Rating Indian Local and State Governments

Important Credit Aspects for National Ratings

Special Report

Major Credit Aspects: This report articulates India Ratings & Research (India Ratings) methodology for assigning ratings to local and state governments in India. India Ratings has assigned ratings to a number of urban local bodies, state government-supported debt programmes of state public sector undertakings and state-owned entities, and central government owned entities.

Institutional Framework: The Constitution of India provides for a division of taxation powers between the central government and the states. The states have a share in the resources available to the central government, which provides fiscal support to the states in times of distress. States are divided into special and non-special categories. Special-category states have always benefited from greater central assistance in relation to their population.

Socio-Economic Profile: Diversification, growth patterns and economic activities are major rating factors. Local and state governments rated in the 'IND A' category and above have a diverse economic structure and good social profile.

The proportion of these state economies to national income is generally more than 5% and their growth performance is either the same as or better than that of the nation. Local and state governments rated in the 'IND BBB' category and below are generally smaller and a have weak social profile, although they may be growing faster than for higher-rated states.

Budgetary Performance: Higher-rated local and state governments ('IND A' category and above) have low dependence on upper tiers of government for revenue. They have current surpluses and high operating margins (15%-25%). Their fiscal deficit (surplus or deficit before debt variation in the international context) is low and most of this deficit is incurred to finance capital expenditure.

Debt and Liquidity: Indian state governments rated in the 'IND A' category and above have low debt (debt/current revenue less than 2.3x), which is sustainable in relation to economic growth. Indian local governments rated in the 'IND A' category and above have debt/revenue income of less than 0.2x.

The sustainability of local government debt in relation to anticipated capital expenditure and revenue patterns is low for lower-rated Indian local governments. Higher-rated Indian state governments have very low dependence on central government and the Reserve Bank of India (RBI) for liquidity.

Management and Administration: India Ratings assesses Indian local and state governments' quality of management on the track record of implementation of reforms and adoption of best practices in fiscal management. Year-on-year performance in relation to budgeted revenue, expenditure and fiscal targets provides an insight into management performance.

State governments are implementing various reform measures suggested by central government, such as the creation of sinking and guaranteed redemption funds and the adoption of new pension schemes. Local governments are implementing reforms under the Jawaharlal Nehru National Urban Renewal Mission.

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Major Rating Factors for Indian Local and State Governments

India Ratings methodology for assigning issuer ratings to Indian local and state governments draws on the agency's Master Criteria Report, *Tax Supported Rating Criteria*, and the Sector-Specific Criteria Report *Local and Regional Governments Rating Criteria* (see under *Related Criteria*). This report should be read in conjunction with those listed above.

The framework for assessing credit quality involves five key aspects: institutional framework, management and administration, socio-economic profile, budgetary performance, and debt and liquidity. India Ratings has adapted its methodology to the Indian context in light of the complex web of inter-governmental relations, and intricate administrative, regulatory and financial structures.

- The institutional framework is the single most important factor in assessment of the credit profile of local and state governments

Institutional Framework

India Ratings institutional framework assessment is based on: local administration and finances; accounting and budgeting; debt, liquidity, contingent liabilities and prudential debt regulations; and oversight, control and bankruptcy proceedings. India Ratings classifies institutional frameworks into three types — Strong, Neutral and Evolving. If the framework is strong, the agency places less importance on the stand-alone fiscal and financial performance of local and state governments. Institutional frameworks are not static and can change, for example from Neutral to Strong.

The Constitution of India provides for a division of taxation powers between the centre and the states. Consequently, states have a share in the resources available to the centre and the centre provides fiscal support to the states in times of distress. This creates financial dependence alongside legislative autonomy. States are wholly responsible for meeting their debt service through their respective budgets.

Planning Commission and Finance Commission transfers are formula based and are made on the basis of grants and loans. The Twelfth Finance Commission (TFC) recommended that Planning Commission transfers should all be in the form of grants rather than loans.

States are categorised as special and non-special; there are 11 special-category states. In line with the TFC's report, all central government assistance is disbursed as grants, with the special-category states receiving 56% of the total and the rest going to the others. Special-category states have always benefited from greater central assistance in relation to their population.

Socio-Economic Profile

One of the most influential determinants of Indian local and state governments' ratings is the size and buoyancy of their economies. A state's revenue generation capacity is directly proportional to the size of its economy and its buoyancy. Although size and structure are equally significant, both these factors are influenced by policy interventions by state governments. National economic, taxation and reform policies define the broad contours of economic policy; however, states define their own industrial and other policies. States derive maximum advantage by aligning their policies with national priorities. Moreover, social and infrastructure development also play a crucial role in the growth of a state.

Economic Drivers

The economic viability of the entity is a fundamental rating strength: ie, a state with an economy based on its own resources and geographic advantages would normally be stronger than one dependent on national tax incentives or grants/subsidies for existing or future employment growth. A diverse economy, with no dominant employer or industry and a blend of manufacturing, agriculture and services is a positive credit factor. Although size of the economy is important, a high per capita income is more important to the rating level. This, along with

- Diverse economy and growth performance over five-year plan periods, and per capita income level are major economic drivers
- Highly rated local and state governments have lower dependence on agriculture and high growth performance.

employment structure, determines the economic growth trajectory.

For Indian states, economic growth performance during five-year plan periods in relation to target and national growth rates are important yardsticks of states' economic performance compared with their peers and the country.

In the absence of city-level income data, India Ratings relies on production activities and distribution of workers in the entity's territory. Information on some of these indicators is available from periodic surveys conducted by government agencies and is generally accessible after a significant delay. At times, information on some of the indicators for smaller states is not available.

The ratings of state/national capital, business centres and tourist towns derive additional support from economic activities originating from different production sectors and are a credit positive.

Wealth

Although per capita income levels are important, per capita income ratios in relation to regions and India as a whole provide an indication of the rate at which wealth will be generated within a region. This influences future revenue generation through consumption.

Figure 1

Economic Performance Through Economic Growth Cycle — Indian State Governments (%)

Rating category	AAGR	Agriculture	Industry	Services	Growth volatility	Per capita income ratio (x)	Proportion to national income
IND AA	>10.0	<20	>30	>50	<3	1.1–2.5	3.5–7
IND A	8–10	20–25	25–30	45–55	3–5	0.9–1.5	2–14
IND BBB	7–8	>25	<25	<50	1–3	0.5–1.4	2.5–8.5
Special-category states	7–8	>25	<25	<50	2–9	0.6–1.2	0.1–1.1

AAGR: Average annual growth rate through the economic growth cycle
Agriculture: Proportion of agriculture in gross state domestic product (GSDP)
Industry: Proportion of industry in GSDP
Services: Proportion of services in GSDP
Per capita income ratio: Per capita net state domestic product to net national product ratio
Source: India Ratings

Figure 2

Economic Performance Through Economic Growth Cycle — Indian Local Governments

Rating category	Major economic drivers
IND AA	Political or business capital, large, diversified services and industrial sectors and buoyant economic activities
IND A	Proximity to political and business capitals for employment and reaping the benefits of "trickle down"
IND BBB	Mostly medium-sized towns with high dependence on a particular sector/industry/government for employment
IND BB and below	Small towns or towns of tourist interest, with very limited economic activities of their own (mainly some government departments)

Source: India Ratings

Demography

- Sound demographic profile and high urbanisation are other key aspects for high rated Indian local and state governments

Demographic trends are also a significant component of the rating analysis, especially as they can affect expenditure on education and public health. In addition, population characteristics can be decisive in terms of the weight of certain liabilities, such as pensions and new debt to finance substantial capital investment to meet the demands of a growing population.

Figure 3

Demographic Parameters — Indian State Governments (%)

Rating category	Literacy	WFPR	Agriculture dependent workers to total workers	Urbanisation
IND AA	67–80	33–45	1–56	30–90
IND A	60–75	42–47	49–77	20–45
IND BBB	47–70	32–47	39–77	15–35
Special category states	54–88	36–52	50–68	10–50

Note: WFPR: Workforce participation rate defined as total number of workers as a percentage of total population
Source: India Ratings

Budgetary Performance

India Ratings assessment of the financial strength of Indian states focuses on the medium-term trends in fiscal performance and position. Although past performance is important, state-level medium-term fiscal policies provide a roadmap of a state's economic growth and fiscal performance. Although national economic and fiscal policies affect all states, state-level policies lead to variations in state-level economic and fiscal performance.

Revenue/Receipts

- Higher own revenue protects governments from major financial shocks originating from the central government's fiscal performance
- Revenue buoyancy above 1x highlights efficiency improvements in the tax administration

Local and state government receipts are broadly divided into two parts — revenue and capital. States derive revenue receipts from their own sources — tax and non-tax revenue — and funds devolved from the centre — shares in central taxes and grants. States' fiscal self-reliance depends on the performance of states' own revenue, both tax and non-tax. A higher proportion of states' own revenue relative to total revenue insulates them from cyclical variations and fluctuations in national economic growth. A higher dependence on the central government for revenue leaves a state susceptible to fiscal shocks, in line with national economic and fiscal performance.

Figure 4

Revenue Performance — Indian State Governments (%)

Rating category	Revenue receipt growth	Proportion of own revenue in total revenue	Own revenue buoyancy (x)	State's own tax revenue/GSDP
IND AA	12–15	73–93	0.7–1.2	7–9
IND A	14–16	58–81	0.9–1.7	7–8
IND BBB	10–17	45–83	1.0–1.2	5–7
Special category states	12–18	8–55	1.2–2.5	2–4

Note: Own-revenue buoyancy is defined as the ratio of growth of revenue collection to nominal growth of GSDP
Source: India Ratings

The buoyancy of states' own revenue — average and annual during the preceding five or six years — is an important indicator for gauging states' resilience. Ideally, own-source revenue buoyancy should be greater than 1.0x. However, state revenue buoyancy depends on the economy's structure and buoyancy. India Ratings would expect a relatively more industrialised and industrially buoyant state to have higher revenue buoyancy than a less industrialised and industrially non-buoyant state. The replacement of state-level sales taxes by state-level VAT was a major fiscal reform; all Indian states have now migrated to a state-level VAT. The proportion of VAT in states' own revenue and its buoyancy has implications for states' own revenue buoyancy.

- Property tax, and octroi for Maharashtra's large urban local bodies, buttresses revenue receipts

With the exception of Maharashtra, all Indian states have abolished octroi (a tax levied on goods entering municipal limits). Even in Maharashtra, it is only being levied in large urban local bodies. Octroi is a major source of tax revenue for these entities; in other municipal corporations property tax is most important. Municipal corporations where octroi has been abolished receive compensation grants from state governments. In smaller municipal corporations, grants (octroi compensation and state finance commission devolutions) are the biggest revenue source. In some smaller municipal corporations, the proportion of grants from

the state government has averaged as high as 85% of revenue income over five years.

Figure 5
Revenue Performance — Indian Local Governments

Rating category	Average revenue receipt (INRm)	Revenue receipt growth (%)	Proportion of own revenue in total revenue (%)	Non-tax revenue to total revenue (%)
IND AA	6,000-116,000	5–28	54–98	12-18
IND A	1,800-6,500	11–16	92–94	10-18
IND BBB	350-2,900	10–16	8–39	5-13
IND BB and below	22-700	7–30	24–75	6-18

Source: India Ratings

Indian local governments' rating levels move in tandem with their economic characteristics. Larger cities with strong economic bases are rated higher than those with shallow economic profiles. Indian local governments rated in the 'IND A' category and above generate most of their revenue from own sources and their reliance on state or central governments for revenue is low.

Higher-rated Indian local governments ('IND A' category and above) have relatively better urban infrastructure and receive a significant proportion of their revenue from levying user charges. In general, Indian local and state governments' finances suffer from low collection of user charges, which could be a major source of non-tax revenue. Incentives such as free power and cheaper food grain offered to certain sections of society by political parties at the time of state elections are also responsible for low user charge income.

State governments' capital receipts come from recovery of loans and advances extended by state governments to various state entities and public servants; they generally do not depend on a state's policy framework. However, an improvement in the fiscal health of state government-owned entities would be reflected in reduced loans and advances and therefore lower capital receipt recoveries.

Municipal corporations' capital income is in the form of loans (from financial institutions and state governments) and capital grants (project-specific grants from central and state governments).

Expenditure

- High capital expenditure indicates robust developmental activity prospects

As with receipts, states' expenditure is also classified into revenue and capital. Revenue expenditure is current and used for items such as consumption, administration — salaries and pensions — and interest payments.

Capital expenditure is mainly for investment purposes. However, principal repayment obligations tend to be classified as capital expenditure and therefore need to be separated out in order to determine aggregate debt-service obligations and analyse the real amount of capex that flows into asset creation. During periods of fiscal correction, curtailment of capital expenditure is universal. This has an impact on physical and social infrastructure creation and therefore affects the future growth prospects of states' economies, which in turn affects a state's economic and fiscal stability.

- Expenditure rigidities make expenditure reforms difficult both for Indian states and local bodies

In India, at both central government and state level, a larger proportion of revenue/current expenditure is committed — eg, salaries, pensions and interest payments. In some cases, committed expenditure accounts for most of states' current revenue, leaving limited resources for capital expenditure. Although the current expenditure trend is important, its structure — committed compared with non-committed — is an important driver in shaping its future direction. Long-term fiscal and economic policy initiatives to curtail and control salary, pension and interest expenditure are credit positive. A higher proportion of committed expenditure in current expenditure makes expenditure reforms more difficult. Trend analysis of current expenditure in

relation to state income and revenue receipts, and in relation to deficits and other macroeconomic trends, is important.

Figure 6

Expenditure Performance — Indian State Governments (%)

Rating category	Revenue expenditure growth	Proportion of development expenditure in revenue expenditure	Proportion of selected committed expenditure in revenue expenditure	Capital expenditure growth
IND AA	7–16	62–63	27–35	11–20
IND A	9–16	55–66	30–36	16–31
IND BBB	9–12	41–59	33–43	3–25
Special category states	8–17	36–63	33–40	8–33

Note: Selected committed expenditure includes expenditure on interest payments, pension and administrative services.
Source: India Ratings

The smaller size of lower-rated local bodies exaggerates expenditure growth figures. Most smaller local bodies spend mainly on establishment (eg, salaries and pension) with very little going to operations and maintenance and assets, leading to poor-quality city infrastructure. The proportion of establishment expenditure in total revenue expenditure is higher due to government employee salary revisions every 10 years. The most revision for local government employees was in FY09 and FY10. Salaries are revised retrospectively and salary arrears can last for two to three years. In many instances incremental establishment expenditure is higher than the increase in revenue expenditure.

The central government has initiated a reform programme to improve urban infrastructure in major Indian cities. Cities were given grants by central and state governments for approved projects (approved by central government in consultation with state governments). The grant component varied between 50% and 100% of project costs depending on the population of the city. In normal years, capital expenditure growth is generally 10%-15%.

Figure 7

Expenditure Performance — Indian Local Governments (%)

Rating category	Revenue expenditure growth	Proportion of establishment expenditure in revenue expenditure	Proportion of O&M expenditure in revenue expenditure	Capital expenditure growth
IND AA	5–28	17–80	5–71	13–54
IND A	9–18	35–61	4–42	3–28
IND BBB	13–19	35–73	13–55	36–71
IND BB and below	2–21	43–88	8-40	9–105

Source: India Ratings

In the absence of city-level income numbers, India Ratings analyses expenditure in relation to revenue for local bodies.

Balances

Receipt and expenditure patterns directly flow into a "balance" matrix. In India, three types of balance — revenue, fiscal and primary — are used in analysis. Although states' fiscal responsibility and budget management Acts (FRBMAs) focus on revenue and fiscal balances, the primary balance (fiscal balance net of interest payments) is crucial in relation to debt sustainability. The revenue (current) balance is the operating balance net of financial revenue and financial expenses.

A surplus in the revenue account implies that the current revenue is higher than current expenditure. A declining current expenditure/current revenue ratio implies that the entity is able to curtail its current expenditure growth compared with current revenue growth. A declining current expenditure/current revenue ratio could be due to a decline in current expenditure growth originating from declines in various sources, such as interest payments, subsidies,

salaries and wages, and development expenditure. Although a decline in interest payments, subsidies, and salaries and wages would be credit positive, a contraction in development expenditure affects future physical and social (including human capital) infrastructure development, affecting medium- to long-term growth prospects and therefore is credit negative.

- Improvement in current expenditure to current revenue ratio due to increase in current revenue is affected by growth cycle
- Quality of fiscal deficit affects the credit profile

Higher growth of current revenue indicates that the state is reaping the benefit of cyclical higher revenue growth, which may reverse and thereby become a credit negative.

The revenue balance has a direct bearing on capital expenditure potential; a large revenue deficit implies that the economy has few resources for financing capital expenditure. Although the revenue balance has an impact on capital expenditure, the fiscal balance has an impact on borrowing; both together affect economic growth and the fiscal profile.

Fiscal balance is the difference between the sum of revenue balance and net lending, and net capital outlays. Fiscal deficit is not in itself an undesirable phenomenon, but its quality needs to be ascertained. The source of the fiscal deficit — whether originating from financing of current consumption or investment — is crucial. A larger revenue balance/fiscal balance ratio implies that the deficit is being incurred to finance current consumption and therefore is a credit negative. However, a smaller revenue balance/fiscal balance ratio implies that the deficit is being incurred to finance investment, and therefore is a credit positive.

Figure 8

Fiscal Balances — Indian State Governments (%)

Rating category	Revenue balance/GSDP	Operating balance/operating revenue	Fiscal balance/GSDP	Primary balance/GSDP
IND AA	0–2	15–25	(4)–(1)	(1)–1
IND A	(2)–2	7–25	(5)–(1)	(2)–1
IND BBB	(4)–1	(5)–23	(7)–(3)	(2)–1
Special category states	2–8	13–26	(8)–3	(2)–2

Note: A number in brackets indicates deficit
Source: India Ratings

The primary balance is fiscal deficit net of interest payment, and shows finances excluding any debt in the accounts. The primary deficit is an important indicator of debt sustainability.

Except for few smaller cities most Indian local governments have a surplus on their current accounts. However, this is not sufficient to fund infrastructure investment. Most lower-rated Indian local bodies ('IND BBB' category and below) have limited execution capacity. As a result, they are unable to spend grants in a timely manner. In some cases this has led to capital income/capital expenditure rising to 1.66x.

Figure 9

Fiscal Balances — Indian Local Governments (%)

Rating category	Revenue balance to revenue income	Capital income to capital expenditure
IND AA	11 – 50	9 – 121
IND A	19 – 36	39 – 66
IND BBB	5 – 23	77 – 108
IND BB and below	(5) – 49	2 – 166

Note: A number in brackets indicates deficit
Source: India Ratings

Debt, Liquidity and Indirect Risk

Debt

Debt[1] is a crucial aspect in evaluating credit risk. Fundamentally, economies may have good economic and fiscal foundations but high debt could undermine this solid base, leading to stress on debt-servicing obligations. Annual fiscal performance has a direct bearing on debt, and persistent fiscal imbalance leads to increasing debt, leading in turn to a vicious deficit-debt cycle or a debt trap. The debt situation may become more alarming during phases of low economic growth.

- The primary balance in conjunction with rate spread gives an indication of future debt sustainability

Two crucial factors affecting debt sustainability are the primary account balance and the rate spread (the difference between nominal growth of the economy and the average interest rate on debt). If a state has a surplus on the primary account and the rate spread is positive, the debt/income ratio will fall. If the economy has a primary deficit and the rate spread is negative, the debt/income ratio will rise, which may be unsustainable. However, if one of the two factors is unfavourable (primary deficit or negative spread), the future course of the debt/income ratio depends on the relative strength of these two factors.

Figure 10
Debt Profile — Indian State Governments (%)

Rating category	Debt/GSDP	Debt/revenue (x)	Debt servicing/ operating balance (x)
IND AA	20–28	1.5–2.0	2.0–8.8
IND A	23–28	1.6–2.3	1.9–9.3
IND BBB	37–49	2.2–3.5	(7.7)–8.2
Special category states	58–66	1.2–1.7	1.2–2.7

Source: India Ratings

Indian local governments are less leveraged than states or the central government. Many local governments are debt free and most of the debt is from states or from financial institutions. Only a handful of local governments have issued debt, and that only on the domestic market. Urban infrastructure is in dire need of improvement and funding requirements for local governments are very high.

Figure 11
Debt Profile — Indian Local Governments (%)

Rating category	Debt/revenue income
IND AA	14.4
IND A	17.8
IND BBB	25.8
IND BB and below	71.2

Source: India Ratings

Other important aspects of an economy's debt are its: use, whether for financing of current consumption or for investment; and structure, including maturity profile. An even distribution of debt-service repayment obligations puts less strain on an entity's finances; however, if most debt repayment is lumped into a particular year, this could put stress on the entity's liquidity.

Liquidity

- Declining use of liquidity-enhancing measures reflects improvement in liquidity positions

Indian states can receive ways and means advances (WMAs) from the RBI and government of India, and overdrafts (ODs) from the RBI to tide them over adverse liquidity situations. RBI has very stringent rules on WMAs and ODs. There have been instances of RBI stopping payment to state governments where there were deviations from WMA/OD rules. Continual use of WMAs and ODs is an indicator of liquidity strain and cash flow mismanagement, and therefore

[1] India Ratings definition of debt is different from the debt definition followed by the RBI. The RBI considers reserve funds and contingency funds as part of debt; India Ratings does not

indicates poor credit quality. Over the years, states' reliance on WMAs and ODs has been declining, in line with the broader trends toward state fiscal consolidation and economic growth.

The overall result (fiscal balance after debt transactions) is an important indicator of liquidity. A high positive overall result/total revenue indicates that the state/local government is increasing its reserves. A negative ratio indicates the opposite. A consistent depletion of reserves would lead to reduced liquidity and would be a credit concern.

Figure 12
Liquidity Profile — Indian State Governments (%)

Rating category	Overall result/total revenue
IND AA	(10)–16
IND A	(3)–5
IND BBB	(18)–6
Special category states	(8)–13

Source: India Ratings

Indian local bodies do not have any liquidity facilities available to them. In stressed liquidity conditions, local bodies generally either depend on state governments or borrow from banks.

Indirect Risk

- High contingent liabilities could weaken the credit quality

The central or state governments can issue guarantees for the debt programmes of public sector entities. Guarantees are contingent liabilities and are only charged as expenditure if the guaranteed entity defaults on its debt-service obligations; they are therefore an indirect risk to states' credit profiles. Most states have created guarantee redemption funds to service debts if a guarantee is called. When assessing the credit profile of states, India Ratings analyses the level of guarantees they have extended.

Management and Administration

Qualitative measures of a state's management calibre are reflected in its track record of success in policy interventions and adoption of best practice in fiscal management. Quantitative yardsticks include metrics that capture performance in relation to budgeted parameters.

Under the Indian system the central government decides most policies, including economic, fiscal and monetary. Before formalisation, five-year plans are discussed and debated in the National Development Council, to which all states' chief ministers, central ministers, and planning commission members belong. Finance commission recommendations on the share of central taxes and other devolutions to states are discussed with them.

The TFC recommended that each state should enact its own FRBMA. The adoption of initiatives such as implementation of VAT, enactment of FRBMAs, introduction of new pension schemes, establishment of a ceiling on government guarantees, and creation of sinking and guarantee redemption funds are among the qualitative indicators for judging management quality.

Limitations

This report describes indicative features for rated Indian local governments and credit opinions on Indian state governments (used in assigning issue ratings to the state government-guaranteed debt programmes). Ratio levels refer to the average during the economic growth cycle, and as a result actual observations are likely to vary from these. The weighting will vary substantially based over time for a given local/state government based on relative significance agreed upon by the rating committee. The aspects described give a high-level overview of the ratings of Indian local and state governments as a convenience, and are neither exhaustive in scope nor uniformly applicable. They may vary for a particular rating category.

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