Criteria for Public Finance – State Governments and Urban Local Bodies

Introduction

ACER Credit Rating Private Limited (ACER), a SEBI-registered credit rating agency, is committed to delivering independent and transparent opinions on issuer and credit ratings. ACER credit insights aim to empower investors, lenders, and businesses with opinions on ratings. With a clear vision to support India's economic growth story, ACER upholds the highest ethical and analytical standards, combining deep domain expertise, advanced analytics, and rigorous processes to ensure every rating is objective and insightful.

The Company reserves the right to amend this policy from time to time in accordance with the applicable regulations, circulars, and directives issued by the Securities and Exchange Board of India. This rating criteria will be reviewed annually.

ACER's rating framework for public finance, including state governments and urban local bodies (ULBs), guides the evaluation of the creditworthiness of entities responsible for the delivery of essential public services and infrastructure. This criterion covers two distinct yet fiscally linked tiers of government: State Governments, which possess significant legislative and taxing powers, and Urban Local Bodies (ULBs), including municipal corporations, which act as local administrations or statutory undertakings providing civic services.

For state governments, a few of the parameters that may be analysed are growth trend in gross state domestic product (GSDP), fiscal flexibility, crystallisation of contingent liabilities, adequacy of liquidity, past performance trends of the government, etc.

For ULBs and municipal bodies, a few key parameters that may be analysed include the sustainability of revenue, effectiveness of tax structures, transparency in disclosures, and effective use of models such as public-private partnership (PPP), etc.

The analysis of such entities may include assessment of the quality of governance, the sustainability of fiscal practices, and the analysis of historical performance. The criterion may embed ESG considerations, if required, to oversee long-term risks and opportunities that encompass environmental sustainability, social inclusiveness, and governance reforms.

Rating Criteria for State Government

Overview

State government credit ratings provide an opinion on the relative credit risk associated with the financial health and economic strength. These ratings are primarily used to assign credit quality to debt instruments issued by state-owned entities, such as power distribution companies and electricity boards, infrastructure corporations, including road, irrigation and other sectors, state finance corporations, etc. The debt instruments are backed by state government guarantees or shortfall undertakings from the state government. The assessment is relative, involving inter-state comparisons of economic and financial indicators to understand a state's prospects and creditworthiness.

Institutional Framework

The institutional framework establishes the legal and constitutional environment in which state governments operate. ACER's evaluation of the institutional framework includes analysing the regulations, degree of control, strategic importance, intergovernmental transfers, fiscal flexibility, transparency, and other areas. Once the framework is evaluated, the credit quality of the state government may be assessed by enumerating the strength of the physical and social infrastructure, analysing the efficacy of the administration, assessing the availability of liquidity to service debt obligations, etc. Further, ratings of state-owned entities may be notched appropriately, from their standalone rating on the basis of the implicit or explicit support from the state government, strategic importance to the state government, and the credit profile of the state government.

ACER notes variation between the Government of India (GoI) and the states, resulting in transfers from GoI to the states to reduce the deficit. The transfers include central taxes and grants, and others, as per the recommendation of the Finance Commission. Tax devolution or distribution of taxes from the union government to the states is an untied source of funds that offers states autonomy, while grants can be tied (scheme-specific) or untied (e.g., GST compensation). Excessive dependence on grants to cover revenue deficits is viewed as an indicator of resource insufficiency and may be appropriately factored.

ACER may enumerate political stability, the quality of administration, and the relationship between the central and state governments, amongst other factors. Stability is vital for continuity in economic decision-making and the implementation of reforms.

On the other hand, under the provisions of the Article 293(3) of the Constitution of India, the financial flexibility of the states is constrained as it requires the GoI's consent for raising loans, if the state is indebted to the Union. Consequently, state ratings are typically lower than the sovereign rating.

Evaluating State's Economic and Demographic Profile

ACER evaluates a state's economic profile by analysing its underlying wealth and its long-term revenue-generating potential. Economic profile is a function of the revenue earned by the state government from taxes, and the likelihood of its sustained growth. The growth in the state tax revenues is driven by the competitiveness of the primary industry activity and supported by allied industries in the state, driving the socio-economic balance. ACER notes that economic diversity cushions the state against the volatility of sectoral disruptions and may be accordingly factored into the analysis. One of the other metrics that may be seen to ascertain the credit quality of a state is the GSDP- its composition with the share of tax revenue from primary, secondary and tertiary industries, and the trend in GSDP growth rate.

Economic and Social Infrastructure: ACER notes that the economic activity in a state is governed by the growth in economic infrastructure, thereby attracting future investments for growth. The economic benefits of physical infrastructure such as facilities for irrigation, power, transport, industry and activities supporting economic growth come with a lag due to the time involved in construction and actual use. However, these become a cornerstone for the analysis of economic growth and the availability of funds with the state for creating such infrastructure. Access to natural resources and their effective use for development may be assessed when evaluating the state's economic growth potential.

Equally important is the evaluation of social infrastructure, particularly education and healthcare, given their role in enhancing human capital, improving productivity, and shaping long-term development prospects. Strong educational institutions contribute to skill formation and workforce competitiveness, while accessible healthcare ensures a healthier population capable of sustained participation in economic growth. Together, these factors provide a comprehensive view of a state's future revenue potential.

Demographic Profile: The demographic profile of a state is a critical determinant of its credit quality. Population size, age distribution, literacy levels, and urbanisation trends collectively influence labour force availability, consumption potential, and fiscal requirements. A younger and expanding population can provide a strong workforce base and drive demand, while higher literacy and urbanisation typically support productivity and tax buoyancy. Conversely, adverse indicators such as high dependency ratios or poor health outcomes may increase expenditure pressures on welfare and subsidies. Careful evaluation of these demographic factors enables a balanced view of growth prospects, revenue potential, and fiscal sustainability.

Evaluating State Government's Finances

Analyses of state government finances encompass a comprehensive evaluation of fiscal management practices, resource mobilisation capacity, expenditure priorities, and level of indebtedness. The assessment considers the efficiency of revenue generation, both tax and non-tax, and the sustainability of expenditure patterns, particularly the balance between developmental and non-developmental spending. Debt management and contingent liabilities are some other parameters reviewed to gauge long-term fiscal risks. In addition, the forward-looking perspective on these indicators provides insights into a state's ability to maintain financial flexibility, support growth initiatives, and uphold credit quality under evolving economic conditions.

a. Revenue Receipts

State governments derive their revenues from a mix of their own sources and transfers from the Union. Broadly, revenues are classified into tax receipts, non-tax receipts, and central transfers. Tax revenues include levies on goods, services, property, and economic activity. Non-tax revenues arise from dividends, interest, and user charges. Central transfers, comprising tax devolution and grants, play a crucial role in balancing fiscal capacities across states.

A state's revenue potential is shaped by its economic structure, with higher per-capita income and a strong industrial base supporting consumption-linked taxes. However, under the GST regime, states have limited flexibility to alter tax rates, restricting the scope for additional revenue mobilisation. State's fiscal health is gauged by revenue balance, where surpluses indicate sound management, and deficits signal stress. Persistent deviations between budget estimates and actual receipts reflect weak planning and may undermine credibility in financial assessments.

Given below is a broad classification of the sources of state revenue.

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- **States' Own Tax Revenues (SOTR):** SOTR is a key component of the state revenues that are largely consumption-driven and arise from taxes levied on goods, services, property, and economic activity within the state. Major components include sales and service taxes, excise duties, value-added taxes, registration and stamp duties, electricity charges, and motor vehicle levies. The buoyancy of these revenues reflects the strength of local economic activity and underpins fiscal autonomy, enabling states to finance developmental programs, welfare initiatives, and capital investments essential for long-term growth and socio-economic progress. SOTR may be looked to assess the level of consumption in a state.

- **States' Own Non-Tax Revenues (SONTR):** SONTR is a relatively smaller (than SOTR) but important component of fiscal resources. These receipts arise from dividends and interest earned on loans and investments, as well as from charges for services such as irrigation, healthcare, and education. Historically, SONTR has contributed modestly to overall revenues due to low fee structures and extensive subsidies, which limit cost recovery. Nonetheless, efficient pricing of public services, improved returns from state-owned enterprises, and rationalisation of subsidies can enhance SONTR, thereby strengthening fiscal flexibility and reducing dependence on external transfers to meet expenditure commitments.

The proportion of own revenues (SOTR and SONTR) used to meet revenue expenditure is a critical metric for assessing self-reliance of a state.

- **Central Transfers:** Central Transfers represent a critical source of revenue support for state governments. They comprise tax devolution, where a constitutionally defined share of Union taxes is distributed to states, and various grants, both tied and untied, provided for specific schemes or general budgetary support. These transfers help bridge disparities in resource mobilisation capacity and enable states to fund developmental priorities. While reliance on central transfers can limit fiscal autonomy, they remain essential for sustaining expenditure, especially in states with weaker own-revenue bases, and are a key factor in assessing long-term credit quality.

Some of the parameters, along with their significance, for evaluating state government's revenue performance, fiscal health, and self-reliance, are given below:

- **Revenue Receipts (RR)/ GSDP:** This ratio evaluates the total size of revenue receipts relative to the Gross State Domestic Product. This ratio is a key indicator of fiscal capacity and a state's ability to translate economic activity into tax and non-tax revenues effectively, reflecting stronger fiscal autonomy and resilience.
- **States' Own Revenue (SOR)/ Revenue Receipts (RR):** This ratio measures fiscal autonomy and resilience. It is a measure of a state's ability to mobilise its resources internally through taxes and non-tax revenues, reducing reliance on central transfers and enhancing flexibility in expenditure planning.
- **States' Own Revenue (SOR)/ GSDP:** This ratio demonstrates fiscal autonomy and reduces dependence on central transfers, thereby enhancing flexibility in expenditure planning and debt management. The ratio assesses a state's ability to convert economic output into internal resources, reflecting strong tax buoyancy, robust non-tax collections, and sound

administrative capacity. It is used to assess revenue mobilisation by measuring the state's economic output.

- **Per-capita States' Own Tax Revenue (SOTR):** This is used to gauge the robustness of consumption levels within a state. It provides a stronger signal for a state's intrinsic revenue-generating ability than the RR/GSDP ratio, which can be skewed by central transfers. It measures the average tax contribution of residents, reflecting both the vibrancy of local economic activity and the efficiency of tax mobilisation.

b. Expenditure Management

State government expenditure covers routine operations such as salaries, subsidies, and maintenance, while state's capital expenditure creates long-term assets like infrastructure, power projects, and irrigation systems. State's capital expenditure covers spending towards enhancing future revenue potential. States prioritising capex demonstrates stronger fiscal management and a commitment to sustainable development and may be accordingly factored in analysis.

Prudent expenditure control is reflected in a state's ability to maintain a balanced or surplus revenue account. The state's ability to spend within revenue collections in a disciplined manner may lower the borrowings of the state for short-term requirements; however, state may have to depend on long-term borrowings to fund sizable expenditure. Effective control of expenditure demonstrates fiscal responsibility, reduces vulnerability to shocks, and strengthens creditworthiness and may be factored accordingly in the analysis.

Management of state subsidies is a critical aspect of expenditure management. Inefficient targeting of subsidies, particularly in power and food, is often seen as wasteful and fiscally burdensome. Progress in power sector reforms is especially important, given the sector's historically high subsidy requirements. ACER would accordingly evaluate the state government's willingness to rationalise subsidies, improve cost recovery, and levy appropriate user charges on non-merit subsidies, amongst other factors. Effective reforms reduce structural imbalances, free resources for developmental spending, and strengthen fiscal health, thereby enhancing the state's overall credit profile.

The quality of expenditure for a state government is analysed through various quantitative ratios that assess spending efficiency, the proportion of asset-creating investments, and the level of budgetary flexibility. Some of these ratios are given below.

- **Capital Outlay/ SGDP:** The ratio reflects how much of a state's economic output is invested in asset creation by the state government. It is an indicator of development orientation, fiscal quality, and growth potential, as capital outlay has a multiplier effect. This ratio measures the level of capital spending relative to the size of the state's economy, serving as an indicator for long-term economic prospects.

- **Capital Outlay/ Gross Fiscal Deficit (GFD):** This ratio highlights the quality of a state government's borrowing and fiscal responsibility. It helps to determine the purpose of borrowing, with a higher share indicating that debt is being used predominantly to fund asset

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creation (infrastructure, development projects). This enhances long-term growth potential and reflects prudent fiscal management.

- **Committed Expenditure/ Revenue Receipts (RR):** This ratio measures how much of a government's recurring income is locked into non-discretionary spending such as salaries, pensions, and interest payments. The ratio assesses fiscal flexibility on the basis of fixed obligations, leaving less room for developmental or discretionary spending. Conversely, a lower ratio reflects healthier fiscal space, enabling greater allocation toward capital outlay and growth-oriented programs.

- **Revenue Expenditure/ SGDP:** This ratio indicates the extent of a state's economic output consumed by recurring government spending such as salaries, subsidies, and interest payments. A high ratio suggests that a significant portion of the state's resources is absorbed by non-asset-creating expenditure, limiting fiscal space for development. A lower ratio reflects more efficient use of resources, leaving room for capital investment and growth initiatives.
- **Interest/ Revenue Receipts:** This ratio measures the share of a government's recurring income that is consumed by interest payments on debt. A high ratio signals heavy debt servicing burden, reducing fiscal flexibility and leaving less room for developmental or discretionary spending. A lower ratio reflects healthier debt sustainability, as more revenue remains available for growth-oriented expenditure.
- **Subsidies/ Revenue Receipts:** This ratio shows the share of the state government's revenue on subsidies, particularly for power and food. A high ratio indicates that a large portion of revenue is being diverted to support consumption or specific sectors, which can constrain fiscal flexibility and reduce resources for capital investment. A lower ratio suggests more room for developmental spending and stronger fiscal health.

c. Deficits, Liquidity and Leverage

The quality of fiscal deficit is assessed by the share of revenue deficit in gross fiscal deficit (GFD). A lower ratio indicates borrowings are used for asset creation, while a higher ratio suggests debt is financing consumption. Persistent deficits, excluding interest payments, allude to unsustainable borrowing patterns and a weak credit profile of the state. A state's fiscal health is judged by its ability to maintain a revenue surplus, where current receipts cover all revenue expenditures. Surplus available with the states allows it to be directed entirely toward capital outlay, strengthening long-term growth.

State fiscal deficit is a function of the revenue receipts and the expenses, including the interest payments on the borrowings. Total indebtedness captures the state's overall leverage by consolidating internal debt, central loans, provident funds, and off-budget borrowings. It also includes non-guaranteed liabilities of strategically important state entities and contingent liabilities, such as guarantees to state public sector enterprises (SPSEs) are included in the calculation of adjusted debt. Maturity profiles of the debt are seen to assess any bunching of repayments, which may lead to refinancing risks during downturns. Track record of debt servicing by the state, including honoring payments of guaranteed instruments, supports in determining the credit quality of the state. One of the key ratios that may be used is the financial leverage of the state, which is evaluated by seeing total debt (including guarantees) in relation to GSDP.

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While there may be fiscal deficits, the state government has some provisions such as the Consolidated Sinking Fund (CSF) and Guarantee Redemption Fund (GRF) to support liquidity and maintain a repayment cushion. States also rely on Reserve Bank of India facilities like Special Drawing Facilities (SDF), Ways and Means Advances (WMA), and Overdrafts (OD) to bridge short-term gaps. However, frequent reliance on WMA or OD signals weak liquidity management. Liquidity is influenced by timing mismatches in revenue inflows and uncertainty of central transfers, making proactive cash flow planning essential for fiscal stability.

A state's ability to manage leverage depends on balancing debt servicing with developmental spending. High interest-to-revenue ratios reduce fiscal flexibility, as debt servicing preempts funds for growth. Effective cash flow management requires forecasting inflows and building buffers. Performance of state-owned entities is critical, as defaults on guaranteed instruments directly impact the state's credibility and may reduce the efficiency of asset creation. Ultimately, the state's credit quality hinges on its capacity to sustain leverage, manage liquidity, and channel resources toward productive capital outlay.

d. Environmental, Social, and Governance Relevance for State Governments

Environmental, Social, and Governance (ESG) considerations are becoming increasingly relevant for state governments as they balance developmental priorities with fiscal sustainability. States play a pivotal role in driving infrastructure growth, social welfare, and environmental protection, making ESG integration essential for long-term resilience. Strong ESG practices enhance transparency, improve creditworthiness, and attract sustainable financing. Investor confidence in a state may be strengthened by effective integration of ESG principles into fiscal planning, debt management, and other areas.

- **Environmental (E):** Environmental factors may be relevant for state governments as they directly shape fiscal resilience and long-term sustainability. States vulnerable to natural disasters such as floods, cyclones, or droughts face heightened risks of economic disruption, infrastructure damage, and increased expenditure on relief and rehabilitation. Similarly, states with sizeable carbon-intensive industries encounter transition risks as national and state policies shift toward low-carbon growth. These challenges may strain budgets, reduce competitiveness, and affect the credit quality.
- **Social (S):** Social factors may be relevant for state governments as they may influence fiscal stability and governance outcomes. Disparities in income levels and unequal access to essential services such as healthcare, education, and housing are likely to impact social order and reduce citizens' willingness to contribute to state taxes. This weakens the revenue base and constrains developmental spending. Conversely, inclusive policies that promote equitable access and reduce inequality strengthen trust in institutions and support sustainable fiscal capacity and resilience.
- **Governance (G):** Governance factors may be relevant for assessing a state's fiscal credibility and institutional strength. Timely and transparent disclosure of fiscal data enhances investor confidence, supports compliance requirements and reflects discipline and accountability. Effective alignment with the central government may influence discretionary grants and investments in infrastructure investments. Overall, governance quality shapes fiscal flexibility, resource allocation, and the state's ability to sustain long-term growth.

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e. Key Takeaways

- The institutional framework defines the legal and constitutional environment for state governments. Adherence to regulations, intergovernmental transfers, administrative quality and liquidity buffers are some parameters that may be assessed.
- Transfers from GoI, including tax devolution and grants, may signal support, but prolonged reliance may be appropriately factored into the rating. Political stability, relations with the centre, and Article 293(3) borrowing restrictions may influence the fiscal resilience of the state.
- A state's economic profile is determined by examining its revenue potential and industry competitiveness, amongst other factors. Economic infrastructure and social infrastructure, including irrigation, power, education, etc., are critical for sustaining growth and attracting investment.
- Demographic factors such as population size, literacy, and urbanisation may influence labour supply and consumption trends. Further, these determine a state's resilience, revenue capacity, and long-term credit quality.
- Analysis of state finances may include fiscal management, resource mobilisation, expenditure priorities, and indebtedness to gauge long-term risks. Revenue receipts comprise of tax receipts, non-tax receipts, and central transfers.
- State government expenditure reflects both routine operations and long-term investments. Revenue spending on salaries, subsidies, and maintenance ensures continuity, while capital expenditure builds infrastructure and enhances future revenue potential. Overall, the quality of expenditure directly influences fiscal health, resilience, and creditworthiness.
- State deficits and liquidity are assessed through the quality of the fiscal deficit. Persistent primary deficits weaken credit profiles, while revenue surpluses strengthen growth prospects. A state's credit quality depends on its ability to manage leverage, sustain liquidity, and channel funds toward productive capital outlay.
- ESG factors are increasingly critical for state governments as they balance growth with fiscal sustainability. Favourable ESG integration enhances creditworthiness, attracts sustainable financing, and supports long-term development.

Rating Criteria for Urban Local Bodies

Overview

Urban Local Bodies (ULBs, including municipal bodies) play a vital role in delivering essential social and infrastructure services, including water supply, sanitation, public health, and road maintenance. With India's urban population growing rapidly, the pressure on existing infrastructure has intensified, necessitating significant capital investment. Traditional funding sources—such as internal resources, including tax and non-tax revenue have been used by ULBs to fund the infrastructure and discretionary expenses. Other sources of funding include grants from state/central governments and loans from specialised lenders, despite which, at times, the funding may be inadequate to meet demand. Consequently, ULBs are increasingly tapping into the capital markets through municipal bonds and other borrowings from banks and the private sector. This criterion assesses the fundamental credit risk of these entities by evaluating their economic, operational, financial, and governance profiles.

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The key ULBs include Nagar Panchayat, Municipal Council and Municipal Corporation. The functioning of Nagar panchayats is areas transitioning from rural to semi-urban and have a population of less than 1 lakh inhabitants. Its work mainly involves essential services such as waste management, sanitation, water supply, etc. On the other hand, a municipal council also known as nagar palika or nagar parishad, caters to towns that have a population between 1 lakh to 10 lakh. Its work mainly comprises public health, sanitation, waste disposal, education services, etc. Lastly, the municipal corporation also known as mahanagar palika or nagar nigam is present in areas where population is more than 10 lakhs. Its responsibility includes urban planning, public transport systems, healthcare facilities, education, environment protection, etc. All three structures have a governance model that encourages economic growth and inclusiveness, and accountability.

The criterion encompasses analysis of the relationship of ULB with the state government, along with the financial flexibility of the latter to support the ULB. The socio-economic balance of the area, signifying the willingness and ability of the local population to contribute (through taxes, user-charge-based services, etc.) to the economic development of the region, is one of the other key parameters. Other factors include the extent of fiscal deficit at the local body that may lead to higher dependence on external funding, track record of governance and transparency in reporting, and execution track record of ongoing and upcoming projects.

Inter-Governmental Fiscal Relationships

The legal and administrative framework of urban local bodies, defined by the governing Act, specifies obligatory and discretionary services, functional domains, and fiscal powers. ULBs operate within a legislative framework that defines their revenue-raising powers and expenditure responsibilities. It highlights clarity in tax and non-tax authority, borrowing limits, and state linkages that strengthen operational and financial management. Revenue flexibility of a ULB is supported by services such as electricity and aided by low user charge services such as government hospitals/ dispensaries, public transport, etc. The state government's support to ULBs discretionary and infrastructure spending in the event of lower collection of taxes, greater services with lower user charges, etc. establishes a relationship between the two bodies.

1. **Dependence on State Support:** The reliance on the state government for discretionary transfers may be assessed in conjunction with the proportion of revenue from grants and devolution. Lower dependence of a ULB on state government to meet its obligatory expenses may be factored favorably into the ratings. If ULBs independence is demonstrated over a considerable period, the ULB’s rating may not be constrained by that of its state government.

2. **Discretionary vs recommendations** Rule-based transfers, that are stable and predictable, based on State Finance Commission (SFC) or Central Finance Commission (CFC) recommendations are preferred over ad-hoc or inconsistent discretionary transfers from the state government. An ULB is considered strongly positioned if the majority of its state transfers are rule-based.

3. **Clarity of Mandate:** Clarity in defining ULBs role in the project and support from the state would be imperative in execution of mandates by ULBs. In case a state passes on expenditure responsibilities to a ULB without providing corresponding earmarked revenue sources, it may be

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unfavourable to the rating. However, the final rating outcome will consider the track record of state support in the past, the ability of the ULB to execute the mandate, and other factors.

4. **Grant Management and Monitoring:** Grants that lead to capacity building within the ULB and are adequately monitored are viewed positively. Grants without specific end-use stipulations are viewed with caution, as they are often used to meet routine revenue expenditures and have lower sustainability.

Economic Base and Strength

1. **Diversity and Growth:** A diversified economic base spanning various sectors—such as IT, manufacturing, engineering, and major services—is a significant credit positive because it ensures the stability of revenue streams. Conversely, an economy dependent on only a few industrial units faces high concentration risk, where a downturn in a single industry could severely impair the ULB's tax collections. Entities in industrial hubs or major tourist destinations are viewed as strongly positioned, while those in regions primarily involved in agriculture are considered to have a weaker economic base.

2. **City Importance:** Ratings consider the city's importance to the state (e.g., state capital, industrial hub, or major tourist destination). The initial assessment of the economic base includes a review of the region's existing infrastructure and available natural resources.

3. **Demographic and Population Profile:** A steadily growing population base in the employable age bracket is viewed favourably. Literacy levels indicate the ability and willingness of the population to pay taxes and user charges. A high proportion of the population living in slums (e.g., more than 50%) is a sign of a weak economic base and limits the scope for levying new taxes or user charges. While growth is positive, rapid urbanization can also be a risk factor, as it puts immense pressure on existing physical infrastructure and the ULB's capacity to maintain service levels.

4. **Income levels and Repayment capability:** The fundamental ability of a ULB to repay its debt without excessive reliance on state or central government grants depends on the income levels of the local population. Regions with higher income levels and diverse economic bases typically demonstrate superior debt-repayment capabilities. While a strong base is essential, these strengths must be effectively tapped through an efficient tax structure to translate economic activity into municipal revenue.

Financial Strength and Performance

The assessment of Financial Strength and Performance evaluates the size, stability, and composition of a ULB's revenue and expenditure to determine its standalone ability to meet obligations. This pillar focuses on the entity's success in generating "own revenue," its expenditure discipline, and its overall operating efficiency.

1. **Revenue Size and Composition:** Receipts are classified into Tax Revenue (e.g., property tax), Non-Tax Revenue (user charges, fees, rentals), Assigned Revenue (shared stamp duty), and Government Grants. A key metric is the share of own revenue sources relative to total receipts, as it determines the ULB's ability to operate without excessive dependence on the state government.

Per-capita own revenue exceeding Rs. 5,000 per annum represents the strongest positioning, while less than Rs. 200 is considered weak.

2. **Performance of Own Revenue Sources:** Property tax and user charges are the primary drivers of internal financial strength. ACER tracks the implementation of unit area-based computation, self-assessment systems, and Geographical Information Systems (GIS) for 100% property mapping. Non-tax revenue is often a weak point due to inadequate user charges. A ULB that demonstrates a track record of upward tariff revisions to cover the growing costs of operations and maintenance (O&M) is viewed as having distinct credit strength.

3. **Expenditure Structure and Discipline:** High staff and administrative costs can crowd out essential capital investments. Establishment expenditure making up less than 40% of total revenue is a strong indicator, while exceeding 80% is a credit negative. ACER reviews trends in O&M spending to ensure that infrastructure is being adequately maintained rather than just created. The methodology also assesses the ULB's financial flexibility to curtail wasteful spending or raise resources to meet unforeseen contingencies.

Operating Efficiency

The revenue balance (surplus or deficit) is the ultimate indicator of an entity's operating efficiency. A consistent revenue surplus is positive because it implies that capital expenditure can be partly funded internally with limited dependence on borrowings.

Debt, Leverage, and Liquidity

The assessment of Debt, Leverage, and Liquidity is fundamental to determining an Urban Local Body's (ULB) creditworthiness, as it evaluates the entity's long-term solvency and its immediate capacity to meet financial obligations. While a ULB may have a strong economic base, its ability to manage its debt profile and maintain sufficient cash buffers is what ensures timely repayment to lenders.

1. Leverage and Debt Profile

ACER examines the magnitude and composition of a ULB's debt to assess its total burden relative to its income-generating capacity.

1.1 **Leverage Metrics:** A key quantitative measure is the Outstanding Debt / Revenue Balance ratio. A ratio of less than 1x is considered the strongest positioning, while a ratio exceeding 3x indicates a weak, highly leveraged position.

1.2 **Composition and Tenure:** The analysis includes the maturity matching profile and the sensitivity of the debt to interest rate changes. Revenue-backed debt—where servicing is linked to specific areas like property tax or water charges—is analysed separately to understand its impact on general liquidity.

1.3 **Historical Performance:** The ULB's past debt service performance and its degree of compliance with credit discipline imposed by previous lenders are scrutinized to gauge its future repayment behavior.

2. Liquidity Management

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Liquidity reflects the ULB's day-to-day cash management and its flexibility to handle unforeseen financial stress.

2.1 **Distinction of Cash Balances (Own vs. Grants):** A critical part of the analysis is excluding unspent funds from various government schemes from the ULB's cash balance. These funds are restricted and cannot be used for discretionary purposes like debt servicing. In contrast, a cash balance accumulated from the ULB's own operating surpluses, without compromising maintenance or expenditure requirements, provides financial flexibility and supports credit assessment.

2.2 **Dependence on State Transfers:** The timeliness of fund transfers from the state (including Central grants passed through the state) is vital. Delays in these transfers can severely impact a ULB's liquidity profile.

2.3 **Non-Debt Liabilities:** The analysis also incorporates hidden liquidity pressures, such as pending dues for staff salaries, contractor payments, and utility (power/water) bills.

3. Credit Enhancement and Structural Features

Ratings for specific debt instruments (like municipal bonds) may be "notched up" based on structured payment mechanisms that provide additional security to investors.

3.1 Escrow Accounts: Identifying specific revenue sources (e.g., property tax) and redirecting them into an escrow account ensures that funds are prioritized for debt servicing before being used for other municipal functions.

3.2 Debt Service Reserve Account (DSRA): Maintaining a DSRA (a reserve typically covering 1–2 cycles of payments) acts as a buffer against temporary cash flow mismatches.

3.3 Waterfall Mechanisms: These define clear payment priorities for the ULB's cash flows, ensuring that debt obligations are met before discretionary expenditures.

Governance, Reporting, and Reform Orientation

Governance assessment reviews management depth and the transparency of operations.

1. Governance and Institutional Capacity

Governance analysis focuses on the organisational structure and the professional capability of the municipal administration to deliver services effectively.

1.1 Administrative Structure: Ratings evaluate the depth of management and the extent of the delegation of powers within the ULB. A sound structure clearly distinguishes between the roles and responsibilities of the elected council and the administration.

1.2 Management Continuity: The quality and continuity of management, along with the division of responsibilities across administrative, finance, and legal departments, are critical determinants of administrative stability.

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1.3 Staff Sufficiency: The adequacy of staff in key positions is viewed as a strong positive. Institutionalized control mechanisms that lower reliance on specific individuals are preferred over person-dependent systems.

1.4 Management Information Systems (MIS): The presence of robust MIS is studied to evaluate the effectiveness of the ULB's control and planning processes.

2. Quality of Reporting and Transparency

Transparency in financial and operational disclosures is vital for gaining the trust of citizens and capital market investors.

2.1 Accounting Practices: While many ULBs traditionally follow cash-based systems, the transition to accrual-based financial statements is a significant credit positive. Accurate and regular preparation of these statements provides a clearer picture of assets and liabilities.

2.2 Audit Quality: The nature, quality, and regularity of audits are closely examined to ensure the reliability of reported fiscal data.

2.3 Public Disclosure: High-performing ULBs maintain transparency through the regular dissemination of status reports on projects and updates on their financial position, often through website disclosures. Consistency in communication and openness in sharing information during the rating process are also factored in.

3. Reform Orientation and E-Governance

A ULB's commitment to reform reflects its willingness to improve operational and financial performance to gain greater access to capital markets.

3.1 Property Tax Reforms: Agencies track the implementation of modern assessment methods, such as Geographical Information Systems (GIS) for 100% property mapping, the unit area method for computation, and self-assessment systems.

3.2 E-Governance Initiatives: The implementation of e-governance for online tax billing, building permissions, and grievance redressal is viewed favourably as it improves overall service delivery and collection efficiency.

3.3 Tariff Revision Track Record: A demonstrated ability and willingness to periodically revise property tax rates and user charges (for water and sewage) to cover growing operational costs is a distinct credit strength.

4. Managerial Autonomy and External Linkages

The ability of a ULB to function effectively within the political system impacts its credit stability.

4.1 Operational Autonomy: The methodology evaluates the degree of autonomy the ULB enjoys and its ability to function without excessive political interference, especially regarding tax hikes.

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4.2 Private Sector Partnership: A ULB's track record in leveraging private sector efficiencies through Public-Private Partnerships (PPPs) or outsourcing activities while retaining operational control is considered a positive rating factor.

4.3 State Influence: ACER also monitors instances where the state government may influence a ULB to participate in projects beyond its scope, which could potentially strain its financial resources.

Project Viability and Execution

Project viability involves a rigorous study of the financial assumptions underlying a project throughout the tenure of the debt instrument.

1. **Revenue Generation:** For Revenue Bonds, debt servicing is strictly limited to the revenue generated by the project itself (e.g., user fees). For General Obligation Bonds, the overall creditworthiness of the ULB supports the project.

2. **Operating Sustainability:** ACER evaluates whether the projected future revenue from project assets is adequate to cover both Operation and Maintenance (O&M) expenditure and debt service requirements. A "very strong" project is one where revenue covers all costs and generates a surplus.

Cost Recovery Mechanisms: A key determinant is the extent of cost recovery through user charges. Ratings also consider the ULB's willingness and ability to revise tariffs and property taxes to support these healthy surpluses.

Key Takeaways

- Urban local bodies (ULBs) operate within a defined legal framework, balancing obligatory services and fiscal powers. Power reliance on discretionary transfers and stronger independent revenue generation are viewed positively, while rule-based transfers provide stability compared to ad-hoc grants.
- Clear definition of ULB responsibilities, matched with earmarked revenue sources, strengthens execution capacity.
- Higher local incomes and diverse economies enhance repayment ability and reduce reliance on state/central grants. Effective tax structures are essential to convert economic activity into sustainable municipal revenues.
- Credit strength depends on the share of own revenues (property tax, user charges, fees) relative to total receipts.
- A consistent surplus reflects strong efficiency, enabling partial funding of capital expenditure without heavy borrowings. However, surpluses achieved by cutting service quality or neglecting maintenance are not considered favourable.
- Effective debt management, prudent leverage, and maintaining adequate cash buffers are essential to ensure timely repayment and financial stability.
- Credit strength depends on robust administrative structures, professional management continuity, adequate staffing, and effective MIS. Transparent reporting through accrual-based accounting, reliable audits, and regular public disclosures builds trust with citizens and investors, enhancing fiscal credibility.

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- Commitment to reforms such as property tax modernization, e-governance, and tariff revisions signals operational efficiency. Adequate autonomy, limited political interference, and effective use of PPPs strengthen stability.
- Project viability depends on whether future revenues from assets can cover O&M costs and debt servicing.
- The extent of cost recovery through user charges and the ULB's willingness to revise tariffs or property taxes.

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