CARE Ratings
Professional Risk Opinion

Methodology for rating State Governments

Introduction

Credit Analysis & Research Limited (CARE) has carried out the credit rating of around a dozen state governments. These ratings include those in the public domain such as ratings of state government guaranteed borrowings by State Electricity Boards, Irrigation Corporations and Road Development Corporations and one time credit assessments undertaken at the specific request of investors and entrepreneurs setting up infrastructure projects in different states. With more state governments accessing the debt market for infrastructure and treasury requirements credit rating will become an important consideration in lending and investment decisions.

CARE bases its assessment of the credit quality of a state government on the following two broad factors:

Financial Risk

Since ratings are relative, an inter-state comparison is made of various parameters to evaluate the risks and their impact on the rating outlook for the state. CARE has identified a series of economic and financial indicators essential in understanding the performance, prospects and hence creditworthiness of the state government. While many of the parameters are quantifiable, subjective judgments are also employed to assess factors such as state policies, which have a bearing on the economic and financial risk but do not readily lend themselves to quantification.

Economic Risk

The overall objective of Economic Risk Assessment is to provide a means of evaluating a state's economic strength and weakness. In general, greater strength of economic parameters would imply lower economic risk and vice-versa. In assessing economic risk, CARE's analysis evaluates the following parameters:

Economic Structure

CARE is of the strong opinion that a state's economic structure is of fundamental importance to its financial strength, debt carrying capacity and future prospects. Key in CARE's analysis of the strength of the economic structure are the following factors:

- Economic and Social Infrastructure
- Real Annual GSDP :its growth and composition
- Employment Growth & Quality of Workforce
- Economic Policies and investment policy framework

Relatively well-developed economic and social infrastructure serves as critical inputs and are reflections of economic structure. CARE believes good infrastructure by enabling the growth of economic activity can result in improvement in the state government's finances by widening the tax base and lowering budgetary requirements of providing for development expenditure. Social infrastructure such as educational facilities and health care institutions by enabling human resource development would ultimately enable economic development. It is known that higher per-capita incomes are an outcome of better economic development and contribute significantly to enhancing a state's revenue potential.

CARE believes strong secondary and tertiary sectors considerably enhance a state's tax potential while providing a measure of stability to revenue flows. Over dependence on the primary sector, in particular agriculture, which CARE recognizes is an important activity, can act as a constraint to a state's tax potential under currently prevalent taxation structures. It has been seen by CARE in practice that state's with stronger secondary and tertiary sectors are more often the ones in better financial position. In our opinion, multiplicity and diversity of economic activities insulate the state from the negative effect of downturn in output from any one activity.

The other socio-economic indicators that CARE factors in its assessment of economic risk are described below.

Demographics & Social Infrastructure

CARE analyzes traditional demographic indicators such as per-capita income, poverty levels, degree of urbanization, literacy rates, vital-statistics, employment rate etc. since it believes favourable demographics significantly improve a state's growth potential while at the same time removing hard budgetary constraints of high social expenditure allocations. CARE recognizes the importance of the availability of growth enabling social infrastructure resulting in favourable demographics. It thus pays particular importance to the availability of schools, hospitals, colleges etc. per capita.

Economic Infrastructure

CARE strongly believes that good economic structure enables the growth of economic activity in a favourable policy environment. It therefore analyzes their availability on per-capita basis to facilitate comparison with other states. Infrastructure availability examined include the following:

- Power
- Irrigation
- Transport
- Communication

Industrialization

The level of industrial activity and their nature have significant impact on the economic development of a state. For instance primary industrial activity such as mining and metals are particularly susceptible to economic downturns as compared to high technology industries, which offer more value-added products. CARE also takes into account the climate for industrialization with particular reference to locational advantages, availability of resources, quality of workforce and the industrial climate as evidenced by union activity, infrastructure availability and industrial policy.

Banking

The availability of good banking infrastructure enables the mobilization and growth of savings and investment within the state and the availability of credit to facilitate economic activity.

Agriculture

Agriculture is important as it lays the foundation for secondary and tertiary sector growth and is therefore an active determinant of tax revenues and future economic potential. CARE evaluates the stability and growth of agricultural output with reference to the following parameters:

- Crops Cultivated
- Cropped and Irrigated areas
- Usage of farm inputs
- Productivity indicators

Plan Outlays and Plan Performance

The state plan prioritizes expenditure with reference to the requirements of the state, resource availability and resource raising plans of the state government. Since these are approved by mutual consultation among the state government and Planning Commission and resources accordingly allocated, the performance of the state government in meeting the Plan, in CARE's opinion, gives good insight into the capacity of the state government to manage the state's economy.

Political Risk

The objective of political risk assessment is to provide a means of evaluating the political stability of state governments on a comparable basis. CARE believes political stability is vital to continuity in economic decision making and growth as political consensus enables economic reforms. Political risk is a judgmental factor and is arrived at after considering stability of the state government, attitudes of major political parties to important issues, socioeconomic conditions, law and order and quality of the administration. The political relationship between the central and state governments is also taken into account as this may have an impact on discretionary grants from the central government and direction of investments in new projects by central Public Sector Units, Railways, National Highways and so on which may have a catalytic impact on the state's economic development.

Financial Risk

State Government Finances

CARE rating methodology makes an objective assessment of state government finances by looking at seven broad aspects: Revenue Performance, Expenditure Management, Dependence on Revenues, Dependence on External Resources, Deficit Position, Debt Profile including guarantees issued and other contingent liabilities, and Performance of state PSEs and SPV's promoted by the state government.

Revenue Performance

Typically, revenue sources may be classified under four heads:

- Own tax revenue
- Own non-tax revenue
- Share in the divisible pool of central taxes

- Grants from the centre

The proportion of own tax revenues in total revenues, in CARE's opinion, indicate the ability of the government to generate revenue and the degree of control it has on its revenues which is vital to revenue stability. Typically, state governments with greater tax potential and tax effort show a higher proportion of own tax revenue in total revenue. The tax potential is dependent on per-capita incomes and composition of the state economy. Higher per capita incomes, signifying higher purchasing power, have the potential of generating higher revenues from consumption taxes. A larger share of the secondary sector in a state's economy translates to greater tax potential. On the other hand, a large agriculture sector or unorganized and tiny manufacturing sectors imply considerably lower tax potential under the prevailing tax regime wherein much of their produce is tax exempt. Income from agriculture, a state tax subject, is also currently tax-exempt. The tax effort itself is dependent on the tax regime and administrative methods employed in their collection. Typically, inferior tax regimes and cumbersome tax administrative procedure result in tax inefficiency by encouraging tax evasion and increase in collection expenditure. Non-tax revenue in most states is limited to interest and dividend incomes and constitutes a relatively minor portion of revenues. But with growing awareness of the necessity of reforms and restructuring, CARE believes non-tax revenue will grow in importance in the future.

A state's share in central taxes is determined on a five yearly basis by the Finance Commission, which is a constitutional body. The Commission arrives at a state's share in the centre's divisible tax pool by employing a formula, which is determined by itself. Since its recommendations are binding, this revenue source is considered stable by CARE to the extent that the divisible pool itself does not fluctuate due to economic cycles. The 'gap filling' approach adopted by the Commission favours financially less efficient states. There are, however, moves to rework the formula to remove the element of moral hazard. CARE considers excessive dependence on this revenue source lower to dependency on own revenues but substantially better than dependence on Finance Commission pre-devolution grants to fill the non-plan revenue deficit, as it indicates resource insufficiency and poor expenditure management.

The primary source of grants is the Planning Commission to fund specific schemes in the state and central plans and to that extent are discretionary in nature and can fluctuate rendering them

less stable. Since they are allocated to specific schemes, they are non-discretionary in the expenditure function, in the sense that they cannot be used for other purposes.

Expenditure Management

In assessing Expenditure Management, CARE's methodology tries to assess the efficacy of expenditure control mechanisms and efficiency in the use of state resources. CARE views favourably those state governments whose expenditure is in tune with available resources. Particular attention is paid to the composition of expenditure, which is broadly classified as development and non-development. Development expenditure has a beneficial impact and leads to economic and social development. Non-development expenditure, on the other hand, captures administrative expenditure and interest expenditure. Trends in the composition of expenditure between these two heads are crucial. A growing proportion of non-developmental expenditure is viewed unfavourably as these are less productive expenditure. That is not to say all development expenditure is productive. So also examined under CARE's methodology is the efficiency of usage of resources and the degree of control exercised on expenditure. Subsidy is a case to point. While subsidy is a large element in many government programmes, their ineffective targeting leads to wastage of resources. CARE would be concerned about proper targeting of subsidies, collection of correct user charges on non-merit subsidies, mechanisms in place to identify wasteful expenditure, willingness shown by the government in controlling or weeding out wasteful expenditure and commitment shown by the government to stay within the budgeted expenditure.

Revenue Deficit

Well managed state governments are those that not only are in a position to meet their revenue expenditure from their revenue receipts but also generate a revenue surplus to meet capital expenditure. Capital expenditure creates assets such as infrastructure that enhance future revenue generation potential of the state government by encouraging economic activity. CARE therefore is concerned about the trend and the level of revenue deficit as it not only reflects the quality of management of state government finances but also has the potential to translate to higher borrowing requirement raising future debt service expenditure of the state government. In CARE's opinion the size and trend in the revenue deficit is a better indicator of fiscal stress than

the Gross Fiscal Deficit. The Gross Fiscal Deficit is predicated on the negotiated borrowing limits of the state government to which expenditure then adjusts. However, the composition of the Gross Fiscal Deficit gives meaningful insights into the purposes of borrowing. A lower share of revenue deficit in the Gross Fiscal Deficit indicates borrowings are predominantly to fund capital expenditure, which is sustainable, if growth in output exceeds the real interest rate. Of equal concern is the Primary Balance, which is the revenue balance after non-interest revenue expenditure of the state government. A negative primary balance indicates that borrowing is taken recourse to finance current expenditure (other than interest) while a positive balance indicates that all or part of interest payments is being financed out of current revenues. A persistent primary deficit will lead to a steady growth in debt. The need to raise resources through tax and non-tax revenue measures will be higher the larger the stock of debt.

Debt Profile

Analysis of the debt and contingent liability profile give important insights into not only the debt carrying capacity of the state government but helps in identifying future stress periods arising from bunching of repayment obligations. Important to CARE's analysis is the debt maturity profile, Debt/GSDP ratio, Liabilities/GSDP ratio, history of debt relief, track record in meeting liabilities, debt/revenue receipts, trend in the weighted average cost of borrowings and trends in the composition of debt.

Liquidity Support

State Governments have access to liquidity support through ways & means advances and overdraft facilities from the Reserve Bank of India in order to bridge their short term resource gaps. Each state has to maintain a daily minimum balance with the central bank. If the balance falls below the agreed minimum on any day, the deficiency is made good by taking ways and means advances/overdraft from the Reserve bank upto a preassigned limit for a maximum of 10 days in continuation. CARE considers the inability of a state government to maintain the daily minimum cash balance and sustained usage of the liquidity support facility of the Reserve Bank as poor liquidity management indicator and susceptibility to liquidity stress.

Performance of State Public Sector Enterprises

The performance of Public Sector Enterprises, Boards, SPV's and other state promoted entities have significant bearing on state government finances. They not only have significant public investments locked in but also contribute to non-tax revenues of the state government. They form an important component of state government capital expenditure and are claimants of plan resources. Poorly performing entities are also the beneficiaries of explicit and implicit subsidies and loan bailouts. Hence, CARE believes it is important to study their performance to assess expected revenues, expected financial liabilities and prospects for their restructuring and divestment.

Credit Rating

In concluding its assessment of the credit quality of a state government, CARE makes a careful study of the overall risk arising from the linkages between Economic and Financial Risks by constructing a risk profile and after inter-state comparisons. A credit rating is then assigned using CARE's standard long term rating scale.

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