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Public Finance System Overview:

Israeli Municipalities

January 17, 2019

Institutional Framework Assessment:

- Extremely predictable and supportive
- Very predictable and well-balanced
- **Evolving but balanced**
- Evolving and unbalanced
- Volatile and unbalanced
- Very volatile and underfunded

Trend:

- Improving
- **Stable**
- Weakening

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Major Factors Of The Institutional Framework For Israeli Municipalities

Strengths	Weaknesses
- Relatively stable intergovernmental system with clear distribution of roles and responsibilities.	- Low medium-term visibility due to no mandatory long-term financial planning.
- Strong oversight by the regulator.	- High variance among municipalities' characteristics and financial position.
- Low and diminishing debt burden.	- Low budgetary flexibility.

Recent Developments:

Israel's local and regional government (LRG) sector benefits from the positive economic developments at the national level via higher grants and transfers flowing into their budgets, as well as directly through higher revenues generated at the LRG level. In the past couple of years, Israeli LRGs have seen a few changes generally intended to reduce the differences between stronger and weaker municipalities, although major roles and responsibilities remained broadly unchanged.

First, the central government amended the general balancing grants formula, targeting a more progressive allocation of funds. The changes set a minimum income per capita level according to the LRG's socioeconomic cluster, which decreases the modeled revenue, and thereby increases the calculated grant. In addition, the central government increased the recognized expense for debt repayment taken into account in the formula, which means it also contributed to the allocated grant.

Second, the government adopted the abolition of the "immigrants city" status. In general, the government pays municipalities discounted property taxes for its assets in their jurisdiction. This discount did not apply in cities that were defined as immigrants cities, in order to strengthen their financial standing in light of potential higher expenses (e.g. on welfare) and weaker socioeconomic position of the population. Up until 2016, the Ministry of Interior, in conjunction with the Ministry of Finance, had the authority to declare a city as an immigrants city, although the guidelines were not clear enough, according to the state comptroller. As part of the 2017-2018 arrangement law, the government determined that the status of immigrants cities is canceled, and all governmental assets will receive a discount of 30%-55% on the municipal property tax in all municipalities. The government's savings from this move, together with additional budget, will be placed in a newly established fund to narrow the differences between Israeli municipalities. The funds will be distributed based on various characteristics, such as socio-economic standing, immigration statistics, and municipal property tax collection rate. We understand this measure will roll out gradually over the coming four to six years, which should enable the affected municipalities to gradually adjust their budgets accordingly.

Lastly, the state, through the Israel Lands Authority and the Ministry of Construction and Housing, has been expanding the scope of the roof agreements with LRGs. These are signed as part of the government's efforts to cope with various barriers in the housing market, and are generally aimed to increase the supply of new housing units in Israel. To date, 28 municipalities (11% of total) have entered such agreements, which constitute about 78% of the current overall approved limit of new housing units by the central government's decision. The development fees collected under the agreements, provide broad financing for development of infrastructures and public institutions, and often also cover the rehabilitation of older parts in the municipalities. As part of the agreements, the state usually provides pre-funding and assistance reducing red tape related to the planning process, while the municipality is in charge of developing the infrastructure and the active expedition of construction, through providing permits in a timely manner, for example.

The high share of governmental funding will mitigate financial needs in the short to medium term, and in most cases will also raise the level of existing infrastructure. In the long run, the effect on financials could vary quite a bit, depending on the commercial/industrial zones added, the expected balance between residential and businesses property tax receipts, and the actual ability of the municipalities to attract businesses to occupy these. Successful planning and implementation will enable these municipalities to counterbalance potential pressures on their budget stemming from the growing population, while others may need more government support and transfers to cope with the increased expenses.

Predictability:

Frequency and extent of reforms

Israel has a relatively stable system of two layers of government, the central government and the municipalities, which are formed either as cities, local councils, or regional councils. There are various laws and regulations setting the general duties and responsibilities of municipalities; the vast majority of them were codified in the 1960s, although building on governance concepts going back as far as the 1930s. While these laws and regulations are frequently amended, material changes have not been implemented. Reforms continue to be discussed intensively, but we understand they are not aimed at modifying the main roles and responsibilities of municipalities. Most changes to date focused on funding mechanisms and clarifications within the legal and fiscal frameworks. For example, increasing the flexibility around the property tax calculation method has been debated for some time, particularly with regards to managing potentially lower revenues from the main municipal tax as a result.

In the early 2000s, the central government cut back on its main item of support, the general balancing grants. This has led to financial distress, mainly in weaker municipalities, which led the ministries (interior and finance) to retract the amendment to this grants' budget. Since then, we believe the ministries are markedly more committed to the financial stability of the municipalities, and we currently do not expect that support from the government will be drastically cut again. One example of this approach was seen in 2014, when financially strong municipalities contributed to this grant's budget in exchange for higher increase in municipal property tax rates, to counterbalance an expected decrease in the overall budget. Moreover, we understand that the recent and proposed changes done in the systemic support were extensively discussed with various municipalities and their representative bodies.

Ability of LRGs to influence or oppose reform

The state parliament has no second chamber representing the municipal sector. As such, the framework does not enable municipalities to formally challenge or oppose bills and decisions made at the central government level. Municipalities can, however, influence the central government's decision via consultations, which often take place prior to implementing a relatively major change. The municipalities are mainly represented by two bodies: the Federation of Local Authorities in Israel, representing all municipalities and local councils in Israel, and Forum 15, an association of the 15 financially strongest and independent municipalities. Forum 15 continues to be the main and stronger body, but both entities enjoy relatively good bargaining position when discussing with the central government.

Revenue And Expenditure Balance:

Overall adequacy of revenues to cover expenditures needs

Overall, in our view, Israeli LRGs' revenues adequately cover their expenditure needs, although they have very low flexibility to adjust revenues. Operating revenues mainly comprise municipal property tax and government transfers (46% and 33%, respectively, of operating revenues in 2017). While we view both as very stable revenue streams, they are set at the central government level.

As such, LRGs mainly depend on the efficiency of collection of the municipal property tax, which is often the most important revenue stream for a local government. This 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 one needs be approved by the Ministry of Interior, which usually approves such requests when the tax rate is substantially lower than in neighboring municipalities or in municipalities that are undergoing a recovery plan.

The government transfers are mainly aimed at covering expenses related to education and social welfare, where a matching funding system exists on pre-defined expenses, although municipalities often provide better services to their residents, which decreases the overall share of these transfers in the corresponding expenses.

While Israel does not have a formal equalization system, if the abovementioned revenue sources are insufficient to cover expenditures, the municipalities can lean on a relatively solid ongoing systemic support from the central government in the form of grants. The most common grant is the general balancing grant, which is set to cover the gap in operating budgets between revenues and expenditures, aimed to secure a basic defined basket of services for the inhabitants. Most municipalities (184 of 257 in 2017) are entitled to receive this grant, which has been budgeted for the whole sector at around Israeli new shekel (ILS) 3.15 billion (about $860 million) for 2019 (about 5% of the sector's expected operating revenues).

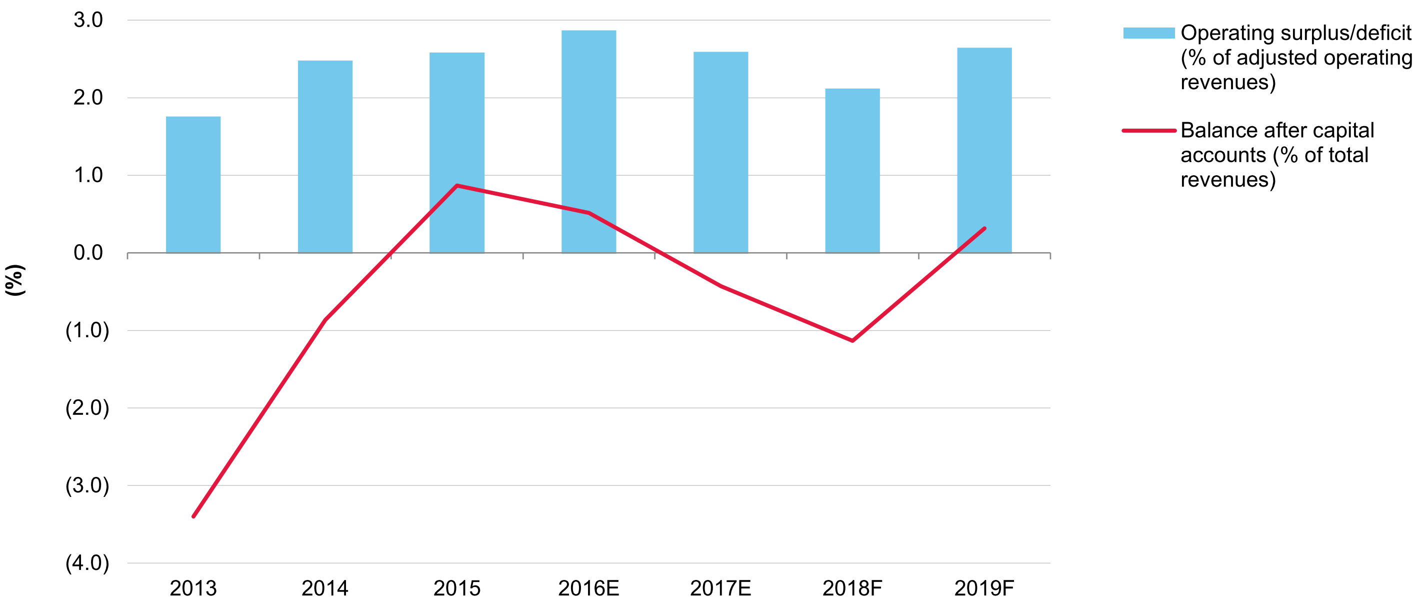
Other types of grants include development grants given for specific projects, those that are given as part of recovery processes, the abovementioned fund to reduce the gaps among Israeli municipalities, and smaller grants that are allocated on the ministry's discretion. The 2019 budget of the total additional grants is about ILS700 million (approximately 1% of the expected sector's operating revenues).

In our view, the overall stable revenue sources lead to balanced performance, which together with a centralized system at the government level mitigates external funding needs for municipalities. This is reflected in the fairly constant absolute debt levels and steadily decreasing debt burden as a percentage of continuously growing operating revenues. With a few large scaled projects we assume debt will slightly increase in nominal terms over the next two to three years, although we expect it will remain structurally below 30% of operating revenues. We estimate LRGs' 2017 direct debt of about ILS15.5 billion, including the municipalities' short-term credit lines. This represents 27% of operating revenues, down from about 40% in 2006.

Overall, we expect continued economic growth will support stable performance in the sector and limit external financing needs. Growing population and increasing prices will result in larger budgets, which should also aid ongoing deleveraging. Nonetheless, we note that the 2018 municipal elections might have triggered slightly weaker annual operating results, although these are unlikely to have a major effect on the long-term, fairly stable trajectory of financial indicators.

Chart 1

Israeli Municipalities Budgetary Performance



E--Estimate. F--Forecast. Source: S&P Global Ratings, based on data from the Israeli Ministries of Interior and Finance.

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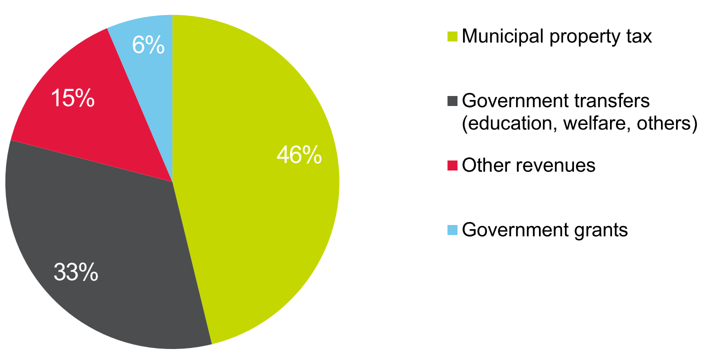
Chart 2

Israeli Municipalities Breakdown Of Operating Revenues, 2017



Source: S&P Global Ratings, based on data from the Israeli Ministries of Interior and Finance.

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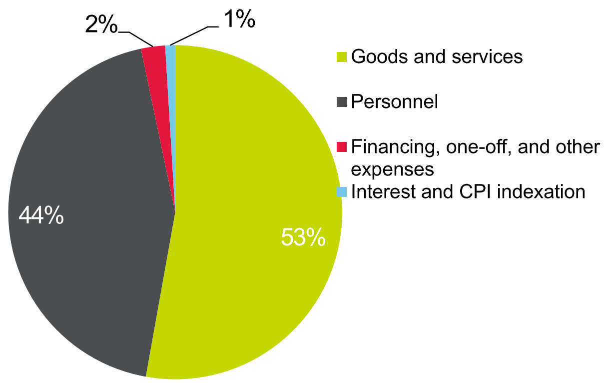
Chart 3

Israeli Municipalities Breakdown Of Operating Expenditures, 2017



Source: S&P Global Ratings, based on data from the Israeli Ministries of Interior and Finance.

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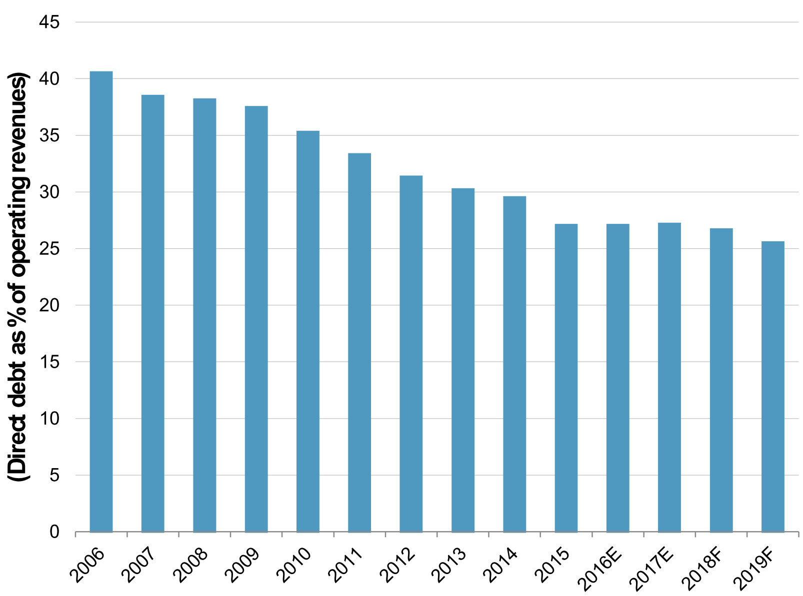
Chart 4

Israeli Municipalities Direct Debt



E--Estimate. F--Forecast. Source: S&P Global Ratings, based on data from the Israeli Ministries of Interior and Finance.

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Fiscal policy framework

Israeli municipalities operate under the Ministry of Interior's tight regulatory supervision. This framework includes the requirement to present and operate according to a balanced operating budget and overall budget (albeit including borrowing and debt repayments). The ministry also approves all municipal budgets, except those defined as robust. These municipalities (less than one-tenth) have more autonomy in various decision-making processes, including approving and implementing budgets independently. New debt intake must be approved by the Ministry, too. Borrowings are done primarily to finance capital expenditures, although in more rare cases can also be used to balance the operating budget, covering accumulated deficits and paying suppliers. In the past few years we have also seen a lot of municipalities taking advantage of current favorable market conditions to refinance their debt with cheaper loans.

Hence, while there is no target for deficits or debt-brake rule, municipalities are overall adequately monitored. Nevertheless, we believe that structural vulnerabilities or weaker management teams will continue to challenge some LRGs' adherence to the balanced plan requirement, which often leads to higher debt accumulation or increased balance-sheet liabilities.

Extraordinary support

Israeli municipalities do not have formal credit support from the central government and there are no dedicated bail-out funds. Nonetheless, some of the support mechanisms can be viewed as extraordinary. The ad hoc support occurs through grants, usually provided with conditions following the municipality's implementation of an efficiency/recovery plan, or other specific programs municipalities can apply to. Such programs usually have targets of reducing costs, improving the tax collection rates, or increasing the labor force participation, among others.

Other governmental initiatives include regional- or sector- specific programs, like the multi-annual program to support economic development in LRGs with minorities populations 2016-2020. This program has a total budget of ILS1.2 billion (2% of operating revenues in 2017), allocated mainly for capital grants, but also to improve preparedness for emergencies, and to develop revenue sources and growth, as well as strengthen human capital in Arab municipalities defined as excellent.

In addition to tightly monitoring the developments and financial discipline of LRGs, the Ministry of Interior can also intervene in municipal affairs in certain defined circumstances, usually when it identifies misconducts in management. Such measures may include appointing a financial comptroller, dismissing the mayor and council, and declaring new elections.

Transparency and Accountability:

Transparency and institutionalization of budgetary process

The distribution of roles and responsibilities within municipalities, in our view, is relatively clear and well defined, with elected officials setting priorities that managers then implement. Some managerial positions are considered to be positions of trust, appointed by the mayor. We believe there is usually good cooperation between elected officials and financial managers across the sector and professional teams are usually stable over political cycles, although political considerations can affect financial decisions from time to time.

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 start of the budgeted year. Adjustments to original budget are often passed throughout the year, but deviations usually occur to both revenues and expenses due to the balanced budget requirement. The capital side could be more affected by cyclical revenue sources, given it includes construction and development fees and levies, and hence to the corresponding approvals of municipal plans. Municipalities aim to collect those prior to executing the related works, which we consider a prudent approach, although not practiced by all municipalities.

Disclosure and accounting standards

Accounting standards and budgetary processes are common to all Israeli municipalities, as determined by legislation and the regulator. In general, municipalities use modified cash accounting, according to which revenues are recorded on a cash basis and expenses are recorded on an accrual basis, which we view as conservative reporting. However, these principles do not consolidate subsidiaries nor capture other liabilities, such as pension liabilities and financial debt stock, under the municipalities' balance sheets, and they are still considered as off-balance sheet items.

Most municipalities own and manage a number of municipal companies and fellowships operating in different sectors, although in the vast majority of municipalities the size of the company sector remains limited. The financial data of this sector is not consolidated into the LRGs' reports, which weakens the sector's transparency, in our view. Municipal companies audit their reports externally, although the availability of these reports remains subjected to the municipality's judgement and is generally still lacking.

Control levels and reliability of information

Local requirements include mandatory financial reporting. LRGs internally prepare unaudited quarterly reports, and annual reports are externally audited and finalized toward September of the succeeding year. All reports are submitted to the Ministry of Interior for monitoring, and are approved at the municipal council. While the intra-annual reports are not always made public, the annual reports are accessible on the websites of the municipalities or at the ministry of interior website.

A cross-sector weakness when comparing the Israeli system with others is the short-term horizon of financial planning. The local regulation requires Israeli municipalities to budget only one year ahead, which we view as short. Some LRGs implement multi-year (up to five years) planning for capital expenditures, but this approach is taken more on a discretionary basis, and the actual execution often deviates from the plan, which is often modified as needed.

Trend: Stable

Overall, we expect the framework for Israeli municipalities to remain relatively stable and balanced. While changes are likely still pending, we expect these will be well thought out and responsibly embedded. The following developments could be positive for the institutional framework:

- The central government structurally raises the general balancing grants budget or a legal basis of municipalities over these funds is guaranteed; and

- Implementation of medium-term realistic financial planning beyond the budgeted year, with stronger accountability across the sector.

Conversely, we would view as potentially detrimental the central government's decision to cut the balancing grants budget, or other transfers, drastically without an alternative plan.

Related Criteria

- Methodology for Rating Non-U.S. Local And Regional Governments, June 30, 2014

Related Research

- Institutional Framework Assessments For Non-U.S. Local And Regional Governments, Nov. 6, 2018

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