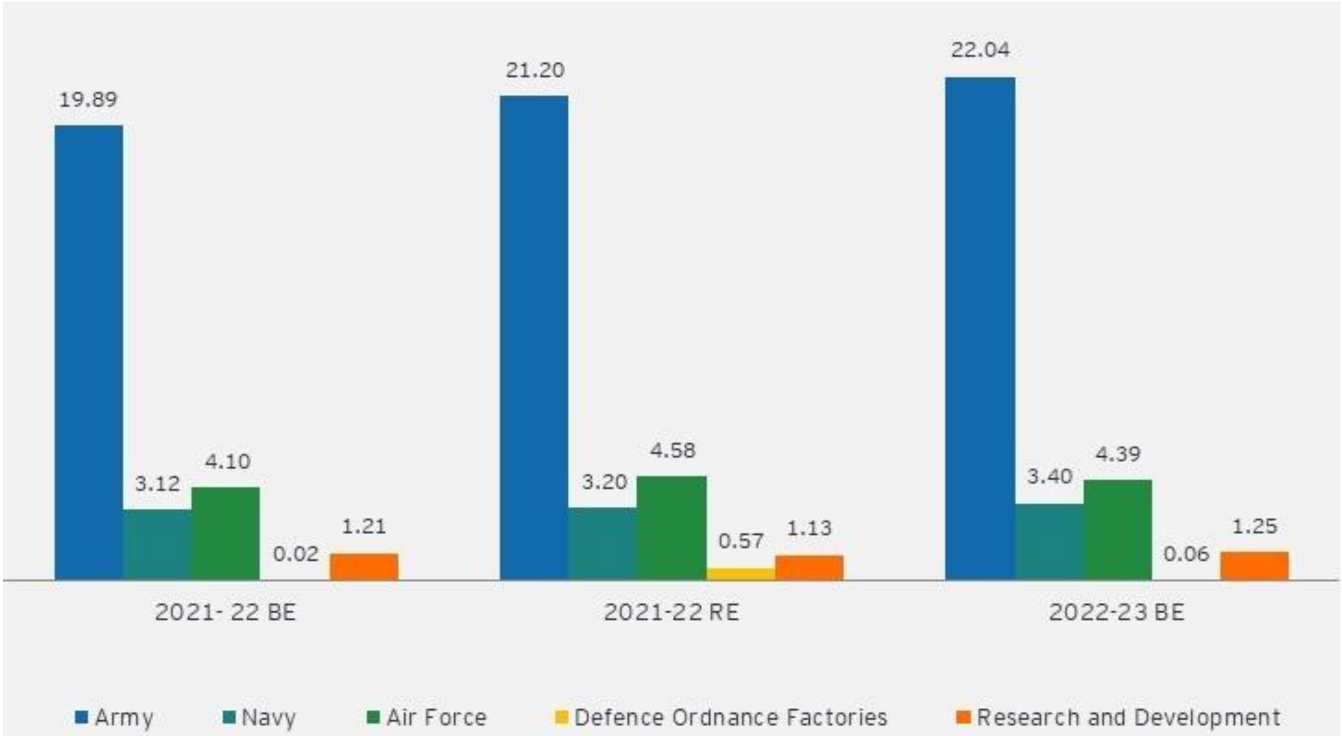
- Revenue budget estimates for 2022-23 have increased by 10% as compared to 2021-22 (RE).

Revenue expenditure (US$ billion)



- When measured in INR currency terms, Army has witnessed an increase of 10% in budget allocations compared to 2021-22 (RE). Navy has witnessed 8% increase and Air Force has witnessed a 7% increase of allocation during the same period.
- Overall, the revenue budget has increased by 10% over 2021-22 (RE).

Breakdown of revenue expenditure (US$ billion)



Notes and Explanations

- US$ amounts for 2022-23 have been computed at INR 74.81 whereas US$ amounts for 2021-22 have been computed at INR 73.05 as on 01 February of respective years.

Key amendments

Customs

- Several changes to duty rates aligned to 'Make-in-India' and 'Atmanirbhar Bharat' policy.
- Measures taken for simplification of Customs tariff structure for products including helicopters, parts of manned/ unmanned aircraft etc. The simplified Customs tariff structure to come into effect from 1 May 2022.
- Sunset date of 31 March 2023 specified for existing exemption available on specific imports in relation to Defence and internal security forces.

GST

- Legislative changes proposed to introduce additional restrictions for availing Input Tax Credit (ITC).
- Time limit for availing credit and issuance of credit note extended to 30 November.

Impact analysis

This financial year builds up very strongly with the beginning of a new decade for an Atmanirbhar Bharat (Self-reliant India) last year. While a 12.82% increase over 2021-22 (BE) in the capital outlay continues to emphasize the importance of modernization of the Indian Armed Forces, there is a significant reduction as compared to a phenomenal 18.75% increase that was seen in the first year of the decade. However, a reservation of 68% of the capital budget for domestic procurement solidifies India's resolve for a self-reliant and Atmanirbhar Bharat. This is an increase of 10% which was spent for domestic procurement in the current year. As we aim to achieve a US$5 trillion economy with US$25 billion (INR 1,75,000 crore) defence production by 2025, this allocation is a giant step towards that goal.

For the first time, a reservation has been made for R&D in defence. The dedicated allocation of 25% in R&D, while encouraging new capabilities in creating and sustaining technologies, shall aid in creating an IP culture. Thus, an increased focus on IP management, output-oriented Industry research in academic institutions and possible collaborations with foreign research labs and centers shall lead to create cutting edge technologies.

With Buy IDDM being the category of highest priority in defence acquisition, this allocation finds synergy with the other stated policies of the GoI, thereby encouraging domestic design to go hand in hand with domestic production.

Domestic demand shall increase with the aforementioned reservations, hence placing an enormous responsibility on domestic suppliers to meet the challenge placed by the Armed Forces. This will indirectly increase capacities, new production facilities, increased collaborative framework with Foreign OEMs, more JVs, and enhanced investments (FDI). FOEMs, of those, who can appreciate the increased focus on domestic spending, shall be lured to find Indian design and production houses for technology transfers, teaming arrangements and a favorable environment to establish production base in India. The spiraling effect shall also be felt in the exports and thus in the economy, with a vibrant industry ready to meet global demands.

Indian Navy's allocation has witnessed the highest increase (~43%) of allocation of the capital budget amongst the three forces. The allocation under the naval fleet has almost doubled. This is attributed to the major platforms that are likely to be inducted in the near future. These include the Indian Aircraft Carrier, frigates under Project 15B, P 17A and Project 1135.6, Scorpene Submarine amongst others. Increased 43% allocation suggests a renewed focus in the Indian Ocean Region (IOR). Increase in allocation for Aircraft and Aeroengines for Indian Navy could indicate procurement of fighter aircraft for the Indian Aircraft Carrier (IAC).

Indian Army's allocation has reduced by 12% in comparison to 2021-22 (BE) with Aircraft and Aeroengines reducing by half. The major committed liabilities include MBT Arjun Mk1A, AK-203 rifles, ATGMs amongst others.

Indian Air Force has witnessed a marginal increase of 4% over 2021-22 (BE) indicating that leasing of BTA and MRTT could be progressed with majority of the budget being utilized for committed liabilities like the Rafales and S-400 Triumf systems.

After the corporatization of the OFB last year, no allocation has been made for the Defence Ordnance Factories (OFs). An allocation of INR13.1 b has been made for the 7 new DPSUs. As against an average of INR6 b each year to the OFs under capital budget, there is more than a 100% increase post corporatization.

Glossary

BE- Budgetary Estimate

IDDM- Indigenously designed, developed and manufactured

GoI – Government of India

RE- Revised Estimate

R&D – Research and Development

DRDO – Defence Research and Development Organisation

SPV – Special Purpose Vehicle

OEM – Original Equipment Manufacturer

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