Conceptualizing rating of state government loans

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An issue which has come up very often is whether or not the time has come to rate state government loans. As of today, these loans, which are called SDLs, are considered to be 'virtual sovereign debt' in the sense that they are called sub-sovereigns but carry the same comfort level as central government debt. In short this means that there is a guarantee that there can never be a default on these loans. While this guarantee is not explicit, it is considered as an 'implicit guarantee'.

The way the implicit guarantee works is that as the RBI is the banker to the government which includes both the centre and states, it is ensured that all payments are made on time. As the banker to the government, all funds flow through the RBI which has a separate department to monitor the same which ensures that all debt components which includes principal and interest are paid on time. Therefore, there is no risk involved.

The raison d'être for having a rating is the following. The states borrow from the market just like the centre. While all debt is approved by the centre and RBI as the FRBM lays down the broad guidelines, states could breach the 3% fiscal deficit target often. Hence we do see that several states run deficits which can be higher than 3%. Further, slippages are often seen due to various reasons. At times revenue does not increase, or there could be additional expenditures which lead to deficits slipping. Hence while there has been a debt to GSDP norm specified, with 25% being the ideal goal, a number of states witness a rising trend rather than a declining one. Similarly while a handful manage to maintain a revenue account surplus, most slip into a deficit which means that borrowings are implicitly being used to finance revenue expenditure. In short, all states do not follow the same level of fiscal discipline when it comes to their budgets. This is why we need to rate the debt of all states.

The issue which crops up is that while all states have different fiscal indicators, the cost of borrowing is virtually the same for all of them. There is normally a 30 bps spread over central government paper, but tend to be the same across all states. Hence states which have larger borrowing requirements would end up borrowing in the market at the same rate as those which have more control over their budgets. In essence, the market does not distinguish between the two which provides room to states to be more liberal with the deficits and borrowing programmes.

In fact, curiously, while states are considered to be as good as the centre when it comes to debt, the same does not hold for municipal corporations (which is the third level in the deferral structure). When municipals borrow money from the market in the form of bonds, they have to get these instruments rated by the credit rating agencies and end up paying the price (interest rate) as per their rating. This is so as their finances are not handled by the RBI and hence there is no implicit guarantee. In fact, often there has to be an escrow mechanism in place which links a certain revenue stream to the debt servicing component which provides additional comfort for the investors. However, for states this is not the case.

The states would however argue that the job of a government is to bring about development and putting constraints in the form of a rating will put pressure on them to think more of finances rather than introducing development programmes. In fact, it is often argued that all social welfare programmes add to economic capital. Giving cash to women helps in empowerment. Providing free transport for women enables them to go to school or work. Giving free cycles or laptops or sewing machines helps to create jobs and has strong backward linkages with other industries. Therefore, technically speaking there is rarely wasteful expenditure. In fact it has been seen that at the national level, giving free food to households releases money for households which can be used for other goods and services. This also comes out in the consumer expenditure surveys of the NSO.

It is against this background that a rating exercise can be undertaken for state government loans. The rationale is that once a rating is given, the market will decide the price at which the SDL will be subscribed. If the market so chooses to price them at the same level for say a AAA and A rated state government loans, then it would be acceptable as being market determined.

What should go into the rating? It must be pointed out that even today rating agencies like CARE, CRISIL ICRA etc. do provide ratings for state owned entities where loans are guaranteed by the state government. The rating is based on the finances of the states and hence the rating of the company is a proxy rating of the state though this is not overtly stated. An example here would be like this. A state road transport company has a standalone rating of say BB, and another one in the financial sector has BBB. If there is an irrevocable guarantee given by the state with a rating of say A, then the two entities would get a rating of the state which is A in this case.

The following factors can be considered when assigning a rating for the state government loan. As all state loans are linked to bringing about growth and development in the state, there must be two parts to the rating scale. The first would pertain to the economic progress in the state and the second would be more specific to the budgets. This separation is needed because the primary objective of any state in the economic field is to enhance growth and development while the budget is one of the tools used to achieve this objective. The other factors which come into play would be the set of policies that drive growth in agriculture, manufacturing and services in general.

The first set of factors would include the following. First is the rate of growth in GSDP over the years. Second would be the growth in the three sectors. Agriculture is important as it also generates substantial employment in the state while manufacturing and services provide the base on which tax revenue is generated by the state. Other factors would include the fresh investment being generated in the state both through the domestic and foreign routes. Over the years several states have held investment exhibitions and symposiums to attract investment where several MOUs are signed which give an idea of potential investment. It also needs to be evaluate as to how much of these intentions fructify into fresh capital formation.

The policy package of the state would next be important as this is the landscape provided by the state government from the point of view of ease of doing business. The ranking of states on the point of ease of doing business becomes critical and this is something which NITI Aayog needs to continue doing as it is the most comprehensive evaluation carried out across states.

The fiscal story is already captured by the rating agencies in their current evaluation for the proxy rating of a state. The indicators that would need to be analyzed are the following. On the revenue side the growth in both tax and non-tax revenue are important. Within tax revenue the elasticity with respect of growth in GSDP is pertinent. Non-tax revenue is important because under the GST framework, the scope to impose taxes is limited for states. Hence non tax revenue is important and revenue from stamp duty, leasing of land, asset sale, etc. become important.

On the expenditure side the focus is both on revenue and capital expenditure. Revenue expenditure comes into focus because of the committed component which includes salaries, pensions, interest and subsidies. The larger are these components, the less space is left for other expenditures. On the capital side, the outlays on projects is an important building block for the state economy as this adds to overall capital formation.

Outside these conventional budgetary items, the contingent liabilities become important. This is the hidden expenditure of the government. It is known that states provide a guarantee on borrowings of state run enterprises. These enterprises normally tend to be loss making as they do not realize the full economic cost of providing a service. This can be seen in the power and transport sector where the public is provided the product or service at a low rate ostensibly to remain popular. Ideally the cumulative losses and resulting debt of all state enterprises should be included in the budget as this will better capture the overall approach to fiscal policy. While there are norms for the guarantees provided on loans taken by state enterprises including them as part of the finances would make sure that this aspect is well captured in the evaluation process.

The rating of SDLs is not a straight forward issue as it does involve governments at the regional level. Borrowings are required to fund overall expenditure and this can be revenue and capital. The implicit guarantee that exists cannot be withdrawn for sure which makes distinction across states hard. Therefore any rating of the SDL should be based on the premise that there is no implicit guarantee which means that these would be standalone ratings. But if states are made to pay a variable rate based on differentiated rating, it will help to bring about more fiscal discipline and they would automatically be more prudent when it comes to drawing up budgets. In this context, the present dispensation given to specific states to run higher fiscal deficits needs to be revisited. As long as exceptions are allowed, it becomes harder to enforce discipline. The problem is normally on the expenditure side where governments tend to spend more than they earn for various reasons.

Having a rating will be a good start to get in discipline because once the market is conscious of these ratings, there will be a tendency to price in this factor. Also the RBI would have to revisit the weights which are assigned by banks for holdings of government debt. This will be a critical factor when it comes to implementing the rating scale because once this is established the market would automatically ensure differentiated pricing. as long as this norm is not changed, banks, which are one of the main buyers of SDLs will be less discerning when it comes to their state government investment portfolio.

To sum up, a credit rating for SDLs is something which needs further deliberation. Having this system will let the market decide and bring about fiscal discipline. But the duty of sub-sovereigns cannot be ignored as they are not commercial entities and work to the betterment of society. Penalizing them could just end up making them spend less on development which is a possible outcome. These possibilities need to be weighed before formulating and adopting this system.