

Institutional Framework Assessment:

Israeli Municipalities

February 3, 2025

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PRIMARY CREDIT ANALYST

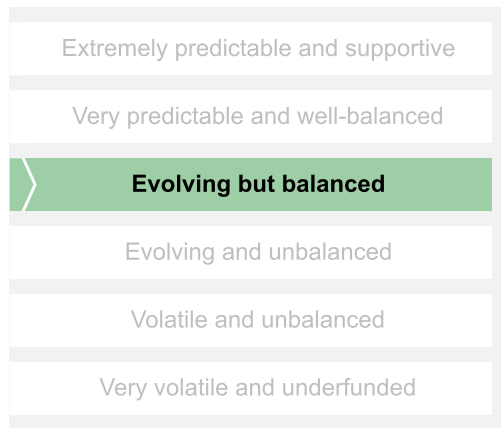
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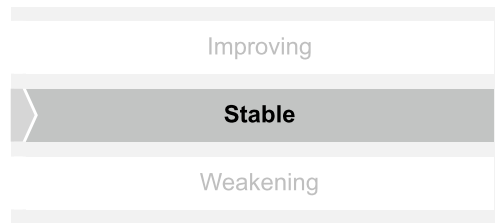
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Institutional Framework Assessment:



Trend:



Highlights

Strengths

Relatively predictable system, with some municipalities able to modify central government policy initiatives.

Adequate revenue-spending balance, resulting in low and declining municipal debt.

Clear distribution of roles and responsibilities.

Stringent fiscal rules, effectively enforced by the central government.

Weaknesses

Regional conflicts could strain the central government's fiscal position and impair its capacity and willingness to maintain municipalities' financial stability.

Low flexibility to increase revenues or cut expenditures.

No mandatory long-term financial planning.

The immediate implications from regional conflicts on municipal finance are limited. This is not least due to resilient tax revenues and the steady flow of grants. Yet uncertainty remains about the conflicts' lasting effects on Israel's long-term growth and public finances.

We view the central government's commitment to preserving municipalities' financial stability as strong. The central government's ability to maintain an adequate municipal revenues/spending balance and enforce fiscal rules has been tested in previous shocks. During the Israel-Hamas war, the central government supported local and regional governments (LRGs) via different grants to mitigate increasing security expenses and provides homes to refugees, among others. Considering the Israel-Hamas ceasefire, we anticipate an economic recovery in 2025. We forecast that property taxes will remain a stable and resilient revenue source for municipalities, thanks to effective fiscal management.

Weaker capital revenues and expensive construction projects will likely lead to minor deficits after capital accounts in 2025, which might be covered by additional borrowings over the short term. Due to the war, capital revenue inflows could reduce as capital grants will increase at a slower rate than before. Additionally, municipalities' revenues will grow at a slower rate because of the economic slowdown. Concretely, the decrease in demand for real estate will reduce construction fees and the shortage of construction workers due to the war will delay projects, which will curb revenues from betterment levies. We project depleting cash buffers and additional borrowing will cover the resulting modest deficits. This will increase debt over the short term, albeit from a low 22% of operating revenues. Based on the expected recovery in budgetary performance over 2026-2027, municipal debt will normalize.

In 2024, the central government established a property tax fund to encourage municipalities to build residential houses. The new property tax fund stipulates that each municipality will transfer approximately 10%-28% of annual property tax revenues collected from businesses to a specific fund. The money from the fund will be distributed to encourage residential construction in municipalities with a low economic status. Yet we expect large revenue gaps between municipalities will remain. Higher ad-hoc grants by the central government and contributions to weak LRGs will partly address these gaps.

Trend: Stable

We could revise upward our assessment of the institutional framework in Israel if the revenue/expenditure balance strengthens, supported by a higher share of modifiable revenues or more predictable central government grants, along with improved fiscal transparency through comprehensive fiscal accounting for government-related entities (GREs) and enhanced local government accountability.

We could revise downward our view of the institutional framework in Israel if municipalities' revenue/expenditures balance deteriorates due to the transfer of responsibilities to municipalities without adequate revenue sources. This could weaken fiscal stability and impair financial predictability at the local level.

Predictability Of The Framework

Israel's stable two-tier government system suggests that the financial effects from the war on municipalities will remain neutral, while operational efficiency will improve. Most laws that determine municipalities' general duties and responsibilities were codified in the 1960s and have since undergone several reforms. LRGs' responsibilities have remained largely intact over the years. Despite looser regulation and the shift of some regulatory responsibilities to the local level, we expect these changes will have no financial effects on the sector. For example, in recent years, the Ministry of Transportation had transferred powers to LRGs and allowed them to manage many aspects of transportation, including how and when to act.

The structure of the property tax, which depends on the property area and the type of use, could undergo more reforms, particularly because LRGs' related revenues differ significantly. In recent years, several reform proposals have been submitted on different issues, including the local autonomy over tax rates, differences between residential and non-residential rates, the need to reduce inequality, and constrained housing supply. The central government or financially strong LRGs rejected all of them.

The approval of the property tax fund in 2024 represents a significant shift in Israel's local governance. The fund, which necessitates adjustments in municipalities' financial strategies, aims to (i) reduce disparities among municipalities, (ii) stimulate economic growth in weaker areas, and (iii) enhance housing availability. We expect the redistribution of funds will encourage residential construction in less affluent areas, which could increase housing availability and improve living conditions. The implementation of the law will likely have immediate effects on municipal budgets and planning as local governments will have to adjust their financial strategies in anticipation of reduced property tax revenues. Additionally, the fund could stimulate economic growth in weaker municipalities as they become more populated. Tax revenues will gradually increase, leading to more balanced regional developments across Israel. Overall, the fund is a proactive step toward addressing inequality and promoting sustainable urban development.

Municipalities maintain some control over local governance and project implementation. They effectively influence national decisions through associations, former mayors in parliament, and informal tactics, such as lobbying and strikes. Even though municipalities cannot formally oppose bills and decisions by the central government, they can exert political pressure via associations. These associations use their bargaining power to influence decisions as they are regularly involved in the design of national reforms and decisions about the municipal sector. Former mayors that now serve as parliament members are also able to represent the sector's interests in the parliament and can oppose decisions. Additionally, municipalities can affect the central government's decisions through informal vehicles. Municipalities can also block, or at least delay, some residential and infrastructure projects in their jurisdiction area as these projects require municipal cooperation.

Revenue And Expenditure Balance

Municipalities demonstrate adequate revenue generation capabilities to meet expenditure mandates, supported by stable operating surpluses. That said, municipalities' revenue flexibility is limited by regulatory constraints. The sector recorded operating surpluses over recent years and, on average, balanced its budgets after capital accounts. In general, municipalities' ability to change local revenue sources--including the tax base and tax rate--is limited. The range of the rate increase is predetermined by the Ministry of Interior and approved by the regulator,

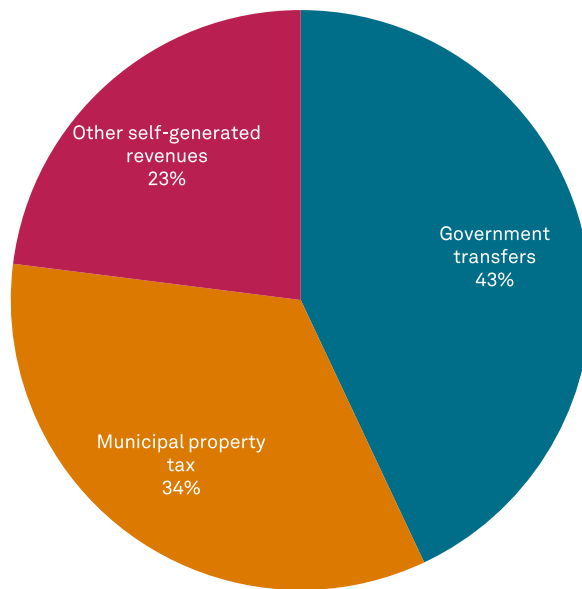
Institutional Framework Assessment: Israeli Municipalities

resulting in only moderate revenue flexibility. The central government determines the nature of some services, meaning some transfers--for example, teachers' salaries--are pass-through items only. We view the sector's revenue base as very stable (see chart 1). Operating revenues comprise municipal property tax revenues and other revenues from local fees and municipal activities, as well as government transfers and grants (57% and 43%, respectively, of operating revenues in 2024). The municipal property tax rate has an automatic annual update mechanism, which reflects inflation and the wage increase in the public sector.

Chart 1

Government transfers will account for most operating revenues in 2025

Breakdown of Israeli LRGs' forecast operating revenues



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

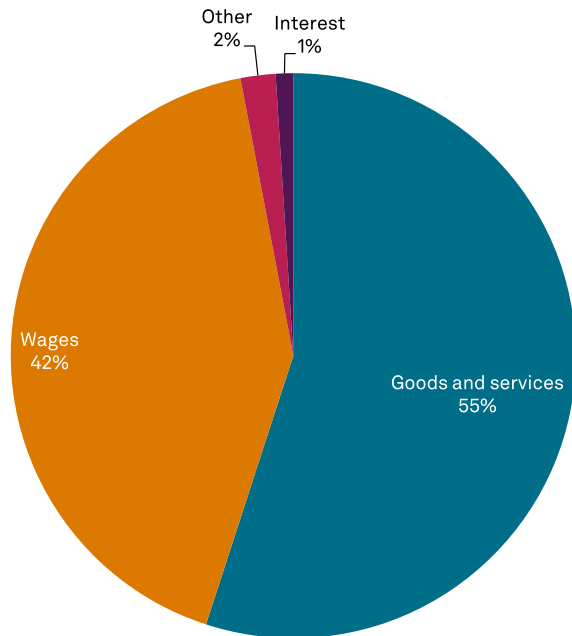
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Typically, public wage agreements weigh on municipal operating expenditures as wage costs increase. Therefore, we believe that the latest agreement signed in 2023 will increase operating expenditures for municipalities over the coming years as wages will increase annually until 2027, which will put pressure on operating surpluses. Additionally, interest payments will increase due to the rise in interest rates over the past two years. We note, however, that interest payments still account for less than 1% of LRGs' operating expenditures (see chart 2).

Chart 2

Goods and services will account for more than half of operating expenditures in 2025

Breakdown of Israeli LRGs' forecast operating expenditures



LRG--Local and regional government. Source: S&P Global Ratings.
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Despite the establishment of the property tax fund, high revenue disparities among LRGs will likely persist. Inequality results from differing socio-economic factors and the difference distribution between residential and business construction in cities. The per-capita tax revenue of the wealthiest municipality is 1.8 times higher than that of the poorest one. Weak municipalities continue to rely on central government grants. That said, grants are highly predictable and allocated depending on municipalities' socio-economic status, geographical location, and tax collection rate. The main grant is the budget balancing grant, which is distributed to 75% of LRGs and contributes 5% to the sector's total operating revenues. Business property tax tariffs exceed residential tax tariffs, meaning LRGs with higher percentage of business construction are more likely to demonstrate financial strength. Consequently, municipalities prefer to promote commercial and industrial projects rather than residential construction. The central government tries to bridge this gap via grants and contributions, and incentivizes municipalities to develop residential space with special programs, such as umbrella agreements, in which municipalities can participate if they want to.

We expect additional borrowings will likely cover minor deficits after capital accounts this year (see chart 3). Capital projects are financed by development and betterment fees, sales of assets or land, and earmarked central government contributions. While the timing of capital revenues does not always synchronize with project execution, municipalities aim to collect fees before

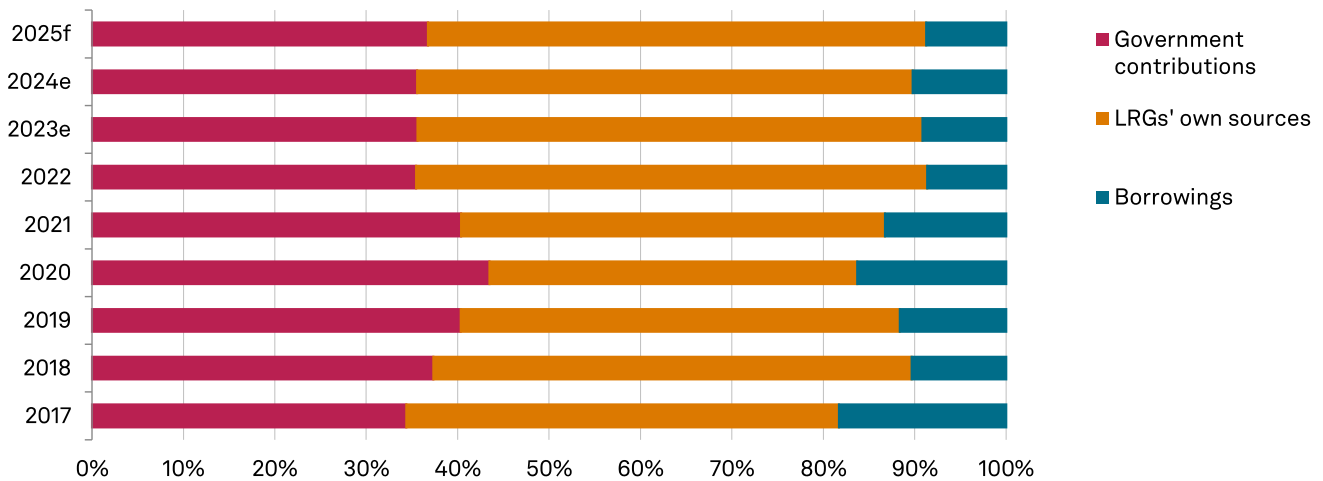
Institutional Framework Assessment: Israeli Municipalities

project execution to avoid large deficits after capital accounts, which we view as a prudent approach. Some municipalities do not follow this approach because the implementation of investment plans can take several years and the timing of revenue receipts and project execution cannot always be synchronized. Municipalities collect capital revenues in off-budget funds, dedicated to specific projects, and transfer them to the capital budget. As the geopolitical situation in the region becomes more stable, municipalities could return to executing projects that were postponed due to the war.

Chart 3

Own sources contribute most to capital expenditure

Breakdown of Israeli LRGs' capital expenditure funding sources



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

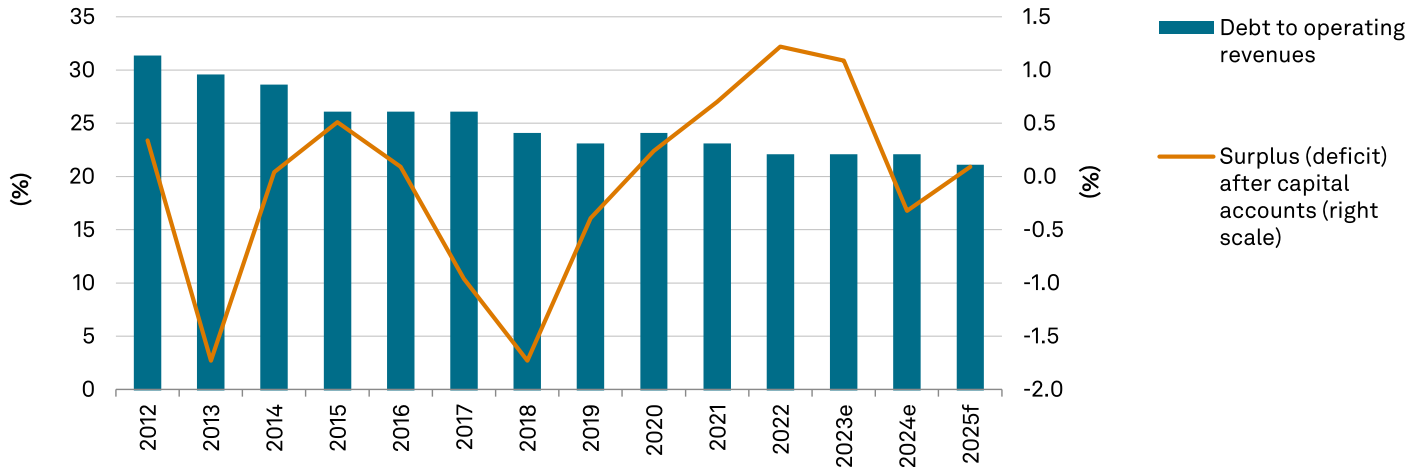
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We expect municipal debt will remain low over the next few years. Debt in the sector increased slightly in 2024, to 21.6% of operating revenues. We expect it will resume declining from 2025 as performance recovers (see chart 4).

Chart 4

Debt to operating revenues will reduce to about 20% in 2025

Israeli LRGs' debt and deficits



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

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Israeli municipalities operate under tight regulatory supervision from the Ministry of Interior.

This framework helps LRGs maintain sustainable finances and mitigates their borrowing needs. The regulator approves municipalities' and their GREs' budgets. Yet it has no say on the budget approvals of the 27 financially strong municipalities, which have gained more autonomy in various policy areas and are authorized to approve and implement budgets independently. As per the regulation, LRGs' capital plans should be detailed and must reflect project schedules, costs, and financing resources.

LRGs' borrowings must also be approved by the central government and are primarily used to finance capital expenditure. Should LRGs record an operating deficit above 5% or accumulate payables above 12.5% of operating revenues, we understand that the regulator would forbid them to make additional borrowings. The same limitation would apply if LRGs' outstanding debt exceeded 50% of operating revenues, or if the annual debt service exceeded 8% of operating revenues. Credit lines are limited to 5% of the municipal budget and guarantees must not exceed 10% of operating revenues. In cases of significant fiscal slippage, the regulator may also appoint a financial controller for affected LRGs and, in some cases, even dismiss the mayor and the council members.

Even if the central government provides support in cases of local financial distress, these transfers might not be timely or meet an LRG's debt service needs. Some extraordinary support may be provided as part of the implementation of a recovery plan, for municipalities that have accumulated deficits. Such programs usually aim to reduce costs, improve tax collection rates, or increase labor force participation. The central government may also interfere in the case of financial stress. More recently, the government increased its support to municipalities affected by

the war.

The central government can also intervene in cases of budgetary slippage or mismanagement.

Such measures may include appointing an external financial controller, dismissing the mayor and council members, declaring new elections, or forcing mergers with other municipalities. Currently, 67 of 257 LRGs have an appointed financial controller, and another six LRGs are managed by alternative mayors and city councils after the elected ones were dismissed by the regulator. We view this approach as proof of the central government's broader commitment to the sector and of its objective to reduce its accountability.

Transparency And Accountability

Roles and responsibilities of elected officials and managers are relatively clear, with elected officials setting priorities that are then implemented by managers.

The political affiliation of the mayor is irrelevant for municipalities' entitlement to central government transfers. Local politics is usually less volatile, which supports the design and implementation of the council's strategy. We believe the cooperation between mayors and financial managers is typically good across the sector, even though political considerations may affect financial decisions at times. Financial managers are usually not replaced when the administration changes, ensuring some continuity of financial policies.

Local regulation requires Israeli municipalities to budget for one year only. Even if some LRGs implement multi-year capital expenditure (capex) plans, we see the short-term nature of these plans as a cross-sector weakness, when comparing the Israeli system with that of international peers. Operating budgets are typically approved by the city council before the beginning of the budget year. The original budget is often adjusted throughout the year, with deviations usually occurring in both revenues and expenses. If budgets are not approved by March 31, the regulator may interfere and, in severe cases, dismiss the mayor or the council members.

The central government has adopted measures to increase the transparency and rule of law for municipalities. Plans exist to strengthen the position of local regulators, grant them more responsibilities, and improve governance transparency, for example for recruitment processes.

The accounting standards that Israeli municipalities follow are relatively high. LRGs produce quarterly reports, which are unaudited, while annual reports are externally audited and published by September of the following year. Financial reports are approved by the municipal council and submitted to the Ministry of Interior. Annual reports, as well as other financial databases and council protocols, are usually published on the municipalities' websites. 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. However, accounting principles do not require consolidating GREs, nor do they clearly reflect other liabilities, such as pension liabilities.

Municipal companies' operations are not consolidated into municipal fiscal accounts.

Generally, LRGs own and manage a city's water and sewage utility, an entity responsible for executing infrastructure projects, and sometimes companies organizing cultural or sports events. These companies' financial data are not consolidated into the LRGs' reports, which weakens the sector's transparency, in our view. Municipal companies' reports are audited externally and approved by the regulator.

Related Criteria And Research

- Sector And Industry Variables: Institutional Framework Assessments For Local And Regional Governments Outside Of The U.S., March 22, 2023
- Criteria | Governments | International Public Finance: Methodology For Rating Local And Regional Governments Outside Of The U.S., July 15, 2019

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