Criteria for Public Finance - State Government Ratings

13-10-2025 (Version 5)

Executive Summary

The framework adopted by Acuité for assessing the overall fiscal health of the states is primarily based on two platforms, i.e. **Fiscal Parameters & Economic Structure**. Acuité tracks and monitors five key fiscal parameters and five economic indicators for assessing the financial health of a state relative to its peers. In this regard, it is pertinent to mention that the fiscal and economic performance of each state varies from year to year due to factors like the overall level of economic activity, spending on infrastructure, political developments like state and central elections, natural calamities, etc. Besides the regular spending on revenue account like salaries, establishment overheads, interest payments and capital expenditure, the state governments are required to invest in infrastructure, which is necessary for the provision of basic amenities to its citizens. A healthy infrastructure network is also a prerequisite for attracting private sector investments and the creation of employment opportunities. Since the infrastructure projects are medium to long-term projects, the impact of these initiatives on the per capita incomes and the overall standard of living is visible after a time lag. Hence, a state on an aggressive infrastructure campaign may exhibit a deterioration in fiscal metrics, though the government may be preparing the ground for sustainable development in future. Besides a high level of planned expenditure, the state's fiscal Parameters for any given period are also impacted by the occurrence of events like natural calamities, which will require the government to augment the spending. In view of the aforementioned factors, we believe a methodology based on **relative benchmarking for any given period** will provide sharper insights into the fiscal health of a state vis–à–vis a methodology based on historical comparison.

Acuité's methodology for State Rating is based on a relative comparison of the various parameters for a given common period. Acuité relies on the fiscal and economic performance of a static sample of states, primarily in the non-special category, for deciding the parametric benchmarks. The Special States are also rated on these benchmarks, albeit with certain adjustments.

The various economic and fiscal parameters reckoned by Acuité in its framework are as under

Fiscal Parameters

(a) **Revenue Deficit/ Surplus as a Percentage of GSDP (Gross State Domestic Product):** The Revenue Deficit refers to be excess of Revenue Expenditure over Revenue Receipts. The focus of any state government should be to optimise the trade-off between the Revenue deficit and the attainment of socio-economic objectives. A continued and persistent high revenue deficit inhibits the ability of the state to invest in infrastructure and other socially relevant projects, thereby impacting its future growth trajectory.

(b) **Fiscal Deficit as a Percentage of GSDP**: The fiscal balance as a percentage of GSDP is a function of the performance on the revenue deficits/ surplus and the capital account deficit / surplus (i.e. state's development plans). For instance, states on a high growth trajectory with aggressive plans to develop infrastructure or states recovering from natural calamities like floods are more likely to end up with a higher fiscal deficit in some cases beyond the benchmark of 3% as per the finance commission recommendations. The key point to be monitored is the "quality" of the deficit rather than the amount of deficit. A large fiscal deficit arising out of continued infrastructural development will give a fillip to future economic growth, thereby translating better quality of life for its citizens. The concept of a Primary Deficit assumes relevance here. Primary Deficit is arrived at by deducting interest payments from the fiscal deficit. Since interest payments are committed in nature, the state has limited flexibility in skipping on these payments. A higher fiscal deficit (vis-à-vis the previous period) along with a lower primary deficit indicates that interest payments are contributing to the increase in fiscal deficit. The higher the interest component of total expenditure lower is the fiscal flexibility. Conversely, if a higher fiscal deficit is accompanied by a higher primary deficit, it indicates that non-interest expenditure is increasing as a proportion of total expenditure.

(c) **Interest Expense/ Revenue Receipts:** The interest expense to Revenue Receipt ratio is a key metric in understanding the proportion of revenue receipts utilised for defraying the interest on the debt. Any ratio significantly beyond 10% indicates that there is scope for improvement in terms of the tax/ non-tax revenue.

(d) **Debt to GSDP:** In this case, Acuité looks at the magnitude of borrowings of the State Government in relation to the size of its GSDP. The higher the ratio (i.e. say >25%) riskier is the fiscal profile. Besides the ratio, more important is the debt profile in terms of the nature of debt, maturity profile, etc. A state required to borrow to meet its operating requirements is a much riskier proposition than a state borrowing for capital asset creation, i.e. infrastructure. Besides direct borrowings, the guarantees extended by the State to public sector enterprises such as power utilities and other off-balance sheet commitments are also to be considered while reckoning the overall indebtedness.

(e) **Own Tax Revenues/ Total Revenues:** The state government's ability to control its revenue base has undergone a radical change post the introduction of the GST regime. Under the GST regime, most of the state taxes have been subsumed under the GST which falls within the purview of GST Council. This limits the state government's ability to control its revenues from taxes. Nevertheless, Acuité considers Own Tax revenues to Total Revenues as a major indicator of the relatively steady revenue generation ability of the state government. The key components of the own tax revenues include SGST, Stamp duty, property taxes etc.

Economic Structure

(a) **Size of GSDP:** The focus of successive governments has always been on balanced regional development and the various policy initiatives, such as fiscal and tax incentives for investments in less developed geographies are reflective of this philosophy. However, it has been observed that certain states like Maharashtra, Gujarat, Karnataka & Tamil Nadu account for a major contribution to overall GDP. These larger states have a demonstrated the ability to attract investments, thereby leading to a large industrial and service sector base. The ability to attract investments from various sectors emanates from a combination of factors like geographical location, well developed infrastructure, investor friendly government policies, availability of skilled labour etc. These states also generate significant employment opportunities and are leading contributors to the national exchequer. The policy initiatives of the central government recognise the importance of these states and ensure adequate fiscal support to them whenever necessary. Acuité believes that on a relative basis, the resilience of the fiscal profile is directly linked to the size of GSDP, i.e. the higher the GSDP more resilient is the fiscal profile.

(b) **Per Capita Income:** Generally, speaking, higher the per capita income, the better the standard of living of the citizens. The focus of infrastructural development results in attracting higher investments in the state, which in turn translates to higher incomes and a better standard of living for its citizens. The per capita income of the state is compared with the national average. The higher the contribution of secondary and tertiary sectors to the GSDP, the higher the probability of a sustainable improvement in per capita income.

(c) **GSDP Growth Rate:** A high GSDP growth rate while desirable, is examined in conjunction with other Qualitative factors such as urbanisation, size of the state vis-à-vis other peers, reasons for high growth and source of growth. The understanding of growth drivers is necessary to understand the sustainability of growth in future. Acuité generally consider a CAGR (Compounded Annual Growth Rate) over past 3 years for arriving at a realistic estimate of growth.

(d) **GFCF / GSDP:** The extent of Gross Fixed Capital Formation in a state is an indicator of the spending on the infrastructure and other social amenities. Besides the magnitude of spending on infrastructure, it is also important to assess that the nature of spending, i.e. how productive is the investment in terms of its ability to contribute to economic development.

(e) **SDG Score:** The SDG (Sustainable Development Goal) scores of Niti Aayog captures a state's performance on around 17 parameters like hunger eradication, climate impact, education etc.

CRITERIA FOR NOTCH UP BASED ON STATE GOVERNMENT SUPPORT

The rating of entities owned by governments needs to be looked at differently from other privately owned commercial entities for two reasons. Firstly, most of the government-owned entities exist to meet broader social objectives such as state-owned power utilities, civil supplies corporation, state finance corporations etc. These entities are of strategic importance to the state. Hence, the government's approach with respect of support to such entities is governed by social considerations rather than commercial motives. Secondly, even in respect of the entities which have a limited social footprint, the implications of a default by a state government-owned entity are high. Hence, the state governments ideally will maintain at least distress capital support to these entities.

Acuité's extant rating methodology for assessment of State Government-owned/controlled entities factors in the likelihood of support from the respective Governments. The support could be 'explicit' and documented in the form of a Letter of Guarantee/ Letter of Comfort or 'implicit' based on majority ownership and strategic importance of the entity to the state. The underlying premise for factoring in such support is that a default by such an entity could have significant socio-economic implications and impact the state's perception among lenders/investors.

A rating of a state government-owned/ supported entity depends on the standalone rating of the entity based on its business and financial parameters & an appropriate notch up for the state government support, based on various economic and other non-economic factors. The notch up depends on (i) the gap between the standalone rating of the entity and state's credit rating (as per Acuité's internal assessment) (ii) the importance of the entity to the state based on various economic & non-economic factors. These factors include extent of ownership of the state in the entity, magnitude of investment, strategic (socio-economic) importance of the entity to the state, implications of default, past instances of demonstrated support, ease of extending support by the state etc. The details of the key parameters assessed by Acuité in rating of such entities is as under

A. **A. Extent of the Government shareholding in the Entity:**
   The extent of shareholding of the state government in an entity is an important parameter in ascertaining the nature of government support. Organisations formed by Acts of Legislature and departments of government are likely to enjoy substantial government support.

B. **Socio-Economic Significance of the Entity:**
   Acuité takes into account the following criteria to evaluate the degree of systemic importance of an entity

- The number of people impacted by the government entity
- Importance of the function discharged by the entity in the state's social & development goals
- Nature and the quantum of the funds allocated/budgeted by the Government

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