ICRA

RATING METHODOLOGY – STATE GOVERNMENTS

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ICRA assigns standalone as well as credit-enhanced ratings to the debt instruments of state-owned entities. In some instances, state governments have provided explicit support to the debt instruments issued by the various state-owned entities by extending an unconditional and irrevocable guarantee for the full repayment of the principal and the payment of interest over the tenure of such debt. Besides extending guarantees, other forms of explicit support that state governments could provide include a shortfall undertaking, letter of comfort etc. The ratings of instruments, that are supported by an explicit support from state governments, fundamentally represent ICRA's assessment of the strength of the respective state's finances, as well as the strength of the explicit support to ensure timely debt servicing. Besides explicit support, the ratings of various state-owned entities can also be uplifted from their standalone rating based on the expectation of implicit timely support from the respective state governments, entities which are strategically important. To factor both explicit as well as implicit support from the state governments while assigning credit ratings to state-owned entities, an assessment of the credit profile of the respective state government is undertaken, as elaborated in this document.

ICRA's methodology for evaluating the credit profiles of state governments starts with the fundamental premise that the local currency debt obligations of the Government of India (GoI) carry the highest rating on ICRA's rating scale. The GoI has unparalleled flexibility to meet its debt obligations, as it can monetise its deficits if required. Moreover, unlike the state governments, the GoI has access to direct taxes, non-shareable cesses and surcharges and certain non-tax revenues (such as dividend from RBI, as well as disinvestment receipts etc.).

The state governments largely levy indirect (consumption-based) taxes, such as excise, sales tax, state Goods and Services Tax (GST) etc. Since the commencement of the GST regime, the states' power to levy and unilaterally change the tax rates is limited to a select set of the consumption-based items on which GST is not levied. Moreover, relative to the GoI, the contribution of non-tax revenues to the total revenues of the state governments has been modest in the case of many states.

A state government's financial flexibility is constrained by the contours of the federal structure as laid down in the Constitution of India. As per Article 293(3) of the Constitution of India, the state governments are required to take the permission of the GoI regarding the magnitude and the timing of certain types of borrowings that they can undertake. The GoI has a supervisory authority over the state governments. Therefore, the ratings of the state governments are lower than the sovereign rating.

This rating methodology provides a reference tool for investors and issuers to understand ICRA's approach in assessing the credit quality of state governments. Given below are the key rating drivers:

Extent of Reliance of State Governments on Transfers from the Union Government

Economic Strength

Revenues and Expenses

Financial Position, Leverage Levels and Liquidity

Quality of Reporting and Monitoring

Extent of Reliance of State Governments on Transfers from the Union Government

As per the provisions of the Constitution of India, the states' share of taxing powers is typically less than their proportionate share of responsibilities, for which they incur expenditure, while the Union Government has a wider tax base and relatively lower spending responsibilities than the states. The overall scheme of revenues and expenditures of the Union Government and the state governments, as set out in the Constitution, results in a vertical imbalance between these two tiers of the governments.

At present, the vertical imbalance between the Union and the state governments is sought to be compensated through a variety of fiscal transfers. For instance, in accordance with the recommendations of successive Finance Commissions (FCs)[1], the GoI transfers (a) a proportion of its shareable Union taxes and duties (direct and indirect taxes, including Central GST) to the state governments, and (b) various tied and untied grants[2].

The FC-recommended fiscal transfers (FC transfers) address the vertical imbalance between the Union and the states and simultaneously aim to reduce horizontal imbalances among states. For the latter, the FCs tend to incorporate parameters, including population, area, efficiency and performance into their Central tax devolution formula. The Central tax devolution is an untied source of funds for the state governments and, therefore, offers the state governments greater autonomy and flexibility to plan their expenditures based on their own priorities.

For achieving horizontal equity, most of the FCs also recommend various grants for the states, which can be tied or untied in nature.

In addition to the grants recommended by the FC, the GoI provides various other grants to the state governments which can be both tied (such as grants for various schemes and untied (such as GST compensation) in nature.

ICRA's analysis of a state government's finances factors in the extent of fiscal transfers from the GoI to the state governments. In ICRA's view, the financial strength of a state government, 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. If a state government meets a higher proportion of its expenditure from its own revenues rather than Central transfers, it is viewed positively by ICRA.

While ICRA takes 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.

Exhibit 1: Transfers from Union Government to State Governments

RATING FACTORS	SOME ANALYTICAL INDICATORS
	Trends and interstate comparisons of:
Access to transfers	(Central tax devolution + grants from the Centre)/Gross State Domestic Product (GSDP)
Extent of self-reliance	Own revenues/revenue expenditure

[1] *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.*
2 Tied transfer means the end-use for which the funds are supposed to be used are specified (example for a particular Centrally Sponsored Scheme) whereas untied transfer means that the receiver has the discretion to spend the amount as it deems fit (Tax devolution, GST compensation grants)

Assessment of Self reliance

[Indicative Metrics[3]]

	Strongest		Weakest
Own revenues as a proportion of revenue expenditure	>81%	→	0-20%

Economic Strength

The size (measured by GSDP) and diversity (measured by composition of GSDP) are among the critical determinants of a state's economic and financial strength outlook, and hence the rating.

The per-capita income is an important indicator for evaluating the scope of consumption in a state, which directly impacts the state's revenue generation ability, either through taxes or fees for the services that it provides. Additionally, the level of urbanisation, literacy rates, per capita power availability, irrigation coverage are some of the key socio-economic indicators that influence the economic output of each state in the long-term, and thus also its revenues and credit worthiness.

Exhibit 2: Economic Strength

RATING FACTORS	SOME ANALYTICAL INDICATORS
	Trends and interstate comparisons of:
Key socio-economic indicators	• Real and nominal GSDP, its composition and growth rate, and per capita income • Urbanization, Literacy rate, Per-capita power availability, irrigation coverage, Infant mortality rate etc.

Assessment of Economic Strength

[Indicative Metrics]

	Strongest		Weakest
Per-capita income	>Rs. 2,50,000	→	<Rs. 1,00,000
Performance on key socio-economic indicators compared to national average	Superior compared to national average on all indicators		Adverse compared to national average on all indicators

[3] *The indicative financial metrics mentioned here and elsewhere in the document are intended to provide a broad overview to the readers regarding what ICRA generally considers as 'relatively strong' or 'relatively weak' metrics. It is, however, possible that a state has relatively weaker metrices on one or more parameters, but its credit risk is assessed to be low because of other mitigating factors, including (but not limited to) stronger metrices on other parameters.*

Revenues and Expenses

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.

Revenue Structure

The revenue receipts of state governments comprise the states' own tax revenues (SOTR), the states' non-tax revenues (SONTR) and Central transfers. To assess the strength of a state's revenues, ICRA evaluates the size of the total revenue receipts of a state relative to its GSDP.

The SOTR comprises consumption-based taxes such as (a) SGST on all specified goods and services consumed within the state, (b) sales tax/VAT on petroleum and petroleum products and alcohol, (c) excise duty on alcoholic liquor for human consumption, (d) stamps and registrations duties levied on purchase of immovable properties, (e) electricity duties on consumption of electricity, (f) motor vehicles tax on purchase of automobiles and (g) some other minor taxes. The GST Council decides the rate on all goods and services which are within the purview of the GST and, therefore, such goods and services have a same rate across the country. The state governments have the exclusive power to levy and modify the rate of taxes on items mentioned under (b) to (g), under the existing tax regime.

The per-capita SOTR is a useful indicator for gauging the robustness of the consumption levels of a state. A sustained improvement in this ratio is viewed positively by ICRA. While the ratio of revenue receipts to GSDP is impacted by the level of central transfers, the per-capita SOTR provides a stronger signal of the revenue generating ability of the state itself.

ICRA evaluates the contribution of each of these taxes to the SOTR, their growth trends and factors that would affect such revenues in the near to medium term. In ICRA's view, high SOTR/GSDP ratios are generally a credit positive.

ICRA favourably views the states' effort to improve revenue collections by improving administrative and collections systems and boosting e-governance leading to reduction in leakages and tax avoidance.

The SONTR comprises interest and dividend income from loans and investments in public sector enterprises (PSEs) and user charges or fees for certain services such as irrigation, health, education, etc. The SONTR has so far been a relatively low contributor of revenues for most states. Interest and dividend income from loans and investments in PSEs have historically been low. Moreover, low user charges or fees vis-à-vis the cost of provision levied by states for services, such as irrigation, health and education, results in a high level of indirect subsidies extended by states to end-users, further depressing this revenue stream.

ICRA's analysis of the states' revenue composition entails an assessment of the sources of revenue, namely SOTR, SONTR and Central transfers and diversity of revenue streams. The flexibility that the states have to increase the rate of tax on various items has declined with the transition to GST, as a common GST rate is applicable to the same item on a pan-India basis, as decided by the GST Council. Accordingly, the state governments have the leeway to raise additional tax revenue only on those items, which are not subsumed under the GST.

Exhibit 3: Revenue Structure

RATING FACTORS	SOME ANALYTICAL INDICATORS
	Trends and interstate comparisons of:
Size of revenue receipts	Revenue receipts /GSDP, Per capita revenue receipts
SOTR	SOTR/GSDP, Per capita SOTR
SONTR	SONTR/GSDP

Expenditure Structure

State expenses are broadly segregated into revenue and capital. A critical aspect of analysing a state's expenditure management is assessing its flexibility to curtail expenses in case of an economic downturn or revenue decline. A relatively high share of capital expenditure normally indicates greater flexibility for curtailment in the immediate term. However, sustained cutback of capital investments could have an adverse impact on the state's infrastructure and hence economic prospects in the long term.

The availability of fiscal space, quality and extent of the existing infrastructure and the execution capabilities of a state determine the state's capital spending. Despite availability of funds, the actual capex could be lower than warranted, due to weak execution capabilities. Therefore, the level of capital spending as a proportion of GSDP is an important indicator for long-term economic prospects.

The proportion of capital expenditure in total expenditure is an indicator of quality of expenditure of the state governments. In ICRA's assessment, a high share of capital expenditure, relative to the revenue expenditure, is generally considered a positive factor.

The key components of revenue expenditure include employee costs, various subsidies, support to public sector units, and debt-servicing, some of which tend to be relatively sticky in nature. ICRA analyses the trends in the salary and pension expenses of states, the commitments to grant-in-aid institutions and the status of arrears on payments, if available publicly. Several states provide a very high level of explicit subsidies to target beneficiaries in their respective states. While many states have their own welfare schemes, the key subsidies common to many states are related to power and food. The power sector, across states, has traditionally received large subsidies from the state governments. Therefore, a key factor in ICRA's assessment of state fiscal health is the progress of power sector reforms.

ICRA assesses the trends in appropriation of revenues by interest payments, to assess the flexibility to spend on other non-development as well as development heads.

Additionally, ICRA analyses the trend in transfers from the state government to local bodies.

Exhibit 4: Expenditure Structure

RATING FACTORS	SOME ANALYTICAL INDICATORS
	Trends and interstate comparisons of:
Size of Revenue expenditure	• Revenue expenditure/GSDP, per-capita revenue expenditure • Components of revenue expenditure ▪ Sectoral break-up, Interest, salaries, pension, subsidies ▪ Interest/revenue receipts ▪ Subsidies/revenue receipts
Size of Capital expenditure	• Capital outlay and net lending[4]/GSDP, Per capita capex • Capex+net lending/Total expenditure

[4] *Gross loans and advances extended to state level entities less recovery*

Assessment of Revenues and Expenses

[Indicative Metrics]

	Strongest	Weakest
Revenue receipts as a proportion of GSDP	>17%	<8%
Per-capita SOTR	> Rs. 15,000	< Rs. 5,999
Size of capital outlay	>3%	< 0.5%

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 the one hand, and lower expenditure on the other.

ICRA analyses the trends in states' revenue balance, fiscal balance and borrowings, in relation with the GSDP.

ICRA views a balanced or surplus revenue account as a positive, as it indicates state's ability to limit its revenue expenditure, a sizable portion of which comprises relatively sticky items such as salaries, pensions, interest payments and power subsidy, to the extent of its revenue collections, leaving the entire borrowing space for capital spending.

A declining or stable level of fiscal deficit is critical for the states to avoid having an unsustainable reliance on debt and to curtail capital expenditure to conform to the deficit and debt targets set by successive FCs. These targets typically guide the annual net borrowing limits set for the states by the GoI, as well as the states' own fiscal responsibility legislations.

ICRA analyses the extent, maturity profiles and cost of market borrowings by state governments. An assessment of the maturity profile of states' debt and guarantees is important for understanding the timing of repayment obligations and the likely liquidity requirements. Bunching-up of repayments may affect the cost at which state governments are able to refinance their debt.

In addition to borrowings, ICRA analyses the 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 subject to availability of such information in the public domain. ICRA also analyses the non-guaranteed financial liabilities of financially dependent and strategically important state-level entities, if deemed relevant and wherever such information is publicly available.

While analysing contingent liabilities, ICRA favourably considers the presence of robust databases and the regular tracking of likely invocation of obligations, as well as maintenance, if any, of sinking funds.[5] 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.

The states' willingness to meet contractual debt and guarantee obligations, as assessed from their available track record in this regard, is an important factor in ICRA's credit analysis. However, ICRA notes that there have been instances of guarantees

[5] *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 amortization of the market borrowings of State Governments.*

not being invoked by the lenders despite delays in payments, and a lack of timely information surrounding the same in the public domain, which constrains our analysis and response.

A state government's ability to forecast and manage cash flows plays a critical role in ensuring timely debt servicing. Various revenue streams tend to follow different inflow patterns over the course of each fiscal. However, the timing of grants from the GoI to each state government tends to be less predictable. Over the past decade, some state governments have built up substantial investments in Treasury Bills, which help tide over liquidity mismatches. Therefore, ICRA tracks the investments in Auction Treasury Bills of state governments.

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, information on which is often not available in the public domain. Moreover, short-term mismatches are usually (though not always) met by utilising the ways and means advances (WMA) and overdraft facility (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 a liquidity strain, or inappropriate cash flow management — both pointing to inferior credit quality.

Exhibit 5: Expenditure Structure

RATING FACTORS	SOME ANALYTICAL INDICATORS
	Trends and interstate comparisons of:
Size of revenue balance	Revenue balance[6]/GSDP
Size of fiscal balance	Fiscal balance/GSDP
Borrowings and other liabilities	• Sources, cost, maturity profile of market borrowing • Debt[7]+Guarantees + non-guaranteed off-budget debt[8]/GSDP
Liquidity	Number of days in WMA and OD

Assessment of Financial Position, Leverage Levels and Liquidity

[Indicative Metrics]

	Strongest	Weakest
Size of Revenue Balance	**Balanced or positive revenue account**	**Higher than -3%**
Size of Fiscal Deficit	**Lower than or equal to -1.99%**	**Higher than -5%**
Size of debt and guarantees	**<20%**	**>50%**
WMA Usage in trailing 12 months	**Zero days**	**More than 270 days**
OD Usage in trailing 12 months	**Zero days**	**More than 180 days**

[6] *Revenue Balance: Revenue receipts less revenue expenditure; Fiscal Balance: Revenue Balance less net capital expenditure and net lending*
[7] *Internal Debt; Loans from the Centre; Provident Fund etc.*
[8] *Subject to availability of information*

Quality of Reporting and Monitoring

The level of transparency and disclosure of state finances, plans and policies has improved over the past two decades. However, the lack of timeliness of reporting remains an impediment to our analysis.

The accuracy of the states' budgets remains relatively low, as is evident from the variance observed among the budget estimates (BE), and actuals. ICRA tracks the variance between the Actuals and the BE for revenue receipts, revenue expenditure and capital expenditure and marks these variables up or down, if there are consistently large variations in them. Such analysis takes into account the Provisional Actuals (PA) for T-1 (where T is the ongoing fiscal for which BE is available) that are available from the Comptroller and Auditor General of India (CAG) within a few months of the end of T-1 fiscal year. The extent of deviation between the PA and that audited actuals of a fiscal has been modest in recent years for most states, providing a better estimate than the revised estimates published by the state for T-1 fiscal year along with the BE for fiscal year T.

In addition, ICRA's ability to analyse some critical variables is constrained by the cash-based accounting method. 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 defined benefit 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.

Moreover, even though there is fair standardisation of accounting practices, and the reports of the CAG do highlight aberrant entries, the existing systems allow for double entries that distort comparison, for instance, the contra-entries for interest income or lottery flows that boosts revenues and expenditures. Therefore, ICRA makes various adjustments to aid its analysis.

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.

Assessment of Quality of Reporting and Monitoring

[Indicative Metrics]

	Strongest	Weakest
Variance in revenue receipts (Act. Vs BE)	**<±1%**	**>±30%**
Variance in revenue expenditure (Act. Vs BE)	**<±1%**	**>±30%**
Variance in capital outlay and net lending (Act. Vs BE)	**<±1%**	**>±60%**

Assessment of Environmental, Social and Governance (ESG) Risks

For assigning ratings to state governments, ICRA seeks to factor in all the relevant credit considerations. ICRA also takes into consideration the impact of ESG factors on the economic output of the state and on the key fiscal variables, contingent on the availability of relevant information. Additionally, there is a fair degree of overlap among the environment and social risk factors, making it difficult to delineate the risk arising from three sub-components. ICRA's analytical approach does not explicitly disaggregate these risks to assess their impact on the rating of the state governments; our endeavour is to develop a qualitative understanding of these risks.

Environmental (E) and Social (S) Risks

Environmental considerations: The pace of growth of the economy of the state, geography of the region, schemes/policies implemented by governments will determine the environmental risk and impact the credit profile of the state. High carbon footprint industries/factories, sowing of water intensive crops in rainfall deficient areas pose environmental risks. Frequent natural disasters such as hurricanes, flooding, earthquakes etc. can negatively impact the economic growth of the region.

Social considerations: The demographic profile of the population, societal trends, perceived threat by local communities to expansion plans of the industry, wide income disparity, divergences in access to basic services can influence the degree of social risk to the economy of a state government.

Governance Risks: For assessing the governance risk of a state government, ICRA factors in the timeliness with which a state releases information on its fiscal position, the adequacy of disclosure of fiscal data etc. The adherence by the state government to the procedures and guidelines regarding sound Public Financial Management set by the CAG are considered while assigning rating to state governments.

Summing Up

ICRA's credit ratings are a symbolic representation of its current opinion on the relative credit risk associated with the state government being rated. ICRA's rating of a state government involves a detailed assessment of factors such as the composition of revenues, extent of reliance on the states' own revenues, growth of various components of revenues, composition and growth of revenue and capital expenditure, revenue and fiscal balances, and the level of debt outstanding and guarantees extended by a state government. ICRA also evaluates the economic strength, demographic trends and the socio-economic infrastructure of a state as they have an important bearing on the long-term economic output of the state. Moreover, ICRA considers the reform efforts and quality of reporting and monitoring, while assessing the credit quality of a state government. This methodology broadly highlights the quantitative and qualitative risk factors that are likely to influence the rating outcomes.[9] 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.

[9] *Subject to availability of relevant information*

ANNEXURE

Summary of rating factors and an example to illustrate the key building blocks of a credit rating for a state government

		Strong	Comfortable	Adequate	Moderate	Weak
Reliance of State governments on transfers from Union Government	Extent of self-reliance in meeting its expenditure from own revenues					
Economic Strength	Per capita income					
	Key socio-economic indicators relative to the national average					
Revenues and Expenses	Revenue receipts as a proportion of GSDP					
	Per capita SOTR					
	Size of capital outlay					
Financial Position, Leverage and Liquidity	Size of Revenue balance					
	Size of Fiscal deficit					
	Size of debt and guarantees					
	WMA usage					
	OD usage					
Quality of Reporting and Monitoring	Difference between Actuals and Budget estimates in Revenue receipts					
	Difference between Actuals and Budget estimates in Revenue expenditures					
	Difference between Actuals and Budget estimates in Capital outlay and net lending					
	Final Rating	AAA AA+ AA	AA- A+ A	A- BBB+ BBB	BBB- BB+ BB	BB- B/ C category

The above graphic is only for illustration purpose and does not represent a rating output from a formulaic model. The ratings assigned by ICRA are determined by Rating Committees based on both quantitative and qualitative considerations.

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Today, ICRA and its subsidiaries together form the ICRA Group of Companies (Group ICRA). ICRA is a Public Limited Company, with its shares listed on the Bombay Stock Exchange and the National Stock Exchange. The international Credit Rating Agency Moody's Investors Service is ICRA's largest shareholder.

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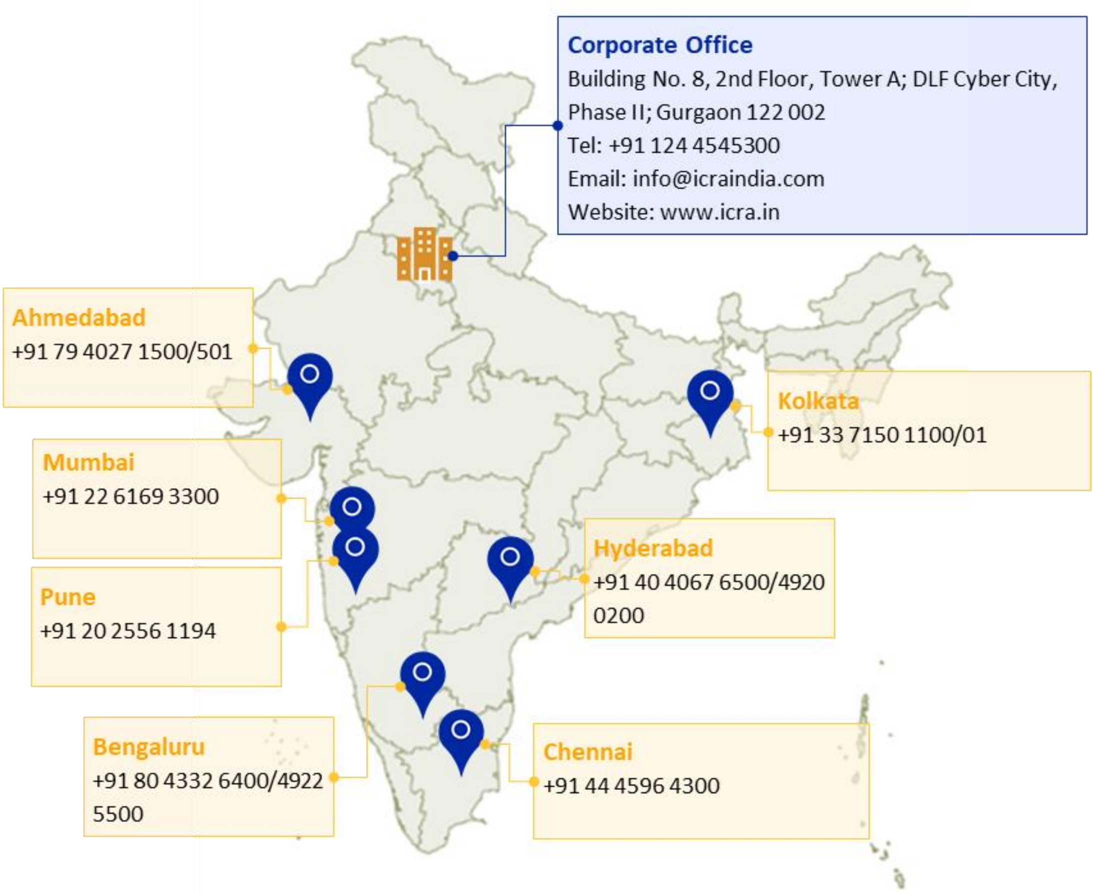

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