

Rating Criteria for Municipal and Urban Local Bodies

Municipal bodies have traditionally relied on internal resources (including own tax and non-tax revenues) grants from state governments and from the central government for specific schemes, loans from institutions such as Housing and Urban Development Corporation, Life Insurance Corporation of India and General Insurance Corporation and concessional finance from multilateral agencies. The emerging scenario indicates that budgetary resources and recourse to institutional finance alone may not be adequate to meet the requirements for urban infrastructure including critical services such as water supply and sewerage. In such a scenario, municipal bodies will need to explore alternatives such as private sector participation in core services and accessing capital markets to fund critical infrastructure projects.

CRISIL has evolved its methodology for rating municipal and urban local bodies after an in-depth study of such bodies in India and abroad. The methodology was used by CRISIL to award a rating to the country's first municipal bond, which was floated by the Ahmedabad Municipal Corporation (AMC) in February 1998.

CRISIL's rating methodology for municipal bodies entails an assessment of the following six factors:

Legal and administrative framework
Economic base of the service area
Municipal finances
The municipal body's existing operations
Managerial assessment, and
Project-specific issues

■ Legal and administrative framework

CRISIL's analysis of the legal and administrative framework is based on the relevant Act, which defines all the legal, structural and administrative elements of a municipal body. The Act also outlines the obligatory and discretionary services to be extended by a municipal body. CRISIL believes that a clear legal and administrative framework for a municipal body, incorporating matters related to functional domain, tax and non-tax powers, administrative and fiscal linkages with the state government, organisation and audit of accounts and borrowing powers, adds clarity and confidence to the rating process.

The key features that are defined in the Act and that are evaluated by CRISIL include:

- *Municipal functional domain*: CRISIL evaluates the obligatory and discretionary services, which have to be extended by a municipal body, to determine the extent of its operational responsibilities and the constraints imposed therein.

- *Taxing powers allocated to the municipal body:* CRISIL evaluates the taxing powers allocated to the municipal body in relation to its functional domain as well as the body's tax effort in terms of deploying all sanctioned tax options.
 - A comparison of the municipality's functional domain vis-à-vis the revenue raising powers allocated to it largely determines the corporation's potential fiscal strength and its ability to maintain acceptable levels of service.
 - *Election of municipal authorities and decision-making process:* CRISIL studies the municipal corporation's constitution, elections to the standing and working committees, the term of office and the like. It also studies the municipal authorities' decision-making process, which throws light on the time involved in taking important decisions as also the corporation's transparency and responsiveness to pertinent issues.
 - *The mechanism for transfer of state government grants to municipal bodies:* CRISIL believes that the level of clarity and transparency of this transfer arrangement defines the stability of grant receipts. CRISIL also looks at the status of implementation of the state finance commission's recommendations.
 - *The tax rates levied by the municipal body and the basis of assessment:* CRISIL evaluates the measures taken by the municipal body to rationalise tax rates and to add clarity to the assessment procedure.
 - *The minimum and maximum tax rates and specific user charges which can be levied by the municipal body:* This is a key input in assessing the level of flexibility as well as the level of autonomy enjoyed by the municipal body.
 - *Borrowing powers and the administrative requirements for mobilising funds from the capital markets as specified in the Act:* CRISIL assesses the municipal body's flexibility to raise funds for projects. The checks imposed on borrowings by the municipality are taken as a critical consideration for the credit enhancement of municipal bond ratings. This includes ceilings on debt levels and the manner in which sinking fund balances are transferred and monitored.
 - *State government - municipal body linkages:* The Act would specify the revenues that the municipal body would receive by way of loans, grants or transfers from the state government. CRISIL studies the method of transfer of such funds from the state government and analyses the extent to which these transfers are discretionary. Formula-linked transfers are viewed favourably as they can be assumed to constitute a steady revenue stream for the corporation in future.
- ### ■ Economic base of service area
- CRISIL analyses the economic base of the municipal body's service area with the objective of assessing the tax base, elasticity of tax income and the possibility of enhancing the body's tax base and revenue-generating potential. Some of the key indicators examined include:
- *The population base and its growth rate*
 - *The level of industrial activity:* This encompasses an assessment of the presence of industrial estates or major industries, and of indicators such as the sanctions and disbursements made by financial institutions, non-domestic power consumption and industrial water connections in the service area.
 - *The level of commercial activity:* An assessment is made of sales tax collections, stamp duty collections on property transfers and collections from licence fees from hotels, restaurants and the like.
 - *Per capita income levels and literacy levels*
 - *Indicators of tax-paying capacity* such as the number of vehicles registered with the Regional Transport Office.
 - *Fixed line penetration and the number of cellular phone users*
 - *Growth in deposits raised by major public sector banks*
- The analysis of the economic base of the service area has limited application today except in the case of octroi-levying municipal bodies, where octroi collections are

linked to economic activity. In such cases, the buoyancy of octroi collection depends on the industrial base's economic growth and diversity. CRISIL anticipates that over a period of time, most municipal entities would get into a regime of full cost recovery. The economic base of the service area would thus be a strong indicator of the citizens' ability to bear increases in taxes and user charges. Further, non-tax revenues from activities like commercial property development would also depend, to a large extent, on the economic base of the service area. The economic base, however, only indicates the potential revenue base and is less critical than the municipal body's efficiency in collecting taxes, controlling expenses and the like.

■ Municipal finances

CRISIL analyses municipal finances in detail in the prevailing framework of the revenue account and capital account. Receipts and expenditures for the past five years are assessed separately. In addition, the municipal body's debt profile and its accounting policies are considered as key inputs in the analysis.

Overall surplus/deficit

In its first stage of analysis, CRISIL assesses the overall surplus/deficit on the revenue account. The surplus position is examined, whether it accrues from an increase in revenues or the control exercised over expenditure or a mix of both factors. A similar exercise is done in case of an overall deficit position. CRISIL does not look very favourably at an overall surplus position that is a consequence of postponing critical capital and revenue expenditure. As local bodies rely primarily on cash-based accounting, a healthy apparent surplus may be offset by uneven capital expenditure, non-payment of arrears and increased liabilities due to deferred payments and the like.

Revenue receipts

Revenue receipts are broadly classified into tax and non-tax revenues. Tax revenues include own taxes (which are collected by the local body, generally within the municipal limits) and shared taxes (which may be levied by either the local body or the state and shared between the two). In the absence of cost recovery for most of the services provided by the municipal body, the quantum and proportion of tax revenues assume importance in assessing the body's fiscal autonomy. CRISIL regards a higher degree of reliance on tax-based revenues as a

positive factor.

CRISIL believes that the overall tax effort can be assessed by comparing the own tax options devolved by the state government and the efforts made by the municipal body to exhaustively exploit this tax base. The trend in per capita tax revenue collections (in real terms) is another comprehensive indicator of the municipal body's tax efforts. CRISIL also examines the details of the tax base, trend of revisions in tax rates, the administrative structure, systems and procedures for improving collections and resulting collection efficiencies, both current and arrears, in order to assess the scope for future buoyancy.

Own tax revenues, over which the local body has greater control, are considered a more stable revenue source. The two main sources of own tax revenue for municipal corporations across the country are octroi and property tax. Not all states allow the levy of octroi, however, which is often substituted by a compensating grant in lieu of octroi from the state government. As property tax is an inelastic and less buoyant source of revenue compared to octroi (due to the present property tax assessment system based on the annual rateable value concept), the financial health of non-octroi levying corporations is constrained to some extent. This also results in non-octroi levying corporations being financially dependent on transfers from state governments. CRISIL places specific attention on the property tax assessment and collection mechanisms adopted by the municipal body. The growth in property tax collections is evaluated in the context of the increase in the number of eligible properties and their assessed rental values. CRISIL also analyses the simplicity and ease of applicability of the taxation rules. Finally, the corporation's track record with respect to the frequency and extent of tariff revisions and collection efficiencies is analysed.

Non-tax based revenues, which are largely in the form of user charges, grants from the state government and income from municipal properties, are analysed by CRISIL as a distinct component of revenue receipts.

CRISIL examines revenues from user charges on the basis of the profile of the charges, which highlight consumer categories, past and existing rates, and the basis of levying charges (flat rate or consumption related). Another critical aspect is the ratio of transfers from the state (shared taxes and grants or compensations for taxes received from state) to revenue receipts, which indicates the corporation's dependence on the state.

While analysing grants from the state government, greater importance is attached to stable and non-conditional grants, which do not impose a burden on the corporation in terms of performing additional functions. The likelihood of any reduction in the grants extended by the state government due to deterioration in the financial health of the state government itself, and the stability and transparency of the transfer mechanism are also assessed. The recommendations of the relevant state finance commission, if available, are also evaluated.

Revenue expenditure

CRISIL carries out an activity-wise and head-wise assessment of the revenue expenditure incurred by a municipal body. The activity-wise analysis considers the proportionate allocations made for providing core services (water supply and sewerage, primary education, public health and medical relief, public safety, public works and solid waste management). CRISIL places emphasis on the stability and consistency in expenditure allocations for these core services. The service quality too is measured by comparing the per capita expenditure on core services across municipal corporations.

CRISIL's head-wise analysis of revenue expenditure considers the allocations made under various functions like wages and salaries, operating expenses, repairs and maintenance and debt servicing. This analysis indicates the causes of any increase in expenditure levels and the flexibility and expenditure controls that can be exercised by the municipal body. CRISIL believes that in cases where the wages and salaries and debt servicing components constitute a major proportion of total costs, the extent of flexibility and the potential for expenditure control are limited.

CRISIL also estimates the extent of cost recovery and cross-subsidisation incurred on these services, based on the percentage of revenue expenses incurred on services that are recovered through fees or taxes levied on users of that service.

The amount of revenue surplus generated by the body is considered critical as it indicates the corporation's ability to fund capital expenditure. It also indicates its operating efficiency. A high ratio of revenue surplus to revenue receipts is considered favourable, implying that a large part of the corporation's revenue receipts can be directed towards productive capital works.

Capital account

CRISIL assesses the level and stability of a municipal body's capital receipts as well as its judicious deployment towards capacity building. CRISIL views negatively, forced capital surpluses arising out of cutbacks in capital expenditure in order to fund revenue deficits. A track record of consistent, rising developmental capital expenditure is viewed positively as this would build the economic infrastructure in the municipal domain and thereby, improve the level of civic services that are provided in the service area. In addition, if the capital expenditure is a large fraction of the body's total expenditure, it is viewed positively.

Debt profile

CRISIL assesses the municipal body's debt profile with reference to the source, tenure, interest rates and repayment arrangements of all the major loans raised by the body. The loan retirement schedule and average interest costs are also examined in detail. In addition, the debt service coverage ratio is assessed. CRISIL also looks at the fraction of capex that is financed through debt. A high ratio implies insufficient internal finances and excessive reliance on debt.

■ The municipal body's existing operations

CRISIL acquires an understanding of the municipal body's existing operations through a study of the range of services provided by the body and by comparing its obligatory and discretionary services as defined in the relevant Act. CRISIL takes a positive view of municipal bodies that focus on providing mandatory services compared to those bodies that focus on discretionary services.

To assess the municipal body's operating efficiency, CRISIL undertakes an in-depth evaluation of its core services including water (area and population coverage, per capita water supply, treatment capacity), sewerage (coverage, sewerage treatment capacity) and primary education and health services (number of schools or hospitals). A low level of current service levels indicates pressure on the body to spend extensively on infrastructure. CRISIL evaluates the corporation's organisational arrangement for delivering the service, its existing infrastructure for providing the service, the level of revenue expenditure, past trends in capital expenditure and the proposed level of service enhancement.

A detailed evaluation is done of the municipal body's efforts to curtail revenue expenditure. CRISIL takes a positive view of municipal bodies that deploy revenue account surpluses to finance capital expenditure.

CRISIL considers the past trends in capital expenditure and capital receipts as a benchmark for assessing the trends, focus areas, and the efficiency and effectiveness of capital outlays for widening the municipal service base. The key parameters considered for this analysis are budgeted and actual outlays, major projects undertaken, track record on project management, extent of service augmentation and comparison with recommended norms.

CRISIL estimates the proposed level of service enhancement by analysing the projects on hand, their completion schedules and alternate institutional arrangements like privatisation.

■ Managerial assessment

It has been CRISIL's experience with municipal bond ratings that a corporation's financial health is, to a certain extent, linked to the initiatives taken by its management to enhance the resource base and improve the level of municipal services. In CRISIL's opinion, it is therefore important to analyse the municipal body's organisational structure, administrative systems and procedures, project management skills as well as the level of control exercised on expenditure, the ability to manage political forces and resist political interference, and the initiative taken to enhance resources and improve collection mechanisms.

■ Project-specific issues

With respect to any project undertaken by a corporation, for which funds are being raised, CRISIL would assess the existing level of service, the improvements envisaged through the project, the project cost, means of funding the project and the effect of debt-funding on the municipal body's debt service coverage ratio.

CRISIL has also developed criteria for credit rating project-specific structured debt obligation instruments. These are debt instruments secured by the cash flows from a specific asset or a pool of assets. The cash flows from the assets are kept separate from the issuer's other

revenues and are the primary source for servicing debt-holders. Such a structure results in a credit enhancement from the issuer's stand-alone rating and provides easier access to the capital markets.

Rating methodology for municipal and urban local bodies

Legal & administrative issues

- Municipal functional domain
- Taxing powers
- Tax-collection abilities and experience in managing arrears in collections
- Transfer of state government grants
- Borrowing powers
- Ability to pledge revenues for servicing debt

Economic base of the service area

- Demographics and the area covered
- Level of industrial activity
- Level of commercial activity
- Diversity and elasticity of tax-base
- Prospects of widening tax coverage
- Per capita income levels

Current financial position

- Accounting quality
- Analysis of surplus/deficits
- Growth in tax & non-tax revenues
- Collection efficiency, debtor analysis
- Dependence on state government for discretionary grants & fund transfer
- Expenditure on core services
- Past/projected debt-servicing needs
- Past/projected debt service coverage
- Liquidity
- Projected revenue/expenditure growth

Managerial assessment

- Organisation structure and responsibility division
- Systems and procedures: Level of computerisation

- Project management capabilities
- Political environment management
- Initiatives taken for enhancing resources
- Level of control exercised on expenditure

Project-specific issues

- Proposed projects
- Project tenure and funding pattern
- Debt servicing requirements due to borrowings for new projects
- Existing level of service and improvements envisaged

Important ratios and parameters

Economic base of the service area

- Population and its growth rate
- Sanctions and disbursements made by financial institutions
- Non-domestic power consumption
- Industrial water connections in the service area
- Sales tax collections
- Stamp duty collections on property transfers
- Per capita income
- No. of vehicles registered with the Regional Transport Office
- Demand for telephone connections
- Growth in deposits raised by banks

Current financial position

- Tax receipts/ Total revenues
- Non-tax receipts/ Total revenue
- Own taxes / Total revenue
- Own income / Total revenue
- Non-tax revenues / Total revenues
- Grants from state government/Total revenues
- Revenue surplus / deficit
- Revenue surplus / Revenue receipts
- Non-debt capital income / Capital expenditure
- Capital expenditure / total expenditure
- Overall surplus / deficit
- Collection efficiency of property tax
- Collection efficiency of water tariff
- Debt service coverage ratio

Operations of the municipal body

- Expenditure on core services/Total expenditure
- Expenditure on wages and salaries/Total expenditure
- Water supplied per capita
- Per capita expenditure on primary education
- Per capita expenditure on health services