Rating Methodology: State Governments

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CareEdge RATINGS

Introduction

CARE Ratings Limited (CARE Ratings) has evaluated the credit quality of state governments as part of the process of assigning ratings to the debt instruments of public sector enterprises (PSEs) that are backed by state government guarantees. CARE Ratings has, over the years, carried out the credit rating of state government-guaranteed borrowings by state power distribution companies, irrigation corporations, road development corporations, state finance corporations, and 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 ratings 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 on the following three broad factors, viz, economic risk, financial risk, and economic management.

1. **Economic risk**

   The overall objective of the economic risk assessment is to provide a means of evaluating a state's economic strengths and weaknesses. In general, the greater strength of economic parameters will imply lower economic risks and vice versa. Relatively, a well-developed economic and social infrastructure serves as a critical input and reflects a strong economic structure. CARE Ratings believes that good social and economic infrastructure can result in improvement in the state government's finances, in terms of 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 will 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. The indicators that CARE Ratings factor in its assessment of economic risk are described below:

- **Growth and sectoral composition of gross state domestic product (GSDP)**

  CARE Ratings believes that 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 recognises as 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 downturns in output from any one activity.

- **Demographics**

  CARE Ratings analyses traditional demographic indicators since it believes that the availability of healthy and trained manpower significantly improves a state's growth potential, while at the same time, removing hard budgetary constraints towards expenditure allocations.

- **Social infrastructure**
  CARE Ratings recognises the importance of the quality and availability of growth-enabling social and physical infrastructure such as educational facilities and healthcare institutions, as the demographic profile of the state correlates with the availability of quality social infrastructure.

- **Economic infrastructure**
  CARE Ratings strongly believes that the availability of economic infrastructure enables the growth of economic activity in a favourable policy environment. It, therefore, analyses their availability in comparison with other states. Infrastructure availability examined includes the following:
  - Power
  - Irrigation
  - Transport
  - Communication
  - Agriculture
  - Natural resources

2. Financial risk

State government finances

CARE Ratings' methodology makes an objective assessment of state government finances by looking at broad aspects, such as: Revenue performance, expenditure management, dependence on the state's own revenues, dependence on external resources, deficit position, and debt profile including guarantees issued and other contingent liabilities. 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, the creditworthiness of a state government. While many of the parameters are quantifiable, subjective judgments are also employed to assess factors such as state policies, which though have a bearing on the economic and financial risks, but do not readily lend themselves to quantification. CARE Ratings also assesses the finances of a state government vis-à-vis the fiscal responsibility and budget management (FRBM) targets, recommendations of the Finance Commission, and the extent of differences in the budgeted as well as revised estimates.

- **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 Ratings' opinion, indicates the ability of the government to generate revenue and the degree of control it has over its revenues, which is vital to revenue stability. Typically, state governments with greater tax potential and tax effort show a higher proportion of their own tax revenue in total revenue. The tax potential is dependent upon per-capita incomes and the 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 or tertiary sector in a state's economy translates into greater tax

potential. On the other hand, a larger agriculture sector or unorganised 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 upon the tax regime and administrative methods employed in their collection. Typically, inferior tax regimes and cumbersome tax administrative procedures result in tax inefficiency by encouraging tax evasion and an 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 that 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 Finance 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 Finance 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 as lower dependency on its own revenues. However, this source of revenue is considered substantially better than the dependence on the Finance Commission's grants, which are given 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, the states may have to dip into their own resources to fund the same.

- Under the new dispensation of the Goods and Services Tax (GST), the state GST (SGST) collections will be the main factor analysed against the 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 the 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-development expenditure is viewed less favourably, as these are less-productive expenditures, i.e., not to say all development expenditures are productive. So also examined under this methodology is the efficiency of usage of resources and the degree of control exercised on expenditure. For example, subsidy, while subsidy is a large element in many government programmes, their ineffective targeting leads to wastage of resources. CARE Ratings will 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. CARE Ratings also assesses the extent of committed expenditure, i.e., salaries, pensions, and interest payments in the total revenue expenditure where the scope of curbing the expenditure is less.

- **Revenue deficit**
  Well-managed state governments are those that not only can meet their revenue expenditure from their revenue receipts but also generate a revenue surplus to meet capex. Capex creates assets such as infrastructure that enhance the 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 into higher borrowing requirements, thereby raising future debt service expenditure of the state government. In CARE Ratings' opinion, the size and trend in the revenue deficit is a better indicator of financial 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 purpose of borrowing. A lower share of revenue deficit in the gross fiscal deficit indicates that the borrowings are predominantly to fund capex, which is sustainable if output growth 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 the borrowing is taking recourse to finance current interest expenditure, while a positive balance indicates that all or part of the interest payment is being financed out of current revenues. A persistent primary deficit will lead to steady growth in debt, and thus, will need higher resources through tax and non-tax revenue for servicing the debt.

- **Debt profile**
  The analysis of the debt and the contingent liability profile (including guarantees) give important insights into not only the debt carrying capacity of the state government but also help in identifying future stress periods arising from the bunching of repayment obligations. It also has a bearing on the interest payments in all subsequent years. Important to CARE Ratings' analysis are the debt maturity profile, debt/GSDP ratio, (debt + guarantees)/GSDP ratio, history of debt relief, track record in meeting liabilities, debt/revenue receipts, (debt + guarantees)/revenue receipts, the trend in the weighted average cost of borrowings, and trends in the composition of debt.

3. Economic management

CARE Ratings analyses the economic policies of the state government to assess their impact on the finances and economic development of the state. Key factors considered by CARE Ratings for assessing the economic management of a state are:

- **Industrialisation and investment policy framework**
  The level of industrial activity and its nature has a significant impact on the economic development of a state. For instance, primary industrial activities 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' analysis also factors in specific projects that are being undertaken by the

states. CARE Ratings also considers the climate for industrialisation, infrastructure availability, industrial policies, and investment climate.

- **Economic policies**
  Economic policies are of paramount importance for encouraging economic activity and growth. Unfavourable economic policies, including populist schemes, make private sector investments unattractive and affect the growth prospects of states, and thus, are detrimental to the fiscal health of the state.

- **Political risk**
  The objective of political risk assessment is to provide a means of evaluating the political stability of state governments. 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 the stability of the state government, the attitude of major political parties to important issues, socioeconomic conditions, law and order, and the quality of the administration. The political relationship between the Central and state governments is also considered, as this may have an impact on discretionary grants from the Central Government and the direction of investments in new projects by central public sector undertakings (PSUs), the railways, National Highways, and so on, which may have a catalytic impact on the state's economic development.

- **Liquidity support**
  State governments have access to liquidity support through ways and means advances (WMA) and overdraft facilities from the Reserve Bank of India (RBI) to bridge their short-term resource gaps. Each state is required 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 WMA or overdraft from the RBI, up to a pre-assigned limit for a maximum of 10 days in continuation. CARE Ratings considers the inability of a state government to maintain the daily minimum cash balance and sustained usage of the liquidity support facility of the RBI as a poor liquidity management indicator and susceptibility to liquidity stress.

  In some cases, while the state government may not have availed WMA or 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 the state government's inability to meet its commitments.

- **Management of guarantees**
  Guarantee management systems of state governments are assessed basis the government's policy for extending guarantees, monitoring mechanisms, and ceilings on the number of guarantees extended (in terms of percentage of GSDP or revenue receipts, etc). CARE Ratings also assesses the maintenance of reserves such as consolidated sinking fund (CSF) and guarantee redemption fund (GRF) for meeting its debt and guarantee obligations in case of any eventuality.

- **Debt servicing track record**

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

- **Performance of state PSUs**
  The performance of PSEs, boards, SPVs, and other state-promoted entities has a 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 capex and are claimants of planned resources. Poorly performing entities are also the beneficiaries of explicit and implicit subsidies and loan bailouts. Hence, CARE Ratings believes that it is important to study their performance to assess the expected revenues, expected financial liabilities, and prospects for their restructuring and divestment.

Conclusion

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

[For the previous version please refer to 'Rating Methodology – State Governments' issued in August 2020]

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