Ratings

CRISIL
An S&P Global Company

Rating criteria for state governments

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Executive summary

While assigning ratings to the debt instruments of public sector enterprises backed by guarantees, letter of comforts (LoC), and shortfall undertakings from state governments, CRISIL Ratings evaluates the credit quality of state governments. The rating on the guaranteed instrument is typically equated to the rating of the state government with the suffix, ‘CE’ (indicating credit enhancement).

CRISIL Ratings evaluates a state government's credit quality on the following factors:

- Economic structure of the state
- State government finances
- Economic management of the state government

Scope

This document elucidates CRISIL Ratings’s rating criteria for assessing the credit quality of state governments. It primarily highlights the criteria[1] adopted by CRISIL Ratings in rating the instruments issued by state government enterprises and backed by guarantees, LoCs, and shortfall undertakings from state governments. The document also covers CRISIL Ratings’ approach to financial ratios used for analysing state governments, including adjustments it carries to the reported metrics in the financial statements.

CRISIL Ratings assigns CE ratings for debt instruments backed by guarantee, LoCs, and shortfall undertakings issued by state governments.

CRISIL Ratings also analyses the adequacy of the payment mechanism to ensure timely debt repayment to investors. However, this article does not deal with the analysis of the payment mechanisms. For more details, please refer to *‘Criteria for rating instruments backed by guarantees’* and "*Meaning and applicability of 'SO', 'CE' symbols*" on www.crisil.com.

CRISIL’s assessment framework

CRISIL Ratings's ratings are forward looking and essentially relative. Assessment is based on evaluation of three factors and relative comparison with other states with a specific focus on future outlook. A brief description of the parameters used to assess the credit quality of state governments is highlighted below:

[1] This article was updated in Sep 2022 to incorporate RBI Guidance note on Bank Loan – CE ratings dated April 22, 2022, and RBI FAQ dated July 26, 2022. The previously published article may be accessed on the following link: https://www.crisil.com/content/dam/crisil/criteria_methodology/criteria-research/CRISIL-Ratings-crieria-state-governments-sep2022.pdf

Economic structure

A state's economic structure impacts its finances and debt-servicing capacity. Well-developed economic and social infrastructure and abundant natural resources are the right ingredients for economic development. CRISIL Ratings believes economic development will translate into improvement in state government finances over the medium to long term, given the enhanced tax revenue from increased economic activity and the reduced need for development expenditure. Conversely, weak socio-economic infrastructure and a socially under-developed population will limit the state's future economic development and necessitate higher developmental expenditure.

The states need to strike the right balance between developing social and economic infrastructure to foster economic development. Both social infrastructure and a socially developed population are required for economic development. Social infrastructure (such as literacy and health services) takes longer to develop and to effect economic development than do economic infrastructure (such as roads and power). However, investments in social infrastructure are necessary to sustain the benefits derived from developing economic infrastructure.

Gross state domestic product

CRISIL Ratings, in its analysis of a state’s credit quality, considers the following as the most critical features of economic structure:

- Sectoral composition of gross state domestic product (GSDP)
- Growth rates of aggregate and per capita GSDP
- Shifts in composition of GSDP

A vibrant economy with strong secondary (manufacturing, construction, electricity, gas, and water supply) and tertiary (trade, hotels, transport and communication, financing, insurance, real estate, business services, public administration, defence, and other services) sectors in the organised segment leads to continuous improvement in the state government's tax revenue. Over-dependence on the primary sector (comprising agriculture, forestry, fishing, mining and quarrying), on the other hand, limits the tax resources. However, significant competitive advantage in the primary sector may translate into higher disposable incomes, and tax and other revenue for the state, and substantial tertiary sector development. Diversity in a state's economic activities mitigates the impact of large fluctuations in economic output by any one sector. Hence, over-dependence on one or two industries or agricultural crops is viewed unfavourably by CRISIL Ratings.

Other socio-economic indicators evaluated in assessing a state's likely future economic growth, and thus, the likely growth in its tax revenue potential, are:

Demographic profile

A socially developed population indicates the availability of trained and healthy manpower, and augurs well for future economic growth. In addition, it minimises the need for expenditure on social development in future. The state's demographic profile is assessed on the basis of per capita income, population below poverty line, level of urbanisation, employment rate, literacy, and birth, death, and infant mortality rates.

Social infrastructure

The availability of educational institutions and health facilities is examined to assess the state's likely social and economic development. Social infrastructure has a critical bearing on demographic profile, which, in turn, plays a key role in economic development.

Economic infrastructure

A state's economic infrastructure indicates its ability to take on greater economic activity and also increases its attractiveness as an investment destination for the private sector. Evaluating these parameters on a per capita basis facilitates a one-to-one comparison with other states. Specific attention is accorded to projects that are coming up in the state to evaluate its outlook. The major parameters evaluated under economic infrastructure are:

Power

The availability of power is a key input for any state's industrial development. Installed capacity, actual power generated, and the augmentation in installed capacity are key determinants of the state's economic structure.

Irrigation

The extent of irrigation facilities available in a state determine its ability to improve agricultural output.

Transport facilities

A well-developed transport sector facilitates smooth intra- and inter-state movement of goods and people. The availability of roads, railways, ports, and airports are key indicators used to evaluate the quality of transport sector infrastructure.

Industry profile

The level of industrial development and diversification, and the prospects for industrial growth have a critical bearing on economic development.

Investment attractiveness

States need to attract fresh investments to achieve strong growth in economy. The flow of private investments (both domestic and foreign) indicates the attractiveness of investment opportunities in the state. The state's ability to attract private sector investments is assessed *vis-a-vis* the size of its economy. A comparison on this parameter with other states is a valuable input to assess investment attractiveness.

Labour market

The availability of trained and skilled manpower, the industrial relations environment, employment rate, and occupational patterns are some key indicators assessed under labour market conditions.

Natural resources

The indicators of natural resources considered in analysing economic structure are:

- Forest cover
- Water and irrigation resources, rivers, and rainfall
- Mineral reserves
- Accessibility (terrain); accessibility to coastline and port facilities

Agriculture

Agriculture remains the primary occupation in most states in India. Stability and growth in agricultural output are, therefore, key factors for economic structure, with the following being the major parameters:

- Cropped and irrigated land under various crops
- Trends in composition of agricultural produce
- Growth trends in total and per hectare output
- Use of modern techniques and inputs such as fertilizers, pesticides, and high yield variety seeds

State government finances

Analyses of state government finances include assessment of fiscal management, resource availability, expenditure management, indebtedness, and the medium-term outlook on these parameters.

Revenues

The four basic categories of revenue sources for a state government are the state's own tax revenues (SOTR), the state's own non-tax revenues (SONTR), the state's share in central taxes (SCT) and grants from the centre (GFC). Of these, CRISIL Ratings considers SOTR as the most important indicator of a state's ability to generate revenue and support expenditure. While SONTR is fairly limited in size and primarily comprises interest income and user charges on various services, CRISIL Ratings considers it an important source for revenue enhancement in future, when more and more state governments would resort to higher recovery of user charges. SOTR depends upon:

- Tax potential
- Tax effort

With the advent of goods and services tax (GST), states no longer enjoy the autonomy to fix tax rates for a variety of goods. Sales tax on several goods, along with other state taxes, which formed a significant portion of the SOTR of a

state, is currently subsumed under GST. The tax rates are currently being fixed by the GST Council, comprising representatives from the central government and state governments. However, states will continue to exercise powers to levy tax on items that do not fall under the purview of GST, like liquor, stamps and registration duties, electricity duties and motor vehicle tax, or on items that are proposed to be brought under the purview of GST on a later date, like crude petroleum, high speed diesel, natural gas. Although state’s powers to levy taxes on goods has been curtailed following GST, taxes on services have been brought under GST, which was earlier exclusive to the central government.

The tax potential (per capita and aggregate) of a state depends on income levels, and also on the GSDP's sectoral composition. For instance, an economy based predominantly on agriculture and an unorganised industrial sector would normally have a low tax potential. The exceptions would be states where a substantial proportion of the families receive remittances from relatives residing outside the state, resulting in increased purchasing power and consumption patterns, which, in turn, would lead to an increase in tax-based revenues.

The tax effort is an indicator of the state’s performance on tax collections, given the tax potential. A superior tax effort results in better tax revenues for the state government. An inferior tax effort, on the other hand, indicates an untapped resource potential, which hinges on the state government's ability to augment its own tax revenues further.

SCT is determined on the basis of the Finance Commission's (FC) recommendations. As the FC is a constitutional body, and the share in central tax is determined on the basis of a formula, CRISIL Ratings believes that this resource can be concluded to be fairly sustainable and non-discretionary in nature. Thus, even though a high dependence on SCT may not be considered to be as favourable as a high reliance on SOTR and SONTR, CRISIL Ratings believes it is better than a dependence on discretionary and nondiscretionary grants.

GFC comprises post devolution revenue deficit grants prescribed by the FC, and other discretionary grants from the centre like centrally sponsored schemes (CSS). CRISIL Ratings views a significant dependence on GFC as unfavourable for state governments as it indicates an insufficiency in the states' own resources, and majority of the GFC are tied to specific end-uses, limiting the flexibility of state governments to deploy these funds as per their discretion.

Revenue Receipts (RR):

The revenue receipts (RR) of states comprise states' own tax revenues (SOTR), states' non-tax revenues (SONTR), share in central taxes and grants from center (revenue deficit grants and grants tied to end use).

Revenue receipts are those receipts that do not produce any liabilities and result in a claim against the state government. Share of state's own revenues (SOTR + SONTR) in its RR, is an important indicator of the state's ability to generate revenue and support expenditure requirements.

SOTR comprises of direct taxes and indirect taxes (such as customs duties, excise taxes). SONTR primarily comprises interest income and user charges on various services – these are important sources for revenue enhancement, if a state resorts to higher recovery of user charges.

Grants from Centre / Revenues:

GFC comprises post devolution revenue deficit (PDRD) grants prescribed by the FC, and other grants from the center like centrally sponsored schemes (CSS). A significant dependence on GFC may be seen as unfavourable for state governments as it indicates insufficiency in the states' own resources, and majority of the GFC are tied to specific end-uses, limiting the flexibility of state governments to deploy these funds as per their discretion.

Expenditure

CRISIL Ratings addresses two major issues while analysing state government expenditure: whether the overall expenditure level has been under control, that is, whether the state government has been spending in line with its revenue sources; CRISIL Ratings also examines if the state government has made and implemented any specific election promises, which have affected its expenditure in the past. CRISIL Ratings believes it is important to examine if the state government has undertaken any specific expenditure control programs. These issues are highlighted by the general level of subsidy and user charges in the state and the government's policy on subsidies.

The other issue that deserves attention is the composition of expenditure. Sizeable developmental expenditure should lead to social and economic development. However, state governments need to achieve a judicious mix between economic and social development expenditure since the neglect of either one could have serious implications on the state's economy.

State expenses:

State expenses are broadly segregated into two categories revenue and capital expenditure.

- The portion of government spending that does not result in the generation of assets is known as revenue expenditure. Revenue expenditure includes employee costs, subsidies payments, support to public sector units, and debt-servicing. If a significant portion of the revenue expenditure is committed expenditure, the fiscal space of the state government to incur developmental expenditure gets constrained, thereby limiting the future economic growth prospects of the state. Hence, a low share of committed revenue expenditure is considered favourable.
- Capital expenditure is associated with investment or development spending, where expenditure has benefits extending years into the future. Capital expenditure includes money spent by the government on the development of machinery, equipment, building, health facilities, education, etc. It also includes the expenditure incurred on acquiring fixed assets like land and investment by the government that gives profits or dividend in future.

Deficit management

Deficit levels are indicative of the quality of economic management. An increasing revenue deficit level, as a proportion of revenue receipts or revenue expenditure, is a cause for concern. The quantum of gross fiscal deficit (GFD) as a proportion of GSDP is another important input that differentiates the credit quality of state governments.

The GFD's composition in terms of the capital expenditure, net lending, and revenue deficit provide an insight into the quality of fiscal and economic management. If the revenue deficit has a lower share in the GFD, it indicates a higher contribution towards capital formation in the state. The states' tax potential should improve if capital formation facilitates increase in economic activity over the medium to long term.

Indebtedness

A state government's level of indebtedness in relation to its revenue receipts, the size of its economy and the debt service coverage by revenue receipts are key indicators of its debt-bearing capacity. Indebtedness factors in debt and outstanding guarantee stocks. CRISIL Ratings evaluates the state's overall level of indebtedness with ratios such as (Debt + guarantee)/Revenue receipts, [(Revenue receipts - (revenue expenditure - interest)]/Interest and [(Revenue receipts - (revenue expenditure - interest)]/ (Interest + debt servicing). In addition, CRISIL Ratings looks at the composition of the debt, its growth rate, its terms in respect of interest rates and tenure as well as other factors such as bunching of repayments, existing quantum and future availability of debt on concessional terms from multilateral and bilateral institutions. CRISIL Ratings also analyses the composition of guarantee stock and the likely impact of its devolution on state finances.

Revenue Deficit (RD) / Revenue Receipts (RR):

RD/RR indicates the revenue deficit as a percentage of revenue receipts of state government.

Revenue deficit refers to the excess of total revenue expenditure over total revenue receipts. It means that govt. is unable to meet its revenue expenditure from its revenue receipts. If the fiscal deficit is constant, a higher revenue deficit means the government bears a higher load of repayment.

Fiscal Deficit:

Fiscal deficit is defined as the gap between the total revenue and total expenditure of a government in a financial year. It is an indication of the total borrowings needed by the government, which will help to cover the fiscal deficit. It serves as an indicator of management of finances by the government.

Capital outlay/fiscal deficit:

Capital outlay to fiscal deficit ratio helps to analyse the contribution of capital outlay to fiscal deficit. Capital outlay is defined as capital expenditure carried out to maintain, upgrade, acquire, or repair capital assets. 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. With this perspective, a higher share of capital expenditure normally indicates greater flexibility for curtailment in the immediate term; however, sustained cut-back of capital investments may likely have an adverse impact on the state's infrastructure and hence economic prospects in the long term.

Gross Fiscal Deficit (GFD)/Gross State Domestic Product (GSDP):

Gross State Domestic Product (GSDP) is a measure in monetary terms, the sum total volume of all finished goods and services produced during a given period of time, usually a year, within the geographical boundaries of the State, accounted without duplication.

A fiscal deficit is calculated as a percentage of gross domestic product (GDP) to understand the trend of borrowing by the government. Lower values of the ratio signify that financial management is better for the government.

(Debt + Guarantees) / Gross State Domestic Product (GSDP):

The ratio measures the financial leverage of the state government and helps to understand the state government's ability to pay back its debts. Generally, the lower the debt-to-GSDP ratio, better is the financial risk profile of the

state government. The guarantees given by the state government for repayment of borrowings is also included to arrive at the overall debt profile of the state government.

(Debt + Guarantees) / Revenue Receipts:

(Debt + Guarantees)/Revenue Receipts measures state government's level of indebtedness in relation to its revenue receipt. Generally, lower the debt-to-RR ratio, better is the financial risk profile of the state government.

Revenue Receipts/Interest:

Revenue Receipts (RR) /Interest measures state government's ability to timely honour its interest obligations in relation to its revenue receipt. Generally, higher the Revenue Receipts (RR)/Interest ratio, better is the financial risk profile of the state government.

[Revenue Receipts - (Revenue Expenditure - Interest)] / Interest:

This ratio measures state government's ability to honour its **interest** obligations in relation to its revenue receipt after accounting for other revenue expenditure (excluding interest). Generally, higher the ratio, better is the financial risk profile of the state government.

[Revenue Receipts - (Revenue Expenditure - Interest)] / (Interest + Debt Servicing):

This ratio measures state government's ability to honour its **debt** obligations in relation to its revenue receipt after accounting for other revenue expenditure (excluding interest). Generally, higher the ratio, better is the financial risk profile of the state government.

Economic management of the state government

CRISIL Ratings analyses the state government's economic policies in order to assess their impact on the state's finances and economic development. The key elements of economic management that have an impact on the state government's rating are:

- Consistent focus on economic reforms
- Guarantee and debt management
- Industry and infrastructure policy

- Liquidity
- Performance of state-owned enterprises
- Political risk

Consistent focus on economic reforms

Consistent focus on economic reforms is the bedrock for sustained economic growth. Any reversal of reforms not only affects the state's fiscal health but also limits its prospects. Events such as providing free power to the agriculture segment, giving away freebies, or waiving off interest and principal on loans are viewed negatively and directly affect the state government's credit risk profile. Conversely, efforts to contain wasteful expenditure and to enhance revenue base support the states' credit risk profile. Consistent adherence to economic reforms strengthens the state's credit risk profile and instils reforms on a sustained basis. This plays a key role in improving a state government's fiscal health.

Guarantee and debt management

Considerable emphasis is placed on the guarantee management systems deployed by state governments. The states have traditionally extended guarantees to the borrowing programs of state-owned enterprises. Therefore, the state government's policy in terms of its criteria for extending guarantees, for guarantee monitoring systems and maintaining prudent limits on contingent liabilities are significant rating factors. The state government's ability and willingness to honour financial commitments arising from contingent liabilities are considered. Moreover, adequate funding of the guarantee redemption fund is a rating comfort as it helps in timely servicing of obligations arising from an unexpected devolvement of guarantees.

Industry and infrastructure policy

A state government's industry and infrastructure policy determines the pace of economic growth, with better growth prospects possible in a period of competitive federalism. It is, therefore, important to understand the state government's policy on the development of roads, rail links, ports, airports, power, telecom, water supply, irrigation and the like. A well-developed infrastructure permits state governments to employ their limited funds for other developmental purposes.

Liquidity

State governments have access to ways and means advances (WMA) and an overdraft facility from the Reserve Bank of India (RBI) to bridge their short-term funding gaps. The number of times a state has had to approach the RBI for WMA and the interest paid on this account reflects the state government's financial flexibility and funding management. Sustained use of this facility in large amounts indicates poor liquidity management, or a liquidity crisis on account of a resource crunch.

Performance of state-owned enterprises

The performance of state-owned enterprises, especially the state power utilities and road transport corporations, can significantly affect state government finances. Hence, it is important to analyse the pricing policy and estimate the quantum of direct and indirect subsidies extended by the state government to the transport and energy sectors.

Most states have undertaken power sector reforms under the Ujwal Discom Assurance Yojana (UDAY). While UDAY is expected to improve the viability of the electricity sector, the financial burden on state governments has increased.

Political risk

The political situation in the state is assessed to evaluate its potential impact on the state's finances and economic development. Political risk is generally driven by political instability. Frequent changes in government may disrupt continuity in the state's economic policies; this is because political instability is known to lead to the implementation of populist schemes, which considerably weaken state government finances. Changes in government have often also led to a cancellation or review of large private-sector projects in the state in the absence of a broad political consensus on major economic policies among the various parties in a state.

Conclusion

CRISIL Ratings believes the future direction of state government finances will determine its ability to meet financial commitments. Past trends are, to some extent, indicative of future financial performance. The credit quality, and therefore, the ratings of state governments will be driven by their economic structure, finances, and economic management.

State government ratings: key indicators

Economic structure

- GSDP composition and growth rate
- Per capita GSDP and growth rate
- Demographic profile
- Availability of power, roads, railways, irrigation etc.
- Availability of education and health facilities
- Industry growth rate
- Natural resources
- Infrastructure index

State government finances

- Revenue Receipts (RR) and Expenditure
- State's Own Revenues / Total Revenues
- Grants from Centre / Revenues
- Revenue Deficit (RD)
- RD / RR
- Fiscal Deficit and its Composition
- Capital Outlay / GFD
- GFD / GSDP
- (Debt + Guarantees) / GSDP
- (Debt + Guarantees) / Revenue Receipts
- [(Revenue Receipts - (Revenue Expenditure - Interest)] / Interest
- [(Revenue Receipts - (Revenue Expenditure - Interest)] / (Interest + Debt Servicing)
- Revenue Receipts / Interest
- Debt profile: interest & principal repayments

Economic management

- Economic and administrative reforms
- Guarantees and debt management
- Utilisation of Ways & Means Advances
- Performance of state-level PSUs
- Power sector reforms
- Political stability

About CRISIL Limited

CRISIL is a leading, agile and innovative global analytics company driven by its mission of making markets function better. It is India's foremost provider of ratings, data, research, analytics and solutions, with a strong track record of growth, culture of innovation and global footprint. It has delivered independent opinions, actionable insights, and efficient solutions to over 100,000 customers. It is majority owned by S&P Global Inc, a leading provider of transparent and independent ratings, benchmarks, analytics and data to the capital and commodity markets worldwide.

About CRISIL Ratings

CRISIL Ratings is part of CRISIL Limited ("CRISIL"). We pioneered the concept of credit rating in India in 1987. CRISIL is registered in India as a credit rating agency with the Securities and Exchange Board of India ("SEBI"). With a tradition of independence, analytical rigour and innovation, CRISIL sets the standards in the credit rating business. We rate the entire range of debt instruments, such as, bank loans, certificates of deposit, commercial paper, non-convertible / convertible / partially convertible bonds and debentures, perpetual bonds, bank hybrid capital instruments, asset-backed and mortgage-backed securities, partial guarantees and other structured debt instruments. We have rated over 24,500 large and mid-scale corporates and financial institutions. CRISIL has also instituted several innovations in India in the rating business, including rating municipal bonds, partially guaranteed instruments and microfinance institutions. We also pioneered a globally unique rating service for Micro, Small and Medium Enterprises (MSMEs) and significantly extended the accessibility to rating services to a wider market. Over 95,000 MSMEs have been rated by us.

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