



ICRA'S URBAN LOCAL BODY RATING METHODOLOGY

Local Bodies play a critical role in the delivery of social, economic and infrastructure services like public health, sanitation, primary education, water supply, and maintenance of road networks. The rapid pace of urbanisation in India over the last few decades has led to pressure increasing on urban local bodies (ULBs) to ensure adequacy of service for a burgeoning population. According to the 2001 census, India's urban population stands at around 28% of the country's total population, and is estimated to have grown significantly over the last few years. Population increase apart, a number of other changes have also been taking place within the ULB domain. The 74th Constitutional Amendment (1992) provides, for the first time, constitutional recognition to ULBs, thereby establishing the legal framework for decentralisation to the level of local government. Simultaneously, the deteriorating fiscal health of States has limited the access of ULBs to the State budgetary support mechanism for the funding of capital projects. Thus, with a growing population to be served, increasing pressure for better service delivery, and curtailed access to traditional sources of funding, ULBs need to increasingly resort to market related borrowings to meet their funding requirements. In such a scenario, it is critical from the lenders' perspective that an evaluation be done of the stand-alone credit quality of ULB.

ICRA's rating methodology addresses the inter-governmental fiscal relationship between a ULB and the next higher tier of government—the State—as one of the key determinants of the credit quality of the ULB. Given the role of States in determining the operational and financial autonomy of a ULB, ICRA's rating methodology also recognises the linkage between the credit quality of a ULB and the State it belongs to. The overall credit quality determinants are:

- Credit Quality of the State and Inter-governmental Fiscal Relationship
- Economy of the Municipal Area
- Operational Efficiency
- Municipal Finances
- Management Quality

Credit quality of the State and inter-governmental fiscal relationship

Until 1992, the Indian federation functioned as a two-tier governance system consisting of the Centre and the States. Formal Constitutional recognition for the third tier—the local government—came through the 73rd (rural local bodies) and 74th (urban local bodies) Constitutional amendments. The Constitution mandated locally elected bodies, with elections to be held within a stipulated time frame. Consequently, the Indian federation now has a three-tier structure with the Central government at the highest tier, the State governments at the second, and local governments (urban and rural) at the third or lowest tier. The Constitution places ULBs within the legal ambit of the respective State governments, with significant linkages between the functioning of ULBs and the States concerned. Given this structure of urban governance in India, ICRA views the rating of a ULB within the overall framework of sub-sovereign rating. Therefore, ICRA's evaluation of any ULB starts with the determination of the credit quality of the next higher tier of government, i.e. the State. This follows the fact that all ULBs are constituted under a State legislation that determines the legal framework within which the ULBs would function. The legislation (usually called as a "Municipality Act") would define, among other things, a ULB's constitution, its range of obligatory and discretionary functions, its revenue raising powers, and the nature and extent of support it would receive from the State government. Also, this legislation can be altered only by the State legislature. In addition, according to the Constitution, the States are obliged to devolve a portion of the net proceeds of their taxes, duties, tolls and fees to the ULBs, on the basis of the recommendations of the State Finance Commissions (SFCs). While such devolutions form an important component of the total receipts of ULB, ICRA also notes the fact that the SFCs' prescriptions on the extent of transfer are recommendatory, and ultimately the extent of transfer is decided by the Legislature (which effectively means the State

government). Thus, ULBs are reliant to a large extent on the State government for both their financial and operational autonomy. Although States cannot directly appropriate any surplus generated by a ULB, they can limit the ULB's autonomy by setting terms for inter-governmental transfer, revenue and expenditure responsibility; allocating/ redistributing tax authority; and mandating spending. Also, a ULB's credit quality depends on the larger macroeconomic environment prevailing in the State, which in turn is influenced by the policies of the State government. As a result of these factors, in ICRA's opinion, the credit quality of a ULB is closely linked to that of the State.

ICRA's local body ratings factor in the stability of inter-governmental fiscal relationship in terms of clarity of expenditure responsibility and revenue assignment as laid down in the relevant Municipal Act as well as the actual practice being followed by the entity whose credit quality is under evaluation. ICRA also places emphasis on the consistency of policies and principles governing the relationship between the State and the local body. A number of Indian States have set up the SFCs which recommend the principles for the sharing of taxes and fees, and determine the grants-in-aid to be given to the local bodies. Although SFCs are constitutionally mandated, ICRA notes that the history of decentralisation up to the third tier is just over ten years old in India, as compared with the over fifty years for which the Central Finance Commission has been functioning. Thus the system of inter-governmental fiscal relationship between the State and local bodies remains at varying stages of evolution across the country, and is likely to evolve further in the course of time. When evaluating the inter-governmental fiscal relationship, ICRA considers allocation of expenditure responsibility based on the subsidiarity¹ principle as a positive. Evidence of the State passing on expenditure responsibility to the ULB without corresponding revenue sources being earmarked, arbitrary withdrawal of tax sources while retaining expenditure commitments, or lack of demonstrated track record in providing timely support through the mechanism of devolution and grants could be clear credit negatives. While the stability of inter-governmental fiscal relationship is an important criterion in ICRA's municipal ratings, the same is not viewed in isolation.

Economy of the Municipal Area

Revenue sources of a ULB like property taxes and user fees are dependent primarily on the level of economic activity within its jurisdiction. The economic base—its growth potential and diversity—is therefore one of the critical determinants of a municipal rating assigned by ICRA. Although State-level GSDP² numbers are available, data on city-level income data is not readily available in India. In its absence, ICRA evaluates the following key parameters to analyse the economic base of the area within a ULB's jurisdiction:

Structure of the economy: As in other ratings assigned by ICRA, municipal ratings also place considerable stress on evaluating the stability of revenues that go towards the servicing of debt. An important consideration here is the depth and diversity of the economic base, the sectors that dominate the economy of the region, and their growth trend. A large industrial base that is labour dependent could be a strength, since it would provide employment opportunities to the local population. However, ICRA also evaluates the level of concentration risk in the economy since a lack of diversity in the industrial base could result in reliance on a few sectors and therefore vulnerability to business/commodity cycles. The contribution of other sectors like construction and service is studied in the light of the growth opportunities they offer and the sustainability of the same.

Demographics: Since local governments are responsible for the provision of public services at the local level, demographic profile is an important consideration for the evaluation of future revenue potential as well as the level of demand on the local body for provision of such services. ICRA evaluates the size of the population served and its growth rate to determine the existing demand for public services and the level of acceleration likely in future. The age profile, per capita income, and literacy levels are analysed to estimate the size of earning vis-à-vis the dependent population and its ability to pay taxes. A rapidly growing population could raise the pressure on demand for services to a level that could be difficult for the local body to scale up to in the short term. On the other hand, a stagnant population skewed towards children and the elderly would restrict the revenue potential, thereby limiting an entity's ability to keep pace with the increase in the need for services. Overall, ICRA believes that a steadily growing population base in the

¹ Subsidiarity Principle: Government services should be provided at the lowest level of government that is capable of efficiently providing this good or service. According to this principle, the area where the benefits of a government service are felt would coincide with the government boundaries at each level of government.

² Gross State Domestic Product

employable age bracket with reasonable levels of literacy is a preferable demographic profile and a positive from the rating perspective.

Growth prospects: A key consideration in ICRA's analysis is the growth potential of the area that a local body serves. Various proxies are used to make this estimation, including: the investment planned in the region; employment levels; trend in growth of deposits in the banking and non-banking sectors; growth in output; competitiveness of local industries; linkages to major markets, ports and airports; level of infrastructure; nature of policies that promote growth; and structural changes that could catalyse growth in the region.

Operational Efficiency

ICRA evaluates the provisions of a State's Municipal Act with regard to the administrative, operational and financial domain of the ULB concerned. The manner in which the deliberative wing (elected council headed by the Mayor) and the executive wing (headed by the Commissioner, usually a State appointee) function, and their interaction with the State government are studied. Regularity of elections and institutionalisation of systems of administration leading to smooth decision making are viewed positively. ICRA's evaluation of operational provisions rests on its study of the obligatory and discretionary services to be provided by the municipality concerned. These are evaluated in the light of the ULB's capacity to deliver the required services both in terms of operational ability and revenue adequacy. A high operational ability, even with limited but growing (own) revenue adequacy, is usually considered a credit positive (given the present stage of evolution that ULBs are passing through), especially if supported by timely inflows from the next higher level of government.

ICRA's rating methodology recognises the fact that although there could be differences in the scope of services across municipal bodies, most are obliged to provide largely similar public utility services. Such services include, among others, maintenance of roads and layouts, water supply, sewerage disposal, solid waste management, street lighting, primary education, and health services. ICRA evaluates an entity's infrastructure in terms of organisation structure and manpower adequacy vis-à-vis its range of obligatory functions. Judging performance or efficiency on the basis of output measures like service delivery levels inevitably poses a problem, given the inadequacy of standardised and comparable data across municipalities. Nevertheless, a local body's performance is assessed on certain service parameters like: coverage of street lighting; percentage of population covered by piped water supply (where water supply is within its domain); days of water supply per week; cost recovery; manpower cost per unit of water supplied; loss levels in water supply; population covered by underground sewerage; and number of solid waste bins per unit of population. However, these measures generally used to benchmark against the mean service levels, and are not taken as absolute indicators. A service level which is significantly away from the mean is usually viewed with concern, more so if it is an obligatory function. A rapidly expanding population is likely to put greater stress on the entity to provide the range of services over a larger part of its domain. In such a scenario, the ULB's ability to outsource part of its activities while retaining sufficient operational control over service levels is judged. A ULB's ability to effectively partner with private agencies to create sustainable infrastructure is viewed positively. ICRA also analyses the capital expenditure requirements under expected levels of growth and service obligations. Adequacy of revenue surpluses and/or capital receipts to fund this level of expenditure is evaluated. The entity's ability to plan for growth and effectively execute projects within the budgeted time and cost are a credit positive.

Municipal Finances

ULBs in India have largely adopted the cash based accounting system³. This system while being conservative on receipts (inflows), underestimates the level of expenses (liabilities). ULBs have also traditionally relied on State budgets for financial planning and control. Annually, local bodies prepare a statement of receipts and payments (cash basis), under the respective item heads in the budget, both for the revenue account and the capital account. The statement is usually audited by the State Audit Department. This audit is fairly limited in its scope, being in the nature of a transaction audit. Although a statement of accounts based on the accrual method of accounting would be more representative, in its absence, ICRA uses the statement of receipts and payments presented along with the budget, statement of outstanding debt and repayment of borrowings for its analysis of the financial performance of the ULB concerned.

³ Some are migrating to accrual (Tamil Nadu) and fund-based (Bangalore) accounting systems.

Analysis of Revenue: In ICRA's opinion, local governments entrusted with expenditure obligations are likely to fulfil them with greater commitment if they are also responsible for raising the revenues they spend, and a larger proportion of these expenses is met from their own revenues. ICRA therefore analyses the extent of own revenue as a percentage of the overall revenue of the entity concerned, as well as sustainability of such own revenue sources. A diversified base of own revenue sources which is not overly reliant on a few items (like property tax or octroi) or on a number of minor and ineffective sources (like boat tax, timber tax etc), where cost of collection is high, is considered a positive. A ULBs primary responsibility lies in making adequate provision for services, which it is required to provide under the relevant Act. Provided these expenditure obligations are largely met, a greater and growing proportion of own revenue is often a credit positive. There are three broad categories of revenue flows to municipal bodies: tax revenues, non-tax revenues, and (revenue) grants from States. Tax revenues and grants form the two largest components, while non-tax revenues are usually lower. Tax revenues comprise both own taxes and share of State taxes as determined by the SFC and passed on through the subvention mechanism like SFC devolution. In general, own tax revenues include octroi, property tax, advertisement tax, motor vehicle tax, entertainment tax, professional tax, etc., while non-tax sources are primarily user charges, fees, rent for municipal properties, fines and penalties, and so on.

Tax Revenues

Own Tax Revenues: ICRA analyses the complete list of tax options available to a municipal body (under the relevant Act) and estimates the effort made by the entity to leverage the available options. A well administered and stable source of own tax revenues is a positive, as is demonstrated ability to utilise the available sources of tax as laid down in the Act. Apart from octroi, which is a major source of own tax revenue for local bodies in some States (but could face abolition), property tax is a dominant own tax revenue source. Across most municipal bodies, the Annual Rental Value (ARV) is the base over which property tax is charged. In ICRA's view, the very definition of this base constrains its potential to a large extent. Most Municipal Acts define the ARV as "gross annual rent of land and building at which they might reasonably be expected to let". Since "reasonable expectation" is subjective (and in some cases capped by fair rent according to the prevailing "Rent Control Law"), the base of property tax as well as its potential remains depressed. This apart, irregular assessment and lack of periodic revision have led to wide gaps between the actual and the assessed base, while a weak administrative system has resulted in low collection efficiency for property tax. Also, many of the newly formed local bodies, owing to inadequate information systems, have not assessed the entire range of properties available under their jurisdiction. As a result of these factors, while property prices might demonstrate reasonable buoyancy depending on demand and supply, property taxes have not shown similar growth rates. Nevertheless, certain entities have been able to initiate reforms in the computation⁴, assessment⁵, use of GIS⁶ for 100% mapping⁷ and coverage of all properties, and improved collection mechanism, which have resulted in growth in property tax receipts. In view of the critical importance of property tax as a source of own revenues, ICRA reviews the efforts made by the ULBs in administering property tax, their track record in revising property tax rates, and their collection efficiency to assess the likely improvement in this source of revenue in future.

Share in State Taxes: To analyse a municipal body's share of State taxes, ICRA studies the recommendations made by the SFC concerned and the extent of adherence to it in the existing devolution mechanism. Of the total pool of SFC devolution (usually a percentage of the State government's Non-Loan Government's Own Revenue Receipts, or NLGRR) the manner in which inter se allocation among local bodies is decided is also evaluated. A formula-based allocation mechanism, which provides incentives for an entity to improve its own revenue collection, is considered positive.

Non-Tax Revenues

This stream of revenues is traditionally the weakest on account of inadequate user charges, poor collection of rent on own properties, and generally lax administration, with the result that the available non-tax revenue sources are under-exploited. In evaluating user charges, ICRA first looks at the quality of service (regularity of service, per capita coverage, etc.) as offered by the ULB. In the light of this factor, ICRA then looks at the level of user charges and makes a peer comparison. A track record of poor service and high user charges that are regularly revised upwards make for an unsustainable revenue model, which is a

⁴ Area Detail System (ADS): Ahmedabad; Unit Area Method (UAM): Delhi, Bangalore

⁵ Self Assessment Schemes: Bangalore, Hyderabad

⁶ Geographical Information System

⁷ Started in Bangalore

credit negative. ICRA however evaluates both the likely potential and the efforts towards enhancing this revenue source, and considers a combination of strong potential and genuine efforts as a positive.

Grants

ULBs obtain scheme specific grants as well as grants-in-aid from the State government to bridge (assessed) revenue shortfall. In addition, they also obtain Central grants-in-aid in accordance with the recommendations of the Central Finance Commission; these are meant to address the vertical imbalance between the Centre and the States and are routed through the State. ICRA evaluates the nature of support, the modality of administering the scheme (for scheme-specific grants) and the commitment of the State government towards the scheme. In general, ICRA views grants positively, provided they lead to capacity build up within the ULB and their utilisation is adequately monitored both by the entity and by the State government. Grants without end-use stipulations, in general, have limited utility and if inadequately monitored could end up being used to meet routine revenue expenditures. In ICRA's view, such grants increase dependence on the State government and their sustainability is usually not very high, given that they are not linked to any policy initiative. Also, considering the tendency of States to delay passing on Central grants to local bodies⁸, ICRA views the resultant uncertainty in the timeliness of release of such grants negatively from the credit perspective.

Revenue Expenditure

The most critical aspect of ICRA's evaluation of expenditure centres on the obligatory functions of the entity and the expenses incurred on the same. The obligatory functions, as defined by the relevant Act, must necessarily be covered by adequate allocation of funds on an ongoing basis. Provided the obligatory functions are adequately covered, a stable level of expenditure on each of these functions is a positive. Evaluating the quality of spending is inevitably more difficult as compared with evaluating the extent of spending. ICRA relies on peer comparison and benchmarks to evaluate the quality of obligatory service provision in areas like water supply and sanitation, primary education, health, road maintenance, and solid waste collection and disposal. A poor track record of service provision despite expenses is an indicator of administrative flaws and is considered a credit negative. Given the cash-based accounting system followed by most local bodies, under-reporting or deferment of expenditure is difficult to evaluate. ICRA tries to capture this by looking at per capita benchmarks, growth trends in expense levels, and abnormal movements, if any, in expense heads. In this regard, any sharp inflection is analysed to understand the underlying cause.

Revenue Balance

ICRA evaluates the surplus/deficit on the revenue account in the light of the quality of service provided by the entity. A high revenue surplus is not necessarily a positive, especially if adequate service levels have not been maintained. If the service levels are found acceptable, a consistent revenue surplus is usually viewed positively since this implies capital expenditure can be partly met out of such surplus. ICRA also looks at a ULB's own revenue balance (total revenue receipts less State grants less revenue expenditure) to evaluate the strength of its own revenues in relation to its expense levels. The operating ratio (revenue expense/revenue receipts) is an indicator of the operating efficiency of the entity. An operating ratio above 1 while indicating operational weakness, may be viewed with less concern if discussions indicate that the service levels are very high, that adequate steps for building up own revenue streams are being taken, and that State support is forthcoming in terms of additional grants.

Liquidity and Debt Profile

In the absence of bank supported lines of credit, a local body's liquidity is a function of its cash management, investment policies, flexibility in deferring certain expenditure, and the strength of its budgetary planning and control functions. The timeliness of State support assumes critical importance in the evaluation of this aspect. ICRA therefore analyses the manner in which the State government concerned extends its subventions and grants (including Central grants where the State is a pass through) both in terms of extent of support and the schedule of flow of these grants. This evaluation is done over a period of time to study monthly patterns. The ULB's revenue supported debt is analysed in terms of its tenure, repayment pattern, and interest rate sensitivity. ICRA looks at debt service coverage through a local body's own revenues $[(\text{Own revenue balance} + \text{interest})/(\text{principal} + \text{interest obligation})]$. Entities with low or negative own revenue balances, which incur debt on the strength of grant flows, are usually viewed negatively as the long-term sustainability of such grants may be an issue of concern. In general, ICRA

⁸ to correct this the Twelfth Finance Commission has recommended that States take a maximum of 15 days to pass on a Central grant to the local body concerned.

examines whether the debt obligation can be adequately met out of an entity's own revenues after it has met its obligatory expenses.

Management quality

ICRA's analysis of this aspect covers three key factors: management capability; adequacy of existing structures, systems and controls; and extent of transparency in operations. ICRA recognises the fact that several aspects relating to the functional domains of municipal bodies are still evolving. These include relationship between the municipal body and the State, the manner in which city governments manage their affairs, the accounting paradigm under which they operate, and the information system on which they rely for their functioning. Given these issues, a management that is able to provide effective leadership, demonstrate its ability to plan and implement programmes, partner appropriately with the private sector, maintain links with citizens, and function effectively within the political system of the State concerned is viewed positively. Institutionalised systems and control mechanisms that lower reliance on individuals are a clear positive in assessing the entity. ICRA also evaluates the timeliness and accuracy of financial reporting, operating statements and budget document.

The key stakeholders for a local body are the citizens it serves. ICRA's evaluation therefore takes a close look at the level of transparency achieved by the entity concerned. Quick and easy dissemination of progress/status reports on projects and regular updates on financial position provided through public media (including website postings) are thus considered positive.

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