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Public Finance System Overview: Israeli Municipalities

Primary Credit Analyst:

Noa Fux, RAMAT-GAN (972) 3-75397-28; noa.fux@spglobal.com

Secondary Contact:

Alois Strasser, Frankfurt (49) 69-33-999-240; alois.strasser@spglobal.com

Table Of Contents

Overview

Recent Developments

Predictability

Revenue And Expenditure Balance

Transparency and Accountability

Trend: Stable

Related Criteria and Research

Public Finance System Overview: Israeli Municipalities

Institutional Framework: Israeli Municipalities

Institutional framework assessment: Evolving but balanced

Trend: Stable

Strengths And Weaknesses Of Israeli Municipalities

Strengths	Weaknesses
Relatively stable intergovernmental system, with strong oversight by the municipal regulator	Low medium-term visibility, owing to absence of mandatory long-term financial planning
Solid ongoing systemic support from the central government	Low budgetary flexibility
Entering loans need approval of municipal regulator	

Overview

S&P Global Ratings regards the institutional framework for Israeli municipalities as evolving but balanced. The public finance system or institutional framework defines the environment in which local and regional governments (LRGs) operate. We view LRGs as part of the wider political, institutional, administrative, and budgetary systems of the country or region in which they are located. Our institutional framework assessment measures how the predictability, reliability, and supportiveness of public finance systems and legislative frameworks are likely to affect an LRG's ability to service debt in the long term.

We base our assessment of the institutional framework on the analysis of the following main factors:

- Predictability, or the frequency and extent of reforms affecting the intergovernmental system and the predictability of their outcome, alongside an LRG's ability to influence or oppose reforms affecting its financial balance.
- Revenue and expenditure balance, or the overall adequacy of the revenues that an LRG receives to cover its expenditure mandates, including ongoing systemic support, prudence of the fiscal policy framework, and availability of extraordinary support in exceptional circumstances.
- Transparency and accountability, or the transparency and institutionalization of budgetary processes, accountability of managers, the disclosure and accounting standards for financial reporting in the LRG sector, along with the reliability of financial information.

We assess each of these factors above on a five-point scale from 1 to 5. We then convert the resulting weighted-average assessment to a six-point scale from 1 to 6.

Recent Developments

There have been no major changes in Israel's municipal sector in recent years, and to our knowledge, none are envisaged at the moment. We note that a few working groups are currently discussing different proposals, but no changes or reforms have been decided at this stage. We believe that any change in the system will be made only after

consultations with the Israeli Federation of Local Authorities or one of its representative entities.

Predictability

Frequency and extent of reforms

Israel has a relatively stable system of two layers of government, the central government and the municipalities. The state parliament has no second chamber representing the municipal sector, and may challenge bills. The law for municipalities became effective in 1964 and sets their general framework. Moderate reforms are discussed intensively but have not changed the main responsibilities of municipalities.

The interior ministry has divided municipalities into groups based on financial performance indicators. This split determines the balance between supervision and independence in which a municipality operates. Consequently, weaker municipalities have tighter supervision and are often have an appointed special government accountant that approves their budgetary plans and reviews performance. More robust municipalities are given more independence in financial conduct and other decision-making processes.

Ability of LRGs to influence or oppose reform

Israeli municipalities are not officially represented in the central government and have no direct power to block reforms. They can, however, influence the central government's decision via consultations, which often take place prior to implementing a major change. The municipalities are mainly organized in two forms: "Forum 15," which consists of the 15 financially strongest and independent municipalities, and the Federation of Local Authorities in Israel, which represents all local/regional municipalities in Israel. We believe both are in good bargaining positions in discussions with the central government.

In the early 2000s, the central government cut back on its main item of support, "balancing grants." This has resulted in financial distress in weaker municipalities and led the ministries (of interior and of finance) to retract the amendment to the balancing grants budget. Since then, we believe the ministries are much more committed to the financial stability of the municipalities, and we currently do not expect that the central government will cut these grants again. Moreover, changes in systemic support and the equalization system are under extended discussion with the Federation of Local Authorities, and could be revised accordingly.

Revenue And Expenditure Balance

Overall adequacy of revenues to cover expenditure needs

We view the overall adequacy of Israeli LRGs' revenues to cover for expenditure needs as good, but with very low flexibility to adjust revenues. On the operating revenue side, the two main sources are receipts from municipal property tax and government transfers (41% and 38% of 2014 operating revenues, respectively). These are both very stable revenue streams, in our opinion. On the capital side, revenues mainly comprised betterment and other development fees, but can also include gross borrowings.

Israel has no horizontal equalization system, and the LRGs depend on the efficiency of collection of the municipal property tax, which is often the most important revenue stream for a local government. The municipal property tax is

a fixed charge with an automatic annual updating mechanism according to a formula reflecting inflation and wage increases in the public sector. A larger tax increase than the automatic rise must be approved by the interior ministry, which usually approves such requests when the tax rate is substantially lower than in neighboring municipalities or in situations when a municipality is in a recovery phase. In 2014, the interior ministry received requests for non-automatic tax increases from almost half of the municipalities, and approved only 18% of them.

Other revenue sources include central government contributions for education and social welfare, which are given according to a pre-set formula or depending on the project executed.

If this revenue stream is not sufficient to cover the budgeted expenditures, the municipalities can also rely on the ongoing systemic support from the central government, which is provided through government grants. The main grant is the budget balancing grant, which is set to cover for the gap in operating budgets between revenues and expenditures, in order to secure a basic service basket for the citizens. Most municipalities are entitled to receive this grant, which was budgeted for the whole sector at around Israeli new shekel (ILS)3.1 billion in 2016 (about 5% of reported operating revenues).

The government also supports municipalities through other grants, including development grants distributed to assist municipalities to execute new projects, and through other special grants. The 2015 total budget of these grants was about ILS800 million (approximately 1.5% of reported operating revenues).

The aggregate direct debt of Israeli municipalities, as a percentage of reported revenues, is decreasing over time. We adjust the reported revenues/expenditures for material non-cash or pass through items. The main adjustments we implement for Israeli municipalities are for discounts in municipal taxes, principal repayments, and gross borrowings. In 2014, direct debt totaled ILS14.3 billion, which accounts for about 26% of reported operating revenues. As most Israeli loans are CPI-linked, the above-mentioned figure also includes the CPI linkage component. The aggregate debt service data includes both the CPI revaluation and interest expenditures, and amounted to about 5% of reported operating expenditures in 2014.

Thanks to the central government's strong commitment to the municipalities, we believe indebtedness will remain stable or even decrease over the next few years.

Chart 1

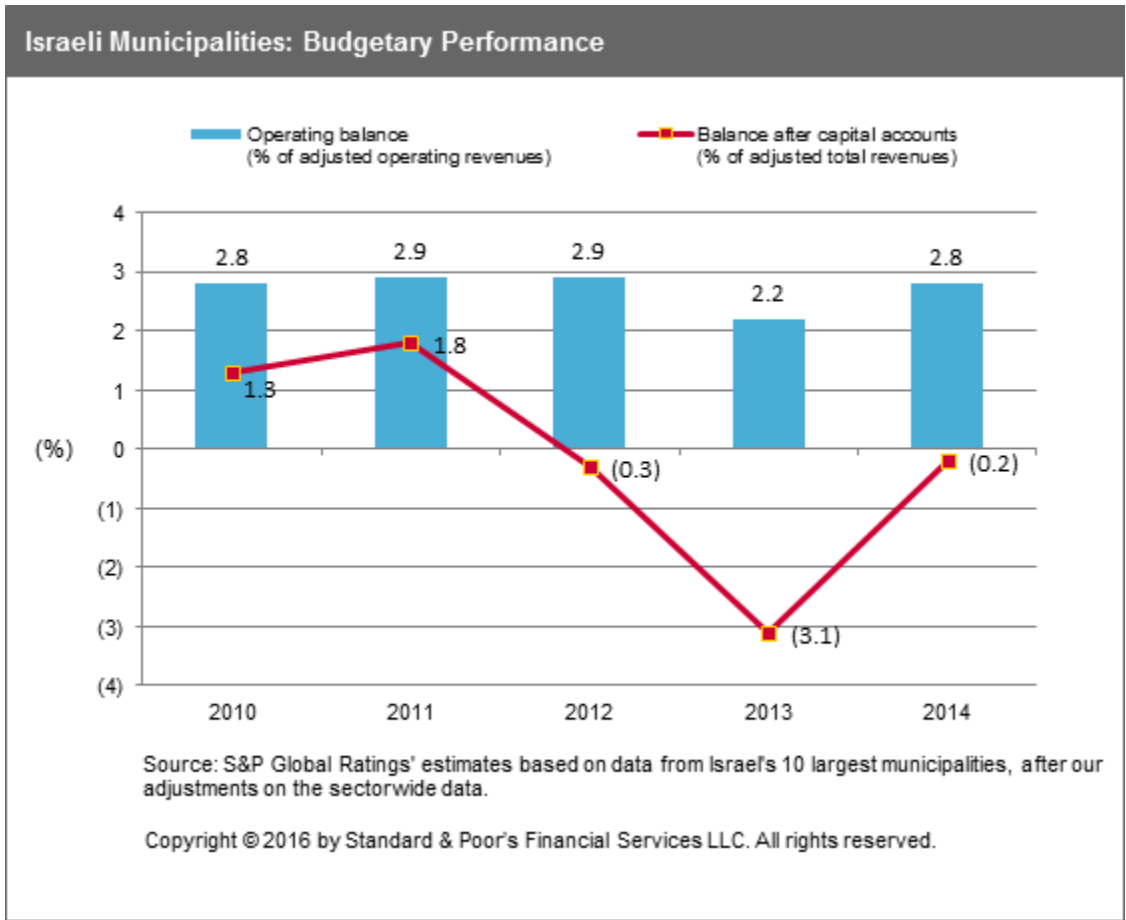


Chart 2

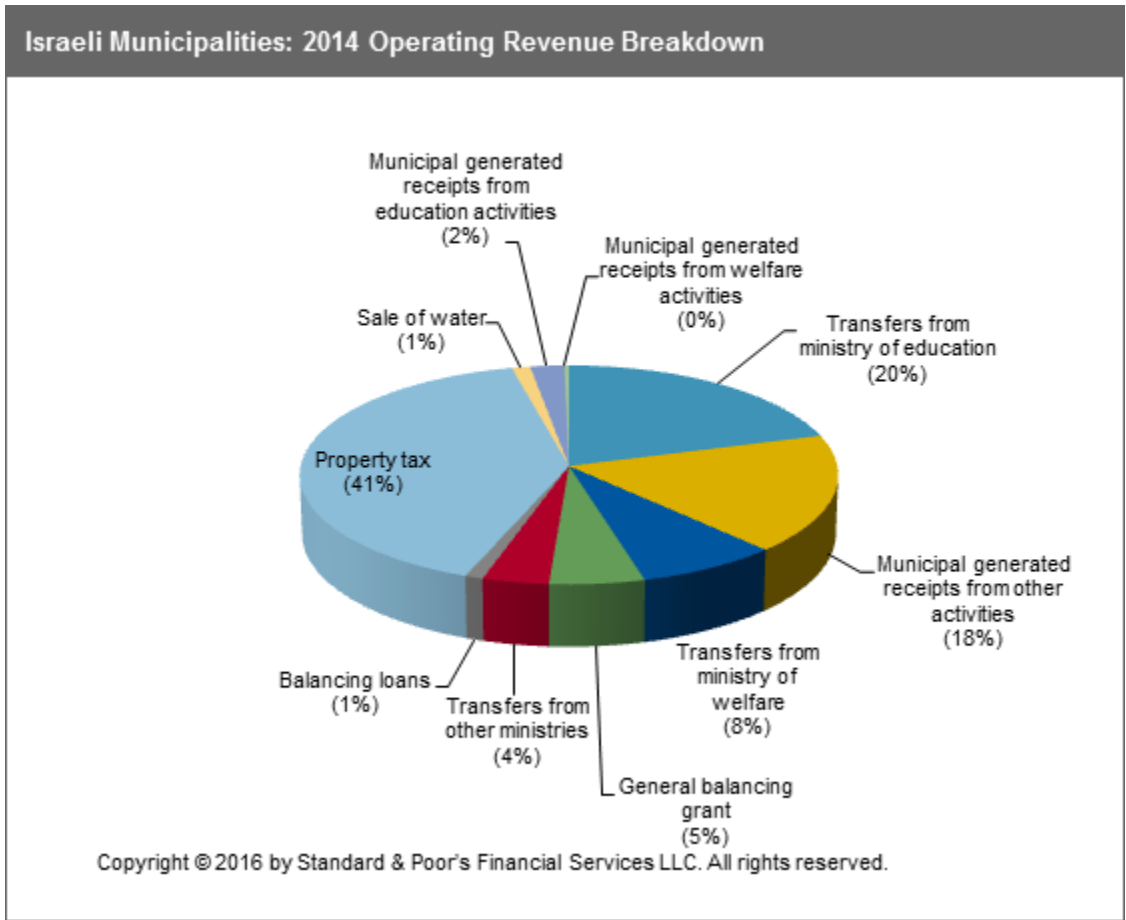


Chart 3

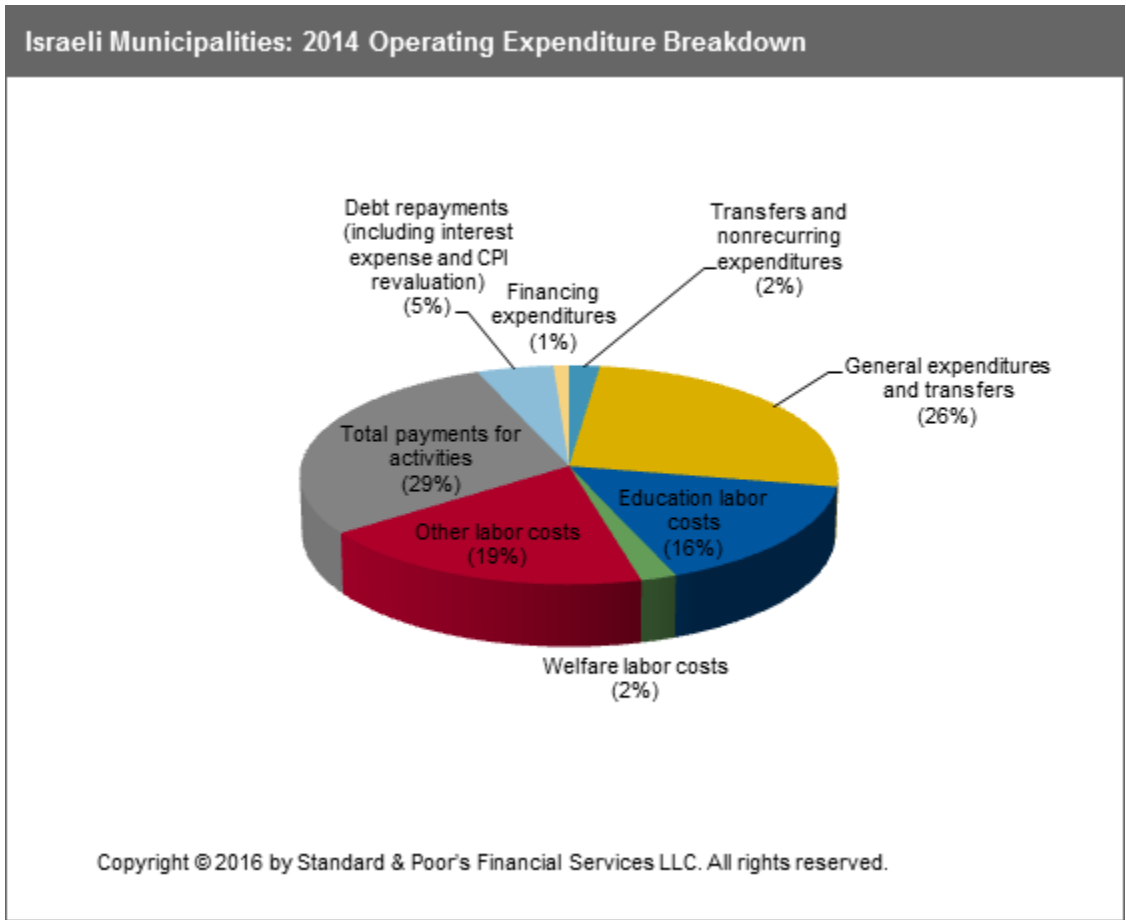
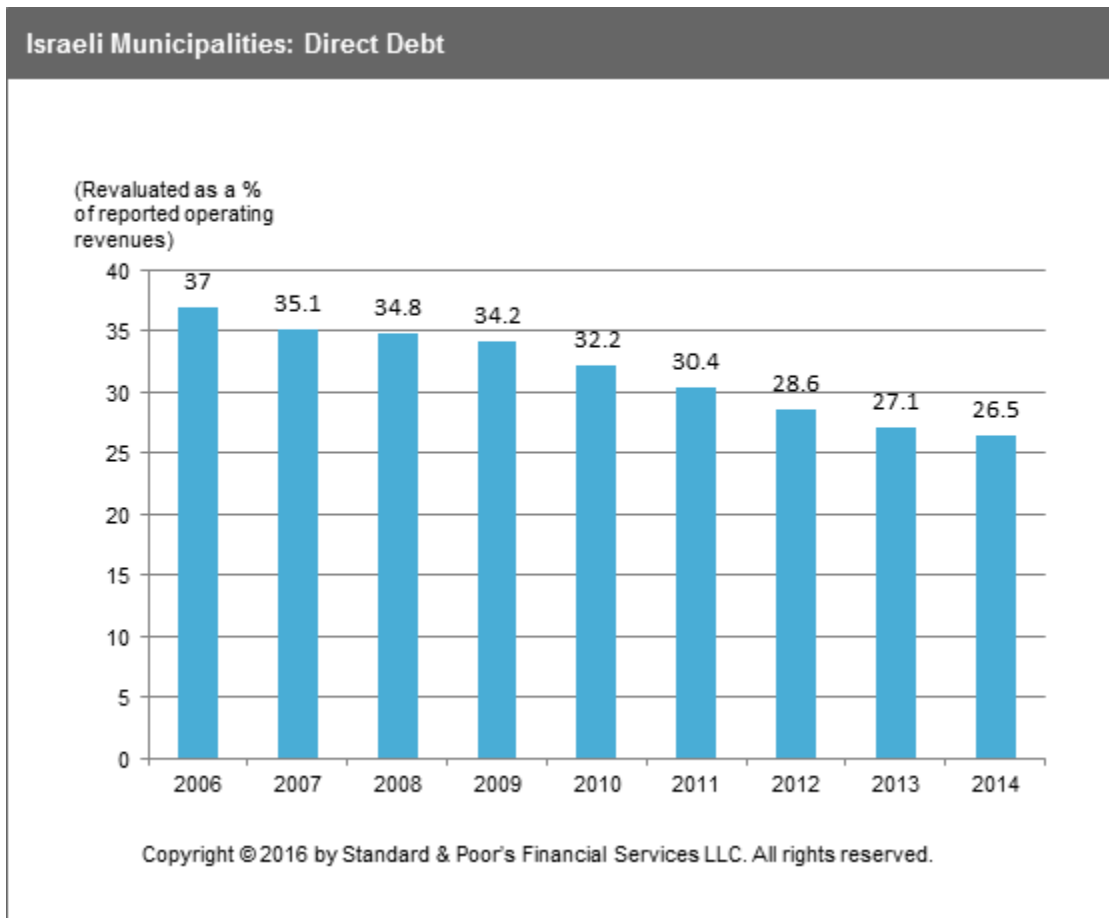


Chart 4



Fiscal policy framework

Israeli municipalities operate under tight regulatory supervision, which includes the requirement to present and operate according to a balanced operating budget and a balanced capital plan that can also include gross borrowing. Even so, not all municipalities keep to the balanced plan, which could lead to higher debt accumulation or accounting deficits on their balance sheets. The interior ministry must approve the municipalities' budgets, except for those defined as robust (9% of municipalities), which are given more independence in various decision making processes, namely approving and implementing budgets themselves. Every long-term borrowing activity must be approved by the interior ministry as well. The municipalities primarily take on debt to finance capital expenditures, although with some exceptions such as for raising balancing loans for the operating budget, covering accumulated deficits, refinancing loans, sewage infrastructure-related loans, and supplier loans.

Extraordinary support

Israeli municipalities do not enjoy formal credit support from the central government and there are no dedicated bail-out funds. However, we regard certain support mechanisms as extraordinary, including special grants to cover deficits, which are extended to weak municipalities that are unable to balance their accounts. The ad hoc support occurs through the grants, usually provided with conditions following the municipality's implementation of an efficiency program. Such programs include reducing the workforce, improving the tax collection system, and signing

settlements with creditors.

The central government can intervene in municipal affairs in certain defined circumstances. For instance, it can impose sanctions, such as appointing a financial comptroller/commissioner, dismissing the mayor, or forcing a merger with another municipality.

One recent example of extraordinary government support is a multi-annual plan drafted to support municipalities in the Gaza Envelope (Israeli region surrounding the Gaza Strip) through government transfers. The plan aims to help development in the area through government transfers from various ministries.

Transparency and Accountability

Transparency and institutionalization of budgetary process

Roles and responsibilities of elected officials and managers are relatively clear, with elected officials setting priorities implemented by managers. Some managerial positions in municipalities are considered to be positions of trust, appointed by the mayor. Generally, we believe there is good cooperation between elected officials and financial managers in the sector.

Operating budgets typically do not vary much over time, due to stable and noncyclical sources, and are usually approved by the city council prior to the beginning of the budgeted year. Adjustments to original budget proposals are often passed throughout the year, but usually do not include major deviations.

Disclosure and accounting standards

Accounting standards and budgetary processes are common to all Israeli municipalities, as determined by the regulator. The municipalities are required to use modified cash accounting, according to which revenues are recorded on a cash basis and expenses are recorded on an accrual basis. We view this as a very conservative approach. However, these principles fail to consolidate subsidiaries or record other liabilities, such as pensions, which are still viewed in Israel as off-balance-sheet. The central government audits the annual financial reports of all municipalities (usually in September of the following year), which they prepare according to Israeli Generally Accepted Accounting Principles.

Most municipalities own and manage a number of municipal companies operating in different sectors. The most important of these are usually water and sewage companies that often fully cover their costs through tariffs. These companies' data is not consolidated in the municipalities' accounts, which weakens the sector's transparency, in our view.

Control levels and reliability of information

Municipalities are obliged to plan their budget only one year ahead, but they often plan for capital expenditures by up to five years. Overall, financial reporting is periodic, and LRGs are required by law to prepare unaudited quarterly reports. The central government covers the costs for the external audits of the annual reports, which are usually finalized in September of the following year and then published on the interior ministry's website.

Trend: Stable

We expect Israeli municipalities' institutional framework will remain stable. The following developments could be positive for the institutional framework:

- The municipalities are legally entitled to receive budget balancing grants from the state, without additional approval needed;
- The central government raises the budget for balancing grants; or
- The regulator implements obligatory financial forecasting beyond the budgeted year.

In contrast, if the central government cuts the balancing grants budget drastically without an alternative plan, we would view this as negative for the institutional framework.

Related Criteria and Research

- Methodology for Rating Non-U.S. Local And Regional Governments, June 30, 2014
- Institutional Framework Assessments For Non-U.S. Local And Regional Governments, April 21, 2016

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Additional Contact:

International Public Finance Ratings Europe; PublicFinanceEurope@spglobal.com

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