Public Finance System Overview:

Israeli Municipalities

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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

Major Factors

Strengths	Weaknesses
Relatively stable intergovernmental system with clear distribution of roles and responsibilities.	Low medium-term visibility due to a lack of long-term financial planning.
Strong oversight by the regulator.	High variance among municipalities.
Solid ongoing systemic support from the central government (CG).	Low budgetary flexibility.

Recent Developments:

The Israeli CG has taken several measures over the past year to support the local and regional government (LRG) sector and minimize the COVID-19 pandemic's effects on its finances. In the opening two months of the pandemic, from March to May 2020, the CG forced many businesses to close but also introduced property tax holidays. To avoid revenue losses, the CG fully reimbursed LRGs for these holidays, except for municipalities with robust finances, which were entitled to 92% reimbursement. Following this, in June 2020, the CG introduced a new program, running until

June 2021, under which it provides 95%-100% discounts on property tax for businesses that lost significant revenue as a result of lockdown measures. Once again, LRGs were reimbursed for the revenue losses resulting from this discount. Outside of reimbursement, the CG has also provided direct support, increasing its earmarked and general transfers for specific LRGs, and continuing to contribute its share to LRGs' education and wealth expenses.

In spite of the CG's efforts to support LRGs, businesses, and households, S&P Global Ratings believes that some businesses will not recover from the pandemic, leading to revenue losses for LRGs not covered by the CG. In addition, we expect a decrease in residential property tax collection, since many households' finances have deteriorated and the unemployment rate is still high compared with the pre-COVID-19 period. Another aspect of revenue loss is demonstrated in LRGs' self-revenue, mostly from cancelled activities. Although a relatively large share of activities and other expenses were cut in parallel, some LRGs did not end 2020 with an operating balance, forcing them to increase debt. As a mitigating measure, the CG approved LRGs requests for new loans from commercial banks following revenue losses. Overall, some vulnerable LRGs might see their finances deteriorate, but the CG has prevented significant effects on most.

The sector still suffers from high inequality between stronger and weaker municipalities, which leads to different public service quality funded or supplied by LRGs. To equalize service levels, weaker municipalities have to rely on higher CG grants and increase their debt. Grants are reallocated to weaker LRGs under clear guidelines, such as socio-economic status, geographic location, and tax collection rate. The CG has also tried to help LRGs via long-term financial support for the creation of new revenue sources, alongside investing in human capital and improving performance equality. However, the absence of an efficient equalization system means gaps remain material.

Another recent development relates to roof agreements, which were signed with about 30 LRGs as part of the government's efforts to increase new housing supply. This includes broad financing for infrastructure development and public institutions with limited debt exposure and is still underway, but progress has been very slow. In our view, one reason for this is that earmarked grants are not sufficient for cities to cover the public service needs of their expanding populations, which leads to deficit accumulation. In addition, the agreements do not include development of commercial centers, which have higher tax receipts than residential assets and can boost city treasuries. Therefore, we could see higher debt at participating cities in the coming years following revenue and expenditures imbalances, or, most likely, a slowdown in the implementation of agreements.

Predictability:

Frequency and Extent of Reforms

Various laws and regulations set the general duties and responsibilities of municipalities. Most were codified in the 1960s, although they build on governance concepts as far back as the 1930s. Israel has a relatively stable system of two layers of government, the CG and 257 municipalities and regional councils. Although Israel's LRG sector is an agent that supplies public services and collects taxes and fees (self-revenue) in return, the CG determines the nature of some services and finances them via transfers and grants. There have been attempts to reshape intergovernmental relations but these ended without change, and so LRGs responsibilities have remained stable in terms of legislation over the years. Nevertheless, some financial developments have occured, focusing on funding mechanisms. The last important change was in 2004, when the CG drastically cut its grants to LRGs, leading to severe financial stress. Since then, grants have gradually increased, with the formula occasionally modified, and LRGs' financial stability has improved. However, most LRGs still suffer from a low self-revenue share and large dependence on CG transfers, excluding a small group of robust municipalities.

Except for the events of 2004, a scenario of reduced support to LRGs has never been tested. In recent years, the CG could always afford to provide ongoing support to LRGs for day-to-day activities, while not leaving them with increased borrowing needs. We have no means to evaluate the revenue and expenditure balance and the capacity and willingness to cut expenditure and repay future debt in such a case, when the CG steps out. This open question effectively prevents us from increasing the institutional framework scores.

Another potential change relates to the property tax system, mainly to consolidate different asset classifications, unify the calculation method, and possibly allow municipalities to set rates within certain brackets. However, these reforms have been explored by special committees with members from municipalities, and the ministries of finance and interior for many years, leading us to believe them unlikely to be implemented soon.

Ability of LRGs to Influence or Oppose Reform

The state parliament has no second chamber representing the municipal sector. As such, municipalities are unable to formally challenge or oppose bills and decisions made at the CG level. However, they can influence CG decisions via discussions and consultations. We believe LRGs have good bargaining positions in discussions with the CG, since they are regularly involved in the design of national reforms and decisions relating to the municipal sector. Municipalities can affect CG decision making processes through informal vehicles, such as lobbying or threatening strikes if their voice is not heard, as seen on occasion. Municipalities can also block, or at least slow, some large regional transportation and infrastructure projects in their jurisdiction area, because these projects require the relevant municipal consent. The two main municipal organizations that drive such discourse with the CG are the Union Federation of Local Authorities in Israel, which represents all the country's local and regional municipalities; and Forum 15, which comprises the 15 financially strongest and most independent municipalities.

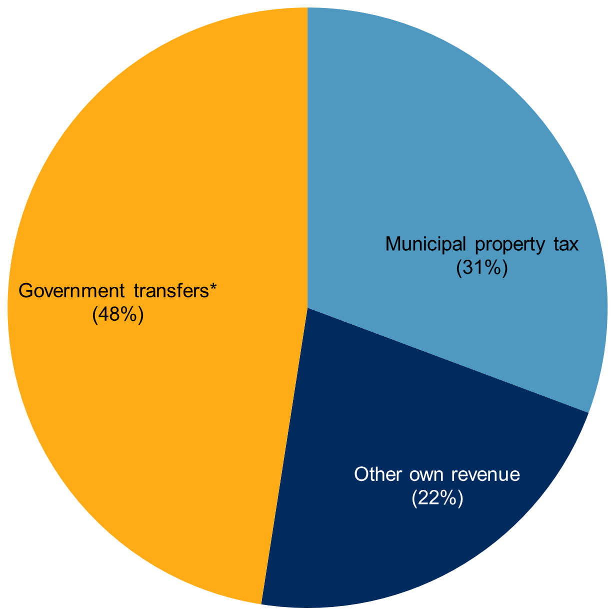
Revenue and Expenditure Balance:

Overall adequacy of revenues to cover expenditures needs

We view the overall adequacy of Israeli LRGs' revenues to cover expenditure needs as good, although they have very low flexibility to adjust revenue. Operating revenue comprises municipal property tax and other own revenue from fees, as well as government transfers and grants. We view these as very stable revenue streams (see chart 1).

Chart 1

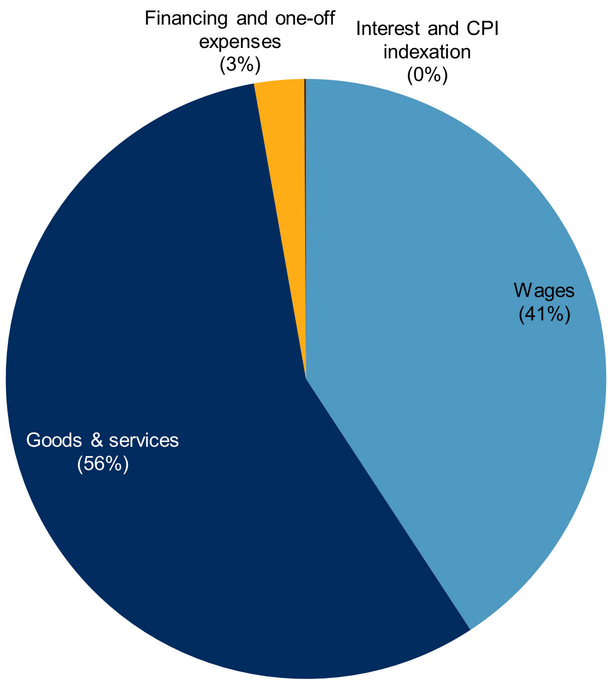
Israeli LRGs' Estimated Operating Revenue Split In 2020



*Central government reimbursement on property tax holidays included under government transfers and not municipal property tax. LRG--Local and regional government. e--Estimate. Source: S&P Global Ratings.

Chart 2

Israeli LRGs' Estimated Operating Expenditure Split In 2020



e--Estimate. CPI--Consumer price index. Source: S&P Global Ratings.

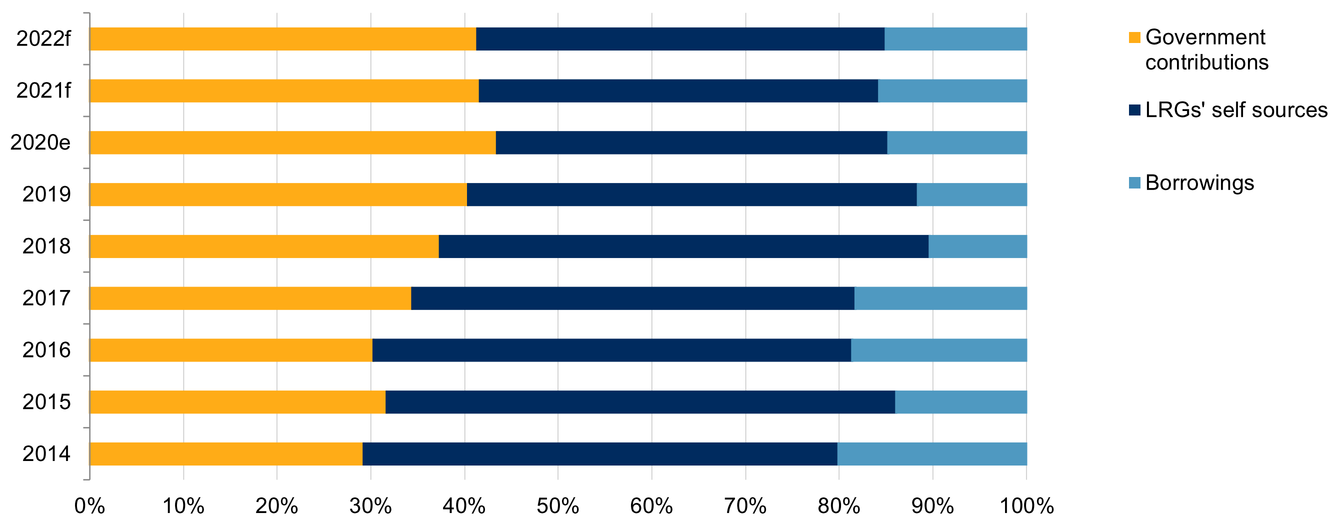
The municipal property tax rate--often the most important revenue stream for an LRG--is determined by the municipality within a bracket determined by the Ministry of Interior, and is subject to its approval. The ministry has an automatic annual update mechanism calculated using a formula that reflects inflation, public sector wage increases, and the property's purpose. Business property tax tariffs are higher than residential ones, with financially stronger municipalities most likely to show a higher share of business property tax. Residential property tax is based on the property's area and not its value or the number of residents. It is also exposed to different discounts decided by the CG and by the LRGs. Overall, residential property tax receipts are in most cases not sufficient to cover the costs of public services provided to residents. In turn, LRGs prefer not to rely on residential property tax, since nonresidential tax revenue subsidizes the municipal public services provided to residents. Therefore, municipalities try to promote commercial and industrial zones development rather than focusing on residential zones. The CG tries to bridge this gap via grants and contributions and incentivizes municipalities to develop residential space with special programs, such as roof agreements.

With respect to government transfers, the CG regularly grants contributions to all municipalities for education and social welfare activities based on a formula. Municipalities can decide to increase their educational and social welfare expenses above the governmental contributions if they have sufficient resources for this purpose. Some of these grants are based on a match-funding system--if the municipality is unable to afford or intentionally avoids participating in service funding from its self-revenue, the governmental grant is not allocated. These differentiations can increase inequality.

The CG also helps finance projects included in municipalities' capital plans, with a focus on infrastructure and public institutions such as schools. In 2019, the government's share of LRGs' capital revenue was about 40% (see chart 3).

Chart 3

Israeli LRGs' Capex Funding Sources Split Up

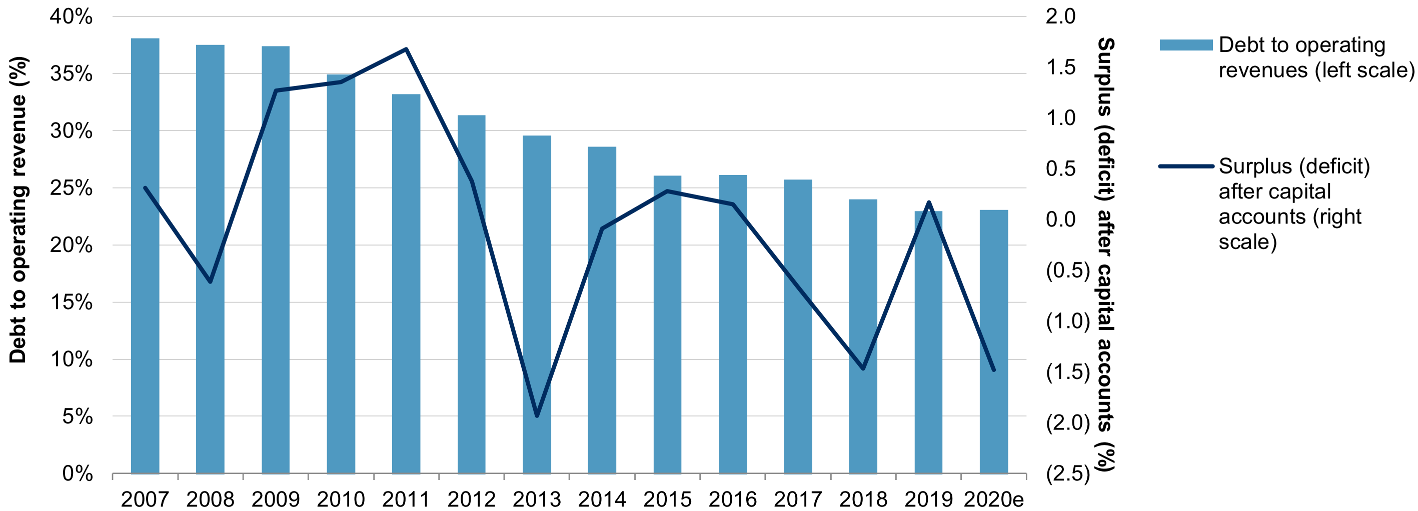


LRG--Local and regional government. Capex--Capital expenditure. e--Estimate. f--Forecast. Source: S&P Global Ratings.

Overall, we think the CG has continued its commitment to municipalities after lessons learned in the past. In our view, overall stable revenue sources, combined with government grants and transfers, lead to balanced performance. Together with a centralized CG support system, this mitigates external funding needs for municipalities. As reflected in relatively stable nominal debt levels and a steadily decreasing debt to operating revenue ratio (see chart 4).

Chart 4

Israeli LRGs' Debt And Deficits



LRG--Local and regional government. e--Estimate. Source: S&P Global Ratings.

We recognize a continuing small deficit after capital accounts in the past few years, which we assume will remain due to the COVID-19 pandemic. We think that some large projects could be canceled or delayed, because of a decline in fees collection, and since the CG may refocus and consolidate spending. As a result, we expect LRGs' debt to slightly increase in nominal terms over the next two-to-three years, although their share of operating revenue will remain stable at below 30%, thanks to COVID-19-related transfers from the CG and LRGs' expected recovery and growth.

Fiscal Policy Framework

Israeli municipalities operate under tight regulatory supervision from the Ministry of Interior. This framework includes the requirement to present and operate according to a balanced operating budget and capital plan for financing activities. Stronger LRGs have balanced budgets and do not accumulate deficits, but weaker ones may breach fiscal limits unless they are strictly supervised. In general, the fiscal policy framework helps LRGs to maintain sustainable finances and in this sense achieves its goal. As a result, LRGs do not take on risky levels of leverage or increase their dependence on the CG (and effectively on tax payers), but they are also limited in the public service levels they can provide.

The regulator approves the municipalities' budgets, except for those it defines as robust (27 municipalities), which are given more independence in various decision-making processes and can approve and implement budgets independently. An LRG's capital plan should be detailed and must include descriptions of every project being executed--with timing, costs, and financing resources--for approval by the regulator. In addition, new debt must be approved by the Ministry of Interior. LRG borrowings are primarily used to finance capital expenditure (capex), although in rare cases they can also be used to balance the operating budget, cover accumulated deficits, and pay suppliers. Credit lines are limited to 5% of the municipal budget and guarantees 10% of the budget. In the past few years, we have seen many municipalities take advantage of favorable market conditions to refinance their debt with cheaper loans.

Hence, while there is no target for deficits or a debt-brake rule, municipalities are adequately monitored overall. Nonetheless, 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 balance sheet liabilities. Such situations could be exacerbated if too high a deficit negatively affects the amount the municipality is granted, as derived from the formula.

Exceptional Support

Israeli municipalities do not enjoy formal credit support from the CG and there are no dedicated bail-out funds. Nonetheless, some of the support mechanisms can be viewed as extraordinary. Ad-hoc support occurs through grants, usually provided with conditions following the municipality's implementation of an efficiency/recovery plan, or other specific programs. Such programs usually have targets of reducing costs, improving tax collection rates, increasing labor force participation, or are extended because municipalities have unique characteristics. The CG may also interfere when financial stress is expected to occur. In light of the COVID-19 pandemic, the government increased its support to municipalities until June 2021, compensating them for lost property tax revenue related to lockdowns and the economic contraction.

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 management misconduct. Such measures may include appointing a financial controller, dismissing the mayor and council and declaring new elections, and even forcing mergers with other municipalities.

Transparency and Accountability:

Transparency and institutionalization of budgetary process

In our view, roles and responsibilities distribution between the CG and municipalities is relatively clear and well defined. This also applies to relationships within municipalities, where elected officials set priorities that are implemented by managers. Some managerial positions are positions of trust, appointed by the mayor. We believe there is usually good cooperation between elected officials and financial managers across the sector, although political considerations affect financial decisions from time to time.

Operating budgets are typically approved by the city council before the beginning of the budget year. Adjustments to original budget proposals are often passed throughout the year, but deviations usually occur in both revenue and expenses. 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 these fees prior to executing the related works, which we consider a prudent approach, although this is not practiced by all.

In 2018, the CG partially adopted the recommendations of a designated governmental work team, which dealt with ways to increase transparency and rule of law for municipalities. Its recommendations focused in the special position of the gatekeepers of the municipality and ways to broaden their responsibilities and other aspects of ethics and transparency. Efforts to revise the municipalities law in parliament started but have yet to be concluded, after the parliament was dissolved and elections were announced for March 2019. The several rounds of elections since then have meant little progress, but we believe the revision will be completed in the coming years.

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 revenue is recorded on a cash basis and expenses are recorded on an accrual basis, which we view as conservative. However, these principles do not consolidate subsidiaries nor capture other liabilities, such as pension liabilities and financial debt, under the municipalities' balance sheets. Notably, the latter is still considered to be an off-balance-sheet item.

Most municipalities own and manage several municipal companies and fellowships operating in different sectors, although in most cases the size of this sector remains limited. Generally, LRGs own and manage a city's water and sewage company, economic company, which is in charge of executing infrastructure projects, and sometimes also cultural or sport events. Large municipalities, such as Tel Aviv, may hold more than two or three municipal companies, such as the parks company or the urban renewal company. The financial data of these companies 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 subject to the municipality's judgement and is generally still lacking. That said, some regulatory moves were taken to improve municipal companies' accountability and transparency.

Control levels and reliability of information

Periodic financial reporting is required by law, and LRGs internally prepare unaudited quarterly reports, while annual reports are externally audited and finalized toward September of the succeeding year. These reports are submitted to the Ministry of Interior and approved at the municipal council. Although intra-annual reports are not always made public, annual reports are accessible on the Ministry of Interior or municipality websites, as well as other financial databases.

Local regulation requires Israeli municipalities to budget only one year ahead, although some LRGs implement multi-year (up to five years) planning for capex. One reason for this short-term planning is that the sector is quite highly dependent on CG transfers, which may change over time according to the approved national budget and government priorities. Moreover, LRGs' capital revenues mainly depend on development fees, which tend to be more volatile and cyclical. This may result in limited flexibility and in turn limited capability for long-term planning. We see the short-term nature of planning as a cross-sector weakness when comparing the Israeli system with others, and we don't think this will change in the foreseeable future.

Trend:

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

- If the CG structurally supports LRGs and takes necessary measures to prevent deterioration in their finances;

- Should gaps among municipalities narrow via different allocation of CG grants and transfers; and
- Through implementation of medium-term realistic financial planning beyond the budgeted year, with stronger accountability across the sector.

In contrast, if the CG cuts the balancing grants budget, or other supportive transfers, drastically without an alternative plan, we would view this as negative for the institutional framework.

Related Criteria

- Methodology for Rating Local And Regional Governments Outside Of The U.S., July 15, 2019

Related Research

- Institutional Framework Assessments For International Local And Regional Governments, Sept. 25, 2020

This report does not constitute a rating action.