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# Municipal bond sectors adapt to federal funding shifts

*Recent shifts in federal funding and policy are creating ripple effects across several key sectors of the municipal bond market. Areas such as higher education, public transportation and energy are seeing varying impacts. As federal support evolves, these sectors may face new financial realities, prompting closer analysis from both investors and policymakers.*

## HIGHLIGHTS

- **The higher education sector faces threats, highlighting the need for deep credit research.**
- **New York Metro Transit Authority capital funding is challenged by a congestion pricing showdown with the federal government.**
- **The Los Angeles Department of Water and Power faces legal action related to the wildfires.**
- **Energy producing state and local governments feel the impact of federal policy changes and evolving electricity demands.**

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## HIGHER EDUCATION IS PRESSURED BY FEDERAL POLICY CHANGES

### Freezing funding

Current and potential federal policy changes are affecting higher education, including staffing reductions at the U.S. Department of Education, cuts in federal research funding and targeted funding freezes for individual institutions accused of discrimination and antisemitism.

Broadly, we believe these challenges will further widen the credit quality between the haves and have nots. However, some changes are novel and may have idiosyncratic effects on higher education institutions. Given the differing scope and severity of these actions, the impact will vary by institution, making careful credit selection more important than ever.

The federal government ordered cuts to research funding from the National Institutes of Health (NIH), the Department of Health and Human Services (HHS) and the United States Agency for International Development (USAID), though these reductions are being challenged in court. For example, the federal government instituted a 15% indirect cost allocation cap for NIH funds, when previously most schools were using a 30% indirect cost allocation.

These cuts heavily impact large universities with substantial research programs. But, thus far, the reductions have been small enough that they could absorb the impacts or eliminate certain research programs.

Separately, the administration has targeted a small handful of elite universities with federal funding freezes related to diversity, equity and inclusion (DEI) policies and antisemitic harassment. In total, 60 institutions received a letter from the U.S. Department of Education indicating that they are under investigation for failing to protect Jewish students on campus.

Most, but not all, of these institutions have extremely strong balance sheets, robust fundraising, access to capital markets and highly skilled management teams that can weather short-

to medium-term funding freezes. Additionally, these institutions have robust legal counsel to vigorously challenge the funding freezes in court.

### Disrupting student loans and visas

Downsizing and reorganization at the Department of Education could interrupt the processing of federal student loans. The inability of current and prospective students to secure loans for fall 2025 could affect enrollment across the sector given the prevalence of federal loans at most institutions.

However, less wealthy institutions that rely heavily on tuition would be particularly hard hit, as they have less cushion to withstand delays or supplement aid. Proposed changes to Pell Grant and student loan programs would further amplify this impact, disproportionately hitting tuition-dependent and low-income serving institutions.

A reduced number of international student visas may also lead to modest declines in enrollment. The impact is expected to be small and primarily affect institutions that are more dependent on tuition revenue and have large graduate programs, STEM programs or art and design programs.

### Changing the tax environment

Other proposed, but not yet enacted, changes include increases or expansions on endowment taxes and removal of the tax exemption for private activity bonds. We believe there is a moderate chance of these changes occurring, but the financial impact would be manageable for most institutions.

In particular, if the private activity bond tax-exemption is eliminated, we believe it would likely apply only to future bond issuances, with outstanding bonds remaining tax-exempt (grandfathered exempt status), which could lead to an attractive investment opportunity. While this change would increase the cost of capital for future debt, most universities could absorb the cost. But it could cause pressure for universities with thinner margins and weaker fundraising abilities.

### Altering the accreditation process

The Trump administration has also signaled that it would like to change the higher education

accreditation process. Universities are typically reviewed for accreditation every 5 to 10 years, so this may have slow-moving and one-off impacts. However, this is an evolving issue, and the administration could make broad changes to the accreditation process, requiring institutions to change accreditors or undergo more frequent review.

### Looking for a silver lining

While these federal policy changes pose headwinds, inherent strengths remain. Endowments provide flexibility, and a college degree remains a critical element to achieving social mobility. These proposals may encourage higher education institutions to reevaluate their business models and realize efficiencies that better address affordability issues and renew the public's faith in higher education. The institutions that can withstand the shifting policy landscape should come out stronger.

### HARVARD TAKES A STAND

Harvard and the Trump administration are engaged in an escalating battle following the university's refusal to concede to the administration's demands for change. The administration has frozen all federal funding and is threatening to revoke Harvard's tax-exempt status. Harvard is challenging the funding freezes in court.

We believe Harvard can withstand some pressure in the near to medium term given its prestige and tremendous wealth. The university can cut research efforts to continue maintaining their finances – either by reducing research activities, finding replacement grants from private foundations or donors, or using its \$50 billion endowment to supplement lost funds.

If the IRS revokes Harvard's 501(3)(c) status, we expect Harvard would also challenge this in court, resulting in a lengthy legal battle. We would expect the tax exemption to be maintained during this time given the unfavorable implications of taxability to a wide-reaching base of investors.

### THE MTA WILL LIKELY FACE REDUCED OR FROZEN CAPITAL FUNDING

The New York Metropolitan Transportation Authority's (MTA) congestion pricing program – also known as the Central Business District Tolling Program (CBDTP) – has become highly politicized in recent months. The program charges a \$9 toll on vehicles entering local streets below 60th Street in Manhattan in order to reduce traffic congestion and generate revenue for the MTA's capital program.

Through the first three months of the program (January to March 2025), the program is largely meeting those objectives. Traffic into the congestion zone was down 13%,<sup>1</sup> and the program generated net revenue in line with MTA projections at \$133 million.<sup>2</sup> However, President Trump has long been opposed to congestion pricing, stating, even prior to his election, that he would terminate the program. The Secretary of Transportation has sent several orders to shut the program down, but the MTA and Governor Hochul stated that they will keep the tolling cameras on unless there is a court order to stop the program.

The court has not ordered the program to halt, and it will likely take time for the litigation to move through the courts. In response to MTA's refusal, the federal government has threatened to freeze Federal Highway Administration (FHWA) construction authorizations as well as FHWA grant funds for New York City and New York State as soon as 28 May 2025 if the MTA does not comply.<sup>3</sup>

The termination of congestion pricing or the freezing of FHWA funds is not expected to impact MTA's day-to-day operations or its ability to pay debt service. MTA issues many types of debt obligations secured by an array of dedicated revenue streams, including transportation revenues, payroll taxes, dedicated state taxes and city sales taxes – none of which are expected to be affected by the congestion pricing standoff.

Though MTA recently entered a \$500 million private, one-year term loan secured by congestion pricing tolling revenue, this private loan is not expected to affect other outstanding debt. Operationally, MTA benefits from diverse

revenues that supported a balanced budget in fiscal year 2025 as well as projections for balance in FY26. MTA maintains \$4 billion to \$5 billion of available liquidity, which is a healthy 90-120 days' cash on hand and provides a good cushion for unanticipated events.

The MTA is likely to face reduced or frozen capital funding, whether congestion pricing is shut down or the federal government takes punitive actions for its not ending the program. It's uncertain how substantial the federal transportation funding freezes could be, but the congestion pricing program was expected to generate \$15 billion in bonding capacity. MTA may need to pause some capital projects or seek replacement funding from the state or city.

The New York legislature is expected to pass its FY26 budget, which includes \$68 billion for MTA's 2025-2029 capital plan. The capital plan includes congestion pricing as one source of revenue, but the most substantial funding comes from an increase in payroll taxes on large employers within the MTA's 12-county service area that is projected to generate \$31 billion in bonding capacity. Increased local revenue can provide some relief while the impasse on congestion pricing is litigated. Additionally, the New York State legislature's commitment to funding the MTA underscores the strategic importance of the transit system to the economy of the entire New York region.

Though federal funding for capital projects is at risk, we expect MTA operations to carry on because they are vital to the economy of New York and the region.

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## **LOS ANGELES DEPARTMENT OF WATER AND POWER FACES LEGAL ACTION**

Investors have been concerned about negative credit developments for the Department of Water and Power of the City of Los Angeles (LADWP), the largest municipal utility in the United States. The department provides water and power services to a large and diverse service area, consisting almost entirely of the City of Los Angeles and serving approximately 4 million customers.

While the operations and finances of the Water System are separate from those of the Power System, the bonds are not separately secured. Many Pacific Palisades residents and businesses have filed lawsuits against LADWP, alleging that the city and the utility department mismanaged the water supplies, particularly the nearby Santa Ynez reservoir that was not operational at the time of the fires. Wildfire experts have asserted that even a functioning reservoir would not have changed the outcome of the fires.

If the utility department were to be found liable, a large legal liability could weigh negatively on the City of Los Angeles and its related enterprises. Legally, both utilities could pass on increased costs to customers by raising rates. Moreover, if costs were significant, the state could support LADWP via securitization or other means. Since the fires began, LADWP water and power bonds have been trading at noticeably wider spreads of a 40 bps to 80 bps increase in yield.

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## **IMPACT OF FEDERAL POLICY CHANGES AND EVOLVING ELECTRICITY DEMANDS ON ENERGY PRODUCING STATE AND LOCAL GOVERNMENTS**

States and communities with above average exposure to energy production – particularly in oil, gas, natural gas and coal – may actually benefit from shifting federal policy. More lenient regulations coupled with expected increases in electricity demand could be credit positives for these tax bases, although caution should be exercised when the top taxpayers are overly concentrated.

The Trump administration shifted from the previous administration's focus on renewable energy in favor of domestic fossil fuel production (oil, gas and coal). The administration eased the regulatory environment by declaring a national energy emergency, which lifted export limits and allowed expedited approvals for energy infrastructure. President Trump also issued executive orders limiting oversight from the Federal Energy Regulatory Commission and removing regulations on oil, liquid natural gas (LNG) and coal production.

These actions support economic development in areas that specialize in fossil fuel production (Permian Basin in west Texas), industries that process fossil fuels (oil refineries in Texas and LNG plants in Pennsylvania) and communities that transport and export fossil fuels (southern Louisiana).

Energy-producing states may also benefit from projected increases in demand for electricity across the U.S. The rise of artificial intelligence is expected to increase demand for data centers. The amount of total U.S. electricity consumed by data centers is forecasted to increase from 4.4% to close to 8% by 2030.

Commercial electricity demand grew significantly from 2021 to 2023 in states such as North Dakota, Virginia and Texas. Specifically in Texas, demand from large flexible load customers that include data centers and cryptocurrency mining is projected to increase by 60% in 2025 year-over-year, per the U.S. Energy Information Administration. Additionally, the push toward electrification of cars and homes could also increase demand for energy.

Careful credit selection within areas with high exposure to energy production remains paramount. Communities in oil and gas producing regions

can see large fluctuations in the assessed value of their tax base as prices change over time. It is also important to understand how concentrated the tax base is, and who the largest taxpayers are. Positively, some communities historically concentrated in oil and gas production have diversified with solar or wind farms. These regions might prove more resilient if a future administration changes energy policy again with a higher clean energy focus.

The United States is the largest oil and LNG producer in the world, and the Trump administration has focused on support for these industries. With the advancement in AI and data centers, meeting new and higher demand will require development across all energy generating sources, which will necessitate higher capital spending. The administration's stance of prioritizing energy production tends to support economic development in communities that specialize in those industries.

While municipalities that have outsized exposure to energy sectors like oil/gas/coal display economic volatility associated with the sector (e.g., oil prices), they also benefit from tailwinds to those industries like easing regulation.



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#### Endnotes

- 1 MTA Metrics. Reduction in Vehicle Entries to the CBD. <https://metrics.mta.info/?cbdt/vehiclereductions>
- 2 MTA Finance Committee. Financial Performance Report. April 28, 2025. <https://www.mta.info/document/170771>
- 3 U.S. Department of Transportation. "Gov. Hochul Cordon Letter 4.21.25 Signed." [https://www.transportation.gov/sites/dot.gov/files/2025-04/Gov.%20Hochul%20Cordon%20Letter\\_4.21.25\\_Signed.pdf](https://www.transportation.gov/sites/dot.gov/files/2025-04/Gov.%20Hochul%20Cordon%20Letter_4.21.25_Signed.pdf)

#### Sources

[eia.gov](https://eia.gov); [energy.gov](https://energy.gov); [whitehouse.gov](https://whitehouse.gov); [kansascityfed.org](https://kansascityfed.org).

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