



ICRA Rating Methodology

This methodology note stands superseded. Refer to ICRA's website www.icra.in to view the updated methodology note on the sector.

Rating Methodology For State Government Finances

Over the last two decades, ICRA has assigned ratings to the debt programmes of several State-level entities. Some of these are standalone ratings, while several are supported by various credit enhancements along with a structured payment mechanism, including a substantial sub-set that are based primarily on financial guarantees extended by the respective State Governments. The ratings of instruments supported by guarantees from State Governments fundamentally represent ICRA's assessment of the strength of the respective States' finances, as well as the quality of the supporting structured payment mechanisms. This rating methodology provides a reference tool for investors and issuers to understand ICRA's approach in assessing the credit quality of State Government finances.

1. Indian Federal Structure: Interplay between the Union and the State Governments

ICRA's methodology for evaluating the credit profiles of State Governments starts with the fundamental premise that local currency debt obligations of Government of India (GoI) carry the highest ratings on ICRA's rating scale. The ratings of State Governments are rankings of credit risk below the sovereign rating, drawing from the fact that the GoI enjoys unparalleled financial flexibility to meet its debt obligations. Such flexibility arises from its ability to monetise deficits if required, its access to a wide range of taxes and revenues, and its supervisory authority over the States.

A State Government's credit strength, on the other hand, is effectively constrained by the contours of the federal structure as laid down in the Constitution of India. The sharing of revenues and responsibilities as set out in the Constitution results in a vertical imbalance between the Union and the State Governments: the States have a less than proportionate share of the taxing powers in comparison with their responsibilities. Moreover, State Governments require the permission of the GoI regarding both the quantity and timing of certain types of borrowings that they can undertake as per Article 293(3) of the Constitution of India.

The vertical imbalance between the Union and the State Governments is sought to be compensated through a variety of fiscal transfers. For instance, substantial funds are transferred by the GoI to the State Governments, in terms of a share in Union taxes & duties and various tied and untied grants, in accordance with the recommendations of successive Finance Commissions (FCs). FCs are constituted by the President of India under Article 280 of the Indian Constitution, to provide recommendations to govern various elements of the fiscal relation between the GoI and the various State Governments over five year award periods. The FC transfers simultaneously aim to reduce

horizontal imbalances among States. While various FCs have incorporated efficiency and performance parameters into their formulae, achieving horizontal equity remains a critical objective. Hence, so far, the lesser-developed States have been receiving a larger share of the transfers from the GoI, which substantially augments their revenues. The extent of fiscal transfers from the GoI and the timing/regularity of these cash flows are factored into ICRA's analysis of any State Government's finances. However, in ICRA's view, for any particular State, its financial strength, and therefore its credit quality, is a function of its extent of self-reliance in meeting its expenditure through its own tax and non tax revenues.

The Fourteenth Finance Commission (FFC) has recommended a shift in the composition of Union transfers to the States to higher formula-based tax devolution rather than grants. The FFC has recommended an increase in the proportion of the shareable taxes of the GoI to be devolved to the State Governments during its award period (2015-16 to 2019-20) to 42% from the 32% that prevailed during the award period (2010-11 to 2014-15) of the Thirteenth Finance Commission (ThFC). Tax proceeds are an untied source of funds for State Governments, offering them greater autonomy and flexibility to plan expenditures based on their own priorities, which is a positive in ICRA's view.

Grants from the GoI are classified as non plan grants and plan grants. Within non plan grant funds, FC recommended grants are a major source of Central assistance for States. The grants recommended by the FFC primarily seek to balance the revenue accounts of the States (untied end-use), provide funds for disaster relief (tied end-use) and supplement the revenues of the urban and rural local bodies (tied end-use). Subsequent to the increase in tax devolution and replacement of the Planning Commission by the NITI Aayog, the magnitude and process of provision of plan grants by the Union to the State Governments is undergoing a change. Until 2014-15, substantial grants were provided to States for implementing 66 Centrally Sponsored Schemes (CSS; predominantly tied end-use). The Union Budget for 2015-16 indicates that from 2015-16 onwards, eight schemes have been de-linked from Central support, 31 schemes are to be fully supported by the Union Government, whereas 24 schemes would be run with a changed sharing pattern (with the Union Government to bear only the capital expenditure towards these schemes); grants for such schemes are end-use specific.

While ICRA does take comfort from the fair level of predictability of the magnitude of Central transfers and the tightly regulated framework within which the States operate, these are not construed as indications of the GoI's support towards debt servicing, unless the borrowings are explicitly counter-guaranteed by the sovereign. Hence, ICRA's ratings are largely determined by the relative fiscal and economic positions of the States concerned.

Table 1: Transfers from the Union Government to the State Governments

RATING FACTORS	SOME ANALYTICAL INDICATORS
Access to transfers & grants or extent of self-reliance	Trends and interstate comparisons of:
	<ul style="list-style-type: none"> • (Shared taxes + grants)/revenue receipts • (Shared taxes + grants)/revenue expenditure • State's share of Union taxes • State's share of grants • (SOTR + SONTR)/revenue expenditure

Note: SOTR: State's own tax revenues; SONTR: State's own non tax revenues

2. Economic Strength: the Fundamental Differentiating Factor

Among the most critical determinants of a State's rating are the size, health and diversity of its economy and prospects for growth. A State's ability to raise revenues, either through taxes or fees for the services that it provides, is critically influenced by the income levels of its people, and hence the economic health of the region. Hence, ICRA evaluates the size and composition of the State economy, the competitiveness of its key sectors, and its vulnerability to external factors. An important aspect is the continuance of the factors currently imparting competitiveness to various sectors of the State's economy and the likely changes in its economic structure in future. For instance, in the case of a State like Punjab, ICRA assesses the robustness of its agricultural economy, given the high share of primary sector output in its gross state domestic product (GSDP) and the forward linkages of this sector in its economy.

ICRA analyses States' economic performance through business cycles, covering different factors affecting or imparting strength to the local economy, like resource endowment (minerals, land-use, water, labour force, etc.), adequacy of economic infrastructure (for instance, extent of irrigation, road density, existence of port infrastructure, air connectivity, proximity to local markets, power supply situation), trends in investments, and new project additions.

ICRA also evaluates the demographic trends, socioeconomic infrastructure, dispersion of wealth and the topography of the State. In ICRA's view, such factors would critically influence the economic output of any State in the long term, and thus also its revenues and credit worthiness.

Table 2: Economic Strength

RATING FACTORS	SOME ANALYTICAL INDICATORS
	Trends and interstate comparisons of:
<ul style="list-style-type: none"> • Size of economic base • Sectoral concentration/diversity • Competitiveness of key sectors • Sustainability of economic strength • Structural shifts anticipated, if any 	Real and nominal GSDP—composition and growth rates both at the aggregate and per-capita levels; competitive landscape in key contributing segments
Demographic trends	Trends in age-profile, density, dispersion, poverty levels, income levels, literacy and education levels, employment rates etc.
Natural resources	Metals and minerals; water resources; coastline and terrain; land-use pattern
Economic and social infrastructure	Availability of infrastructure and trends in investments in infrastructure creation

3. State Finances: Flexibility in Revenues and Expenses Critical Determinant of Fiscal Position

ICRA's assessment of a State's fiscal performance entails an analysis of the composition of, and growth trends in, its revenue and expense heads; the likely trends in the near-to-medium term with particular emphasis on potential for growth in revenues and scope to rationalise or reduce unproductive expenses; the trends in the levels of revenue and fiscal balances; and the extent of leverage.

3.1 Revenue Structure

Apart from the shared Union taxes and grants discussed earlier, revenue receipts for States are clubbed broadly under the heads State's own tax revenue (SOTR) and State's own non-tax revenue (SONTR). The

Constitution lays out the States' powers to tax; currently, sales tax is the largest own revenue stream for all States. Other key revenue streams are excise on liquor, motor vehicle tax, stamp duties and registration charges, electricity duty and tax on sale of power, and taxes on agriculture, among others.

ICRA's analysis of States' revenue structure entails an assessment of the sources of revenue, diversity of revenue streams, correlation of key revenue streams with trends in the economy, and flexibility the State has to raise additional taxes. ICRA however notes that some of this flexibility may materially reduce subsequent to the adoption of the Goods and Services Tax. Nevertheless, ICRA expects that structural changes in the sharing of taxation powers between the Union and States Governments (to reduce vertical imbalances), such as the transfer of the right to tax services, may have a positive impact on the revenue buoyancy of most State Governments.

While ICRA does like to see high SOTR/GSDP ratios, it also believes that very high tax rates on a narrow base or sustained additional resource mobilisation by States would have an adverse impact on the competitiveness of the State concerned in the long term. There exists scope for improving collections by streamlining the existing administrative and collections systems and boosting e-governance. ICRA views very positively the efforts that some States have made to improve collections not only by getting arrears cleared, but also by putting in place systems to reduce leakage and avoidance.

SONTR has so far been a relatively low contributor of revenues for most States. Interest and dividend income from loans and investments in public sector enterprises (PSEs) have historically been very low. Moreover, low user charges or fees (vis-à-vis the cost of provision) levied by States for services such as irrigation, health, education (resulting in a high level of indirect subsidies extended by States to end-users) further depresses this revenue stream. While political considerations do not make it easy for governments to increase such charges, the trend of most States gradually raising some of the user fees has had a positive impact (though limited so far) on their revenues.

Table 3.1: Revenue Structure

RATING FACTORS	SOME ANALYTICAL INDICATORS
	Trends and interstate comparisons of:
SOTR: quality and prospects	<ul style="list-style-type: none"> • Growth rates • Rate structures • Revenue mix, concentration/diversity • SOTR/GSDP, SOTR buoyancy • Individual tax/GSDP, tax buoyancy • Per capita levels of SOTR & individual tax streams
SONTR: quality and prospects	<ul style="list-style-type: none"> • Performance of PSEs • Growth rates • SONTR/GSDP • User charges and fees • Extent of cost coverage/level of implicit subsidies

3.2 Expenditure Structure

In the current financial reporting structure, States' expenses are broadly segregated as revenue and capital; a critical aspect of analysing a State's expenditure management is assessing the flexibility it has to curtail expenses in case of an economic downturn or revenue decline. With this perspective, a higher

share of capital expenditure normally indicates greater flexibility for curtailment in the immediate term; however, sustained pressures on capital investments would have an adverse impact on the State's infrastructure and hence economic prospects in the long term. Hence, the quality and extent of existing infrastructure impacts a State's flexibility to defer capital expenditure. Nevertheless, almost all States require substantial development funding at present. In this context, ICRA assesses States' policies aimed at creating capital assets, encouraging private investments, and creating a conducive investment climate. The trend in public asset creation necessarily has to be seen in tandem with the returns generated by these assets and the State's policies on user charges.

Apart from long-term capital commitments, the most immediate and critical cost concerns for most States are employee costs, various subsidies, support to public sector units, and debt servicing. ICRA analyses the trends in the salary and pension expenses of States and the extent of linkage between their and Central structures. The analysis also covers States' commitments to grant-in-aid institutions and the status of arrears on payments. Over the last two decades, States have initiated a number of steps like curtailing recruitment, abolishing redundant posts, creating low-cost temporary posts, outsourcing activities, and introducing contributory pension schemes; all these are likely to have a positive impact on their long term cost structures. However, for the immediate term, the salary structures remain quite inflexible, and moreover, the States' likely pension liabilities, which are not quantified as yet, could be very high.

In February 2014, the GoI appointed the Seventh Central Pay Commission (SCPC), which was given 18 months from the date of its constitution to make its recommendations. These recommendations would be applicable to Central Government Employees and Pensioners. In line with the prevailing practice, several State Governments are expected to use the SCPC's recommendations as a foundation to formulate their own pay revision. In this context, the ThFC's recommendation that structural shocks, such as payout of Pay Commission related arrears, be avoided, would help smoothen the revenue expenditures of the State Governments and prevent income-expenditure mismatches. As has historically been seen in India, settlement of large Pay Commission related arrears imposes considerable stress on the fiscal balances of the State Governments, which then take recourse to debt funding, in the process suffering deterioration in their debt service indicators. While avoidance of such structural shocks would prevent the periodic weakening of the States' credit profiles, it remains to be seen whether this recommendation is politically acceptable.

Apart from the high level of implicit subsidies that States extend through low user charges and free services, they also provide a very high level of explicit subsidies. While many States have their own welfare schemes, the key subsidies common to a large number of States are related to power and food. The power sector, across States, has been the single largest claimant of subsidies; thus, progress of reforms in this sector is a key factor in ICRA's assessment.

Sustained assistance to inefficient State entities has also been a drain on States' finances. Thus, ICRA also evaluates the progress made by the States concerned in restructuring their state-level enterprises and the possible assistance requirements of such enterprises in future. Also, the framework for and trend in transfers from the State Government to local bodies is a key element of ICRA's analysis.

A substantial increase in fiscal transfers in conjunction with the introduction of caps on fiscal deficits under the fiscal responsibility legislations have led to some reduction in the magnitude of fiscal deficits

relative to the respective State's GSDP over the last decade. Although interest expenses of States have declined over the last decade, they vary substantially across States, and ICRA continues to assess the likely trends in States' interest costs in the context of their projected funding requirements and the mix of borrowings. Moreover, with an increase in the proportion of untied funds from 2015-16 onwards, the quality of total expenditure and fiscal deficits would assume added importance.

Table 3.2: Expenditure Structure

RATING FACTORS	SOME ANALYTICAL INDICATORS
	Trends and interstate comparisons of:
Expenditure	<ul style="list-style-type: none"> • Growth rates • Mix <ul style="list-style-type: none"> - Revenue/capital - Capital expenditure/total expenditure - Sectoral break-up - Interest, salaries, pension, subsidies - Assignment to local bodies - Committed/flexible • Payment record
Appropriation of revenues for large revenue expenses	<ul style="list-style-type: none"> • Revenue expenditure/revenue receipts • Interest/revenue receipts • Salaries & pension/revenue receipts • Subsidies/revenue receipts
Capital asset creation	<ul style="list-style-type: none"> • Capital expenditure/ revenue receipts • Ability to execute • Private sector participation; investment climate and policies • Returns on investments

3.3 Financial Position, Leverage Levels and Liquidity

ICRA's assessment of the trends and outlook for deficits or surpluses hinges on its view on the sustainability of States' efforts to raise revenues on one hand, and lower expenditure on the other.

ICRA analyses the trends in States' revenue balance, fiscal balance and borrowings, both in absolute terms and in relation with the States' economic output, revenue receipts and SOTR. The analysis also factors in the economic and business cycles affecting the States, besides changes in policies.

A balanced or surplus revenue account and a declining or stable level of fiscal deficit is critical for States to avoid having an unsustainable reliance on debt and conform to the deficit and debt targets imposed by recent FCs, which guide the annual borrowing limits set for the States by the GoI, as well as the States' own fiscal responsibility legislations.

Apart from the levels of deficits and borrowings, ICRA's analysis entails assessment of the mix, maturity profiles and cost of borrowings by States. Following the recommendation of the Twelfth Finance Commission (TwFC), external assistance from multilateral agencies is passed on to the States on a back-to-back basis through the Centre since 2005-06, making it subject to the risk of foreign exchange fluctuation. Nevertheless, the proportion of external debt within State Governments' aggregate debt stock is limited at present.

The annual borrowing limit for State Governments is set by the GoI on a gross basis, after adding back principal repayments due in any given year, allowing for refinancing of principal repayments. Nevertheless, an assessment of the maturity profile of States' debt and guarantees is critical to understanding the timing of repayment obligations and the likely liquidity requirements. Bunching of repayments may affect the cost at which States are able to refinance their debt.

In addition to borrowings, ICRA analyses States' contingent liabilities to assess the overall leverage levels of States. This analysis is based on a consolidation of off-budget liabilities, including guarantees extended (with or without budgetary provisions) to lenders and suppliers, non-guaranteed liabilities of financially dependent and strategically important State-level entities, and losses accumulated in the books of the State-level entities.

While analysing contingent liabilities, ICRA likes to see robust databases and the regular tracking of likely invocation of obligations, as well as maintenance, if any, of sinking funds¹. The emphasis on monitoring follows directly from the fact that inefficient systems have in the past resulted in the delayed servicing of a number of guaranteed borrowings in certain States. In addition, there have been instances of guarantees not being invoked on account of the considerable bargaining power wielded by State Governments. Therefore, States' willingness to meet contractual debt and guarantee obligations, as assessed from their track record in this regard, is an important factor in ICRA's credit analysis.

A State's ability to forecast and manage cash flows plays a critical role in ensuring timely debt servicing. Various revenues streams tend to follow different inflow patterns over the course of each fiscal year. For instance, the GoI typically transfers around 7% of its budget estimate of tax devolution to the State Governments on a monthly basis from the start of each fiscal year, with adjustments typically made in Q4 in line with actual collections. However, the timing of grants from the GoI to each State Government is somewhat less predictable. Over the last decade, some State Governments have built up substantial investments in Treasury bills, which are used to tide over liquidity mismatches.

Assuming a certain level of reliability of systems for tracking contractual liabilities, an "easy" response to liquidity strain is to delay payments to contractors and employees. Moreover, short-term mismatches are usually (though not always) met by utilising the ways and means advances (WMA) and overdrafts (OD) provided by the Reserve Bank of India to the States. Recurring instances of delayed contracted payments and sustained utilisation of WMA and OD are, in ICRA's view, indicators of liquidity strain, or inappropriate cash flow management—both pointers to inferior credit quality.

Table 3.3: Financial Position, Borrowings and Liquidity

RATING FACTORS	SOME ANALYTICAL INDICATORS
	Trends and interstate comparisons of:
Fiscal imbalances	<ul style="list-style-type: none"> • Revenue balance/GSDP, fiscal balance/GSDP, change in debt stock/GSDP • Revenue balance/fiscal balance

¹ Such as Guarantee Redemption Fund, the balances of which are intended to be utilised for meeting the payment obligations arising out of the guarantees extended by the respective State Government. Additionally, some States have created Consolidated Sinking Funds, which provide cushions for amortisation of the market borrowings of State Governments.

Borrowings & other liabilities	<ul style="list-style-type: none"> • Sources, cost, maturity profiles • Debt²/revenue receipts, D + G/revenue receipts • Debt/SOTR, D + G/SOTR • Debt/GSDP, D + G/GSDP • Capex & net lending/fiscal balance
Liquidity	<ul style="list-style-type: none"> • Payment record (lenders; employees) • WMA & OD utilisation levels • Fiscal Deficit/change in debt stock

Note: D+G: Debt + Guarantees

4. Reform Efforts

Over the last two decades, the commitment to and success of reforms have varied considerably across States. While ICRA broadly classifies reforms as Policy-oriented, Institutional and Administrative, the objective of reforms is essentially to advance the human development indices, add to economic wealth, and improve the fiscal position of the State concerned. ICRA closely tracks the efforts made by States to identify areas needing reforms, besides examining the reform map drawn up and the extent of success achieved. For instance, in the case of power sector reforms, most reform plans involve financial restructuring, tariff rationalisation, and subsidy reduction (in the tariff structure), apart from improvement in the quality and reliability of supply. ICRA's assessment would entail an evaluation of:

- existing inefficiencies and accumulated liabilities in the system,
- targets and road map for improvement,
- extent of progress against the targets and timelines set,
- impact of the reforms on the State's finances—achieved, targeted, and likely.

ICRA's assessment of States' reform efforts gets manifested in its projections and forecasts for the States concerned, and thus becomes a critical parameter for credit rating.

5. Quality of Reporting and Monitoring

While the level of transparency and disclosure of State finances, plans and policies have improved over the last decade, the timeliness of reporting remains an impediment to analysis.

The accuracy of the States' budgeting process remains unfavourable, as evident from the variance observed among the budget estimates (BE), revised estimates (RE) and actuals. Of great concern is the material variance between the RE and accounts for a number of States. Given that the accounts figures are available nearly a year after the close of the fiscal year, ICRA is forced to base its assessment for any year on the RE (marking them up or down in qualitative terms on the basis of discussions with the States concerned as well as its own analysis of accuracy of the State's estimated based on past trends).

In addition, the cash-based accounting method constrains ICRA's ability to analyse some critical variables. For instance, a consolidated figure for current liabilities is usually not available, and ICRA relies on discussions to form an opinion on this. Similarly, the pay-as-you-go system for pension payments for older employees and the absence of actuarial assessment of future liabilities imply that a very significant liability cannot be quantified at this juncture by most States.

² Internal Debt; Loans from the Centre; Provident Fund etc.

Also, even though there is fair standardisation of accounting and the reports of the Comptroller and Auditor

General highlight aberrant entries, the existing systems allow for double entries that distort comparison, for instance, the contra-entries for interest income or lottery flows. Therefore, ICRA bases its analysis on adjusted numbers.

A significant gap in information is the absence of reliable centralised data on the extent, the repayment terms, and the assessed need for funding support of contingent liabilities (including details of guarantees and letters of comfort) of certain State Governments. In the absence of these, ICRA uses its discussions with various Government officials and State entities to fill in the gaps in information.

6. Political Leadership and Management Capabilities

An important aspect of State assessment is the analysis of electoral trends and its implications for change or continuity in policy. The ability and willingness of incumbent governments to balance political and electoral compulsions against fiscal prudence is a critical factor influencing the health of State finances. Additionally, continuity in administrative set-ups may lead to stability in policy direction as well as on the quality of fiscal and economic management by States. ICRA's assessment of any State, therefore, takes into account its institutional robustness and its administrative capabilities.

Summing Up

This methodology broadly highlights the quantitative and qualitative risk factors that are likely to influence the rating outcomes. It should not be treated as an exhaustive discussion of all the factors considered while assigning a credit rating but a broad framework to help stakeholders understand the approach to the same.



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