CARE Ratings
Professional Risk Opinion

Rating Methodology - State Governments

[In supersession of “Rating Methodology – State Governments” issued in August 2019]

Introduction

CARE Ratings evaluates the credit quality of state governments as a part of the process of assigning ratings to the debt instruments of public sector enterprises that are backed by state government guarantees. CARE Ratings has, over the years, 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, Road Development Corporations, State Finance Corporations, Infrastructure Development Corporations, to name a few. With more state government enterprises accessing the debt market for various requirements with state government backing, the credit rating of state governments will become an important consideration in lending and investment decisions.

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

(1) 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 Ratings 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.

(2) 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 Rating’s analysis evaluates the following parameters:

- **Economic Structure**

CARE Ratings is of the strong opinion that a state’s economic structure is of fundamental importance to its financial strength, debt servicing capacity and future prospects. Key factors in

CARE's analysis of the strength of the economic structure are:

- Economic and Social Infrastructure
- Real Annual Gross State Domestic Product (GSDP): its growth and composition
- Economic Policies and investment policy framework

Relatively well-developed economic and social infrastructure serve as critical inputs and are a reflection 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 healthcare 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 Ratings 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 Ratings recognizes is an important activity, can act as a constraint to a state's tax potential under currently prevalent taxation structures. This usually also puts pressure on expenditure in the form of subsidies that are given or loan waivers at times. It has been seen by CARE Ratings in practice that states 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 indicators that CARE Ratings factors in its assessment of economic risk are described below.

- Demographics & Infrastructure

CARE Ratings analyses traditional demographic indicators such as per-capita income and the quality and availability of infrastructure, since it believes these factors significantly improve a state's growth potential while at the same time removing hard budgetary constraints towards expenditure allocations.

CARE Ratings recognizes the importance of the availability of growth enabling social and physical infrastructure.

- Economic Infrastructure

CARE Ratings strongly believes that good economic structure enables the growth of economic activity in a favourable policy environment. It therefore analyses their availability to facilitate comparison with other states. Infrastructure availability examined includes the following:

- Power
- Irrigation
- Transport
- Communication

- Industrialization and Investment

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 Ratings also takes into account the climate for industrialization, infrastructure availability, industrial policies and investment climate.

- 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 Ratings believes that political stability is vital for 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 Ratings 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 SPVs promoted by the state government. Further, prudent buffers built to service debt and guarantees are also important factors looked at when evaluating the state finances.

- Revenue Performance

Typically, revenue sources may be classified under four heads:

- Own tax revenue
- Own non-tax revenue
- Share in divisible pool of Central taxes
- Grants from the Centre

The proportion of own tax revenues in total revenues, in CARE Ratings' 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. However, with growing awareness of the necessity of reforms and restructuring, CARE Ratings 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 Ratings 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 Ratings 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 central government where funds for specific schemes in the state and central plans are disbursed. 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. At times if these allocations are lower, states may have to dip into their own resources to fund the same.

Under the new dispensation of GST, the SGST collections would be the main factor analysed against earlier taxes that were imposed by the state government.

- **Expenditure Management**

In assessing Expenditure Management, CARE Ratings' methodology tries to assess the efficacy of expenditure control mechanisms and efficiency in the use of state resources. CARE Ratings favourably views 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. On the other hand, non-development expenditure 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 less favourably as these are less productive expenditures. That is not to say all development expenditure is productive. So also examined under this 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 Ratings 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 Ratings 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 also helps in identifying future stress periods arising from bunching of repayment obligations. It also has a bearing on the interest payments in all subsequent years. 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 (WMA) /overdraft from the Reserve bank up to a pre-assigned 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.

In some cases, while the state government may not have availed WMA/overdraft from the RBI but has failed to honour any guarantee commitment to state entities, the liquidity situation of the state government is viewed with concern, as this reflects on the state governments' inability to meet its commitments.

- **Debt servicing track record**

The assessment of the debt servicing track record of entities that carry/carried the state government guarantee is critical to evaluating the risk associated with the state government guaranteed borrowings. Default of debt servicing of any 'state government' guaranteed instruments would be an area of concern and would have a bearing on the credit quality of all the instruments that carry the said 'state government' guarantee. Such debt servicing record of the state in the last three years may be considered for this evaluation.

- **Performance of State Public Sector Enterprises**

The performance of Public Sector Enterprises, Boards, SPVs 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 Ratings 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 Ratings' standard long-term rating scale.

[Reviewed in August 2020. Next review due in August 2021]

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