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MuniNotes
from our Credit Research Team

August 2025

Federal policy shifts reshape the municipal bond landscape

The One Big Beautiful Bill Act introduces sweeping changes to municipal credit across multiple sectors. Despite Medicaid reforms, education funding cuts and energy policy shifts, municipal issuers remain resilient with strong fundamentals, revenue growth and historically high reserves.

HIGHLIGHTS

- **Municipal tax-exemption remains intact while SALT cap increases to $40,000 for qualified joint filers.**
- **Medicaid reforms starting in 2027 will reduce federal funding by $219 billion over ten years, challenging both states and health care providers.**
- **Higher education faces graduated endowment taxes and restricted student loan programs, potentially affecting enrollment and institutional finances.**
- **Renewable energy tax credits phase out after 2027, increasing costs for electric utilities and clean energy projects.**
- **States maintain historically high reserve levels, providing a cushion against federal funding shifts.**

MUNICIPALITIES REMAIN RESILIENT AMID NEW LEGISLATION

The One Big Beautiful Bill Act (OBBBA) and other federal policy changes will significantly impact municipal credit across multiple sectors. Medicaid changes may affect state/local government finances and strain health care providers. Higher education faces new endowment taxes and revised student loan rules, while energy policy changes will shift production and consumption patterns.

Funding reductions to education, supplemental nutrition assistance program (SNAP) benefits, and FEMA disaster recovery will require greater self-sufficiency from local governments. And changing tariff and trade policies could create challenges for certain sectors and regions.

Despite these shifts, the municipal bond market remains fundamentally strong. Most issuers provide essential services with monopolistic positions and broad authority over taxes and fees. State and local governments show robust credit fundamentals with positive revenue trends (tax collections up more than 5% in Q1 2025 versus Q1 2024) and high reserve levels (averaging 12.8% of 2025 expenditures, up from 7.9% in 2019).

Overall, municipal issuers are well-positioned to navigate these policy changes due to their strong financial foundation.

Medicaid changes impact states and health care providers

Federal Medicaid reforms will significantly affect states fiscally, with impact varying by state Medicaid population size and policy responses. Importantly, these changes don't take effect until 2027, giving stakeholders time to adapt.

The federal government will reduce Medicaid expenditures through administrative changes projected to decrease enrollment, not direct benefit cuts. Currently, about 72 million Americans (20%) receive Medicaid through programs jointly funded by the federal and state governments.

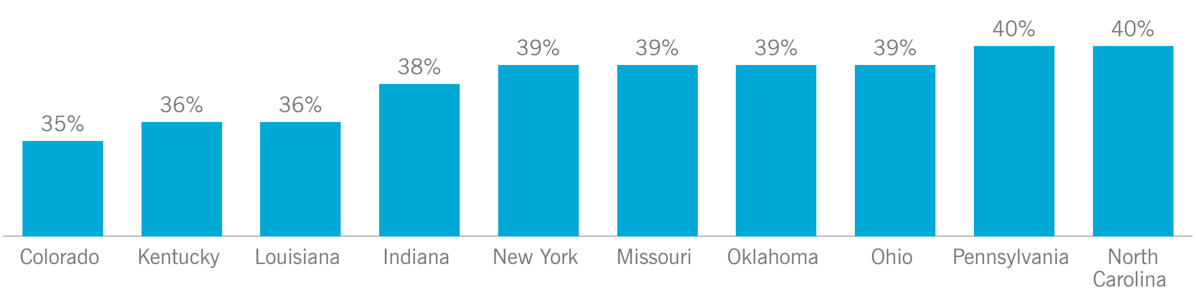
Key upcoming changes include:

- Restricted federal matching of state provider taxes
- New patient cost-sharing requirements
- Work requirements implementation
- Enhanced eligibility verification
- Limited non-citizen care reimbursement
- Constraints on state-directed payments to health care facilities

These measures could increase the uninsured population by 11+ million by 2034, with federal Medicaid funding to states decreasing by $219 billion over 10 years.

Figure 1: Medicaid is the largest expenditure for most states

Medicaid as a percentage of total expenditures: top 10 states



Data source: National Association of State Budget Officers 2024 State Expenditure Report.

States retain authority to determine how their programs operate and can adjust benefit offerings. While some may maintain coverage levels, many budget-constrained states will likely modify eligibility. States that expanded Medicaid under the Affordable Care Act face additional challenges as provider tax rates must decrease from as high as 6% to 3.5% by 2032, increasing states' self-funding burden.

Health care providers, especially those serving low-income populations, will face significant challenges. Hospitals must provide care regardless of patient payment ability but operate on narrow margins. Changes in payor mix and increased uncompensated care will strain financial performance. A $50 billion relief fund has been established for vulnerable rural hospitals, though larger uninsured populations will pressure health care delivery nationwide.

TAX-EXEMPTION UNCHANGED AND SALT CAP RAISED

The budget bill maintains key provisions beneficial to municipal bond investors and taxpayers in high-tax states. The municipal tax-exemption remains intact, with all previously authorized entities retaining their ability to issue tax-exempt bonds. Private activity bonds face no new restrictions, and spaceports gain new authorization to issue tax-exempt debt. Additionally, an expanded low-income housing tax credit program will likely increase tax-exempt issuance for affordable housing projects.

The state and local tax (SALT) deduction cap increases to $40,000 for joint filers earning under $500,000 beginning in 2025. Both the deduction cap and income limit will grow by 1% annually through 2029, before reverting to the current $10,000 cap in 2030. This enhanced deduction provides modest tax relief for residents in high-tax states and temporarily reduces concerns about population shifts to lower-tax jurisdictions.

Higher education faces new tax and student loan policies

A graduated endowment tax structure will affect universities differently based on their resources. Institutions with endowments exceeding $2 million per student face an 8% tax on investment income, while those with $750,000 to $2 million per student will pay 4%. Schools with $500,000 to $750,000 per student maintain the existing 1.4% rate. Only five elite institutions — Harvard, MIT, Yale, Princeton and Stanford — will pay the maximum 8% rate, which they can generally absorb without major disruption.

Simultaneously, federal student loan programs face significant changes, including reduced repayment options and borrowing caps. These restrictions may decrease enrollment, particularly among lower-income students who would need to rely on costlier private loans instead. Institutions with weaker demand and higher proportions of low-income students will likely experience the greatest enrollment and financial challenges from these policy changes.

Renewable energy and manufacturing tax credits are rolled back

Tax incentives for renewable energy are being phased out. Solar and wind project credits established in the 2022 Inflation Reduction Act will expire after 2027. Electric vehicle incentives will begin phasing out in September 2025, while charging infrastructure credits will end in June 2026.

These changes will increase costs for renewable power projects across all electric utilities, with higher expenses likely passed to customers through increased rates. Cities and states may delay transitioning to electric vehicle fleets, potentially resulting in lower-than-projected electricity demand growth.

FEMA changes have implications for disaster aid

While the administration has signaled interest in restructuring disaster aid funding and management, complete elimination of FEMA remains unlikely without congressional action, and Congress has historically supported the agency.

Under the current system, disaster costs are initially covered by affected parties or local governments before FEMA reimbursement. Delayed reimbursements — typically taking 1–3 years but sometimes exceeding 6 years — can strain local government finances, forcing budget cuts or borrowing.

Recent staffing reductions (nearly 2,000 full-time employees laid off out of 6,100) have slowed rebuilding grants and payments. These cuts disproportionately affect disaster-prone states like Florida, Texas, North Carolina and Hawaii.

Given this uncertainty, municipal issuers should consider maintaining higher reserve balances and may need to issue new bonds for disaster remediation projects rather than relying on timely federal assistance.

Tariff turbulence affects municipal issuers

Tariff and trade policy uncertainty threatens economic growth, affecting municipal credit through lower revenue growth and higher costs. Potential new tariffs ranging from 10% to 70% could drive inflation and reduce 2025 economic growth projections.

Expanded aluminum and steel tariffs will increase capital project costs for all issuers. Infrastructure-heavy sectors including transportation, electric, water and sewer utilities may need to pass these higher construction costs to customers through rate increases.

Port revenues could face pressure from changing trade patterns, though volumes are currently at record highs as importers rush to beat tariff implementation. West Coast ports face greater vulnerability due to their reliance on trade with China.

Export-dependent state economies like Texas, California and Washington face heightened risk from potential trade disruptions, as their tax revenues are more directly tied to international commerce.

STATES' FISCAL STRENGTH CUSHIONS FEDERAL POLICY SHIFTS

Despite challenges from recent federal policy changes, states are operating from a position of financial strength with reserve levels near historic highs. This cushion results from years of extraordinary federal support and robust state revenue growth. Through fiscal year (FY) 2025, revenue collections exceeded projections in most states, with estimates revised upward by an average of 2.2% compared to original budgets.

However, states are preparing for slower growth in FY26, with median forecasted revenue growth of 2.8%. This moderation reflects slower economic growth, lower inflation and tax cuts in some states. Projected revenue increases include 3.4% from sales and use taxes, 4.9% from personal income taxes and 1.6% from other sources, while corporate income taxes are expected to decrease by 3.3%. Several states have recently revised forecasts downward, citing economic and policy uncertainty.

Spending growth is expected to flatten in FY26 as states reduce one-time investments and constrain recurring expenditures through hiring freezes and smaller pay increases. Twenty-four states forecast declining general fund spending compared to the previous year. Many state budgets show expenditures outpacing revenues, potentially creating growing out-year deficits without corrective action.

Fortunately, states have built substantial reserves, providing flexibility as they respond to federal funding changes. The median rainy-day fund balance is projected at 12.9% of general fund expenditures for 2026 — significantly higher than the pre-pandemic level of 7.9% in 2019. With most consequential federal policies not taking effect until 2027, states have adequate time to adapt.

California addresses continuing deficits

California's $321.1 billion FY26 budget includes $228.4 billion in General Fund spending and addressed a $12 billion deficit. This follows $30 billion in expenditure reductions and a reserve draw implemented in June 2024, marking the third consecutive year the state closed its deficit.

The state forecasts declining revenues from its primary sources: personal income, corporate income and sales taxes. To close the budget gap, significant cuts to the Medi-Cal program and other recurring expenses were implemented, while lawmakers preserved funding for state transit programs and the University of California and California State University systems.

The approved budget includes a $7.1 billion withdrawal from the Rainy Day Fund, leaving $15.7 billion in total reserves — equivalent to 7.0% of General Fund expenses — at the end of FY2026.

New York projects modest revenue growth

The New York State legislature passed its $254 billion FY26 budget on 01 May, one month past deadline due to policy disagreements rather than financial concerns. The balanced budget maintains reserves at historic highs (16% of operating fund spending).

Revenue growth projections are modest, with personal income taxes increasing 4.1%, down from 5.2% in FY25. Tax policies remain largely unchanged, with the notable exception of a payroll tax increase on large employers in the MTA's 12-county service area, providing an estimated $31 billion in bonding capacity.

The budget approves MTA's 2025–2029 capital plan with an additional $3 billion in state appropriations, demonstrating strong legislative support for transit.

While the budget doesn't address potential federal funding cuts, the governor indicated a special session could be called if necessary. However, with major federal changes to Medicaid and SNAP not occurring until 2027, New York has time to address these impacts in its FY27 budget.

New Jersey implements new revenue measures

Governor Murphy signed New Jersey's $58.8 billion FY26 budget into law on 30 June. The budget includes a 2.6% operating deficit, using $1.5 billion from reserves to close the gap. Despite this drawdown, the projected general fund balance remains healthy at $6.3 billion (11% of revenue), providing adequate cushion for contingencies.

The budget projects a 3.5% revenue increase, derived from inflationary growth in income and sales taxes, plus new revenue measures including higher taxes on vapes, cigarettes, online gambling, sports wagers and a new mansion tax on properties sold over $2 million.

Importantly, the budget fully funds the state's pension payment ($7.2 billion) for the fifth consecutive year — a credit positive that will help reduce pension liabilities over the long term.

Illinois balances the budget for seventh straight year

Illinois' FY26 budget was adopted on time, marking the state's seventh consecutive balanced budget. The $55.1 billion General Fund spending plan increases expenditures by $2 billion (3.5%) over FY25 projections. To achieve balance, nearly $400 million in cuts were implemented, including $330 million saved by eliminating health care benefits for undocumented immigrant adults.

Pension contributions remain substantial at 19% of General Fund expenditures, reflecting the state's ongoing management of significant unfunded liabilities. Revenues are projected to exceed expenditures by $217 million, with $161 million directed to the Budget Stabilization Fund, which is expected to reach $2.5 billion by fiscal year-end. Additionally, $100 million is reserved for potential federal funding shortfalls.

This maintenance budget leaves several key issues unaddressed, most notably additional transit funding. Chicago area transit agencies face a $770 million funding gap beginning in 2026, an issue the state is expected to revisit before year-end.

Florida maintains a strong financial position

Florida's enacted FY26 budget totals $117.4 billion, following negotiations primarily focused on tax relief measures amid healthy revenue growth and historically high reserves. Rather than implementing property tax reforms, legislators made certain sales tax holidays permanent, including a month-long back-to-school holiday in August and exemptions for emergency preparedness items during hurricane season.

The state approved approximately $1.3 billion in tax cuts, which are not expected to significantly impact Florida's exceptionally strong financial position. With $40 billion in reserves (nearly 50% of own-source revenue), the state maintains substantial fiscal flexibility.

Additionally, legislators advanced a proposed constitutional amendment that would formalize Florida's practice of annually transferring $750 million, or up to 25% of state general fund revenue, to the Emergency Preparedness and Response Reserve for hurricane relief. This measure now requires voter approval to be enacted.

Texas establishes an education savings account

Last May, Texas passed its $338 billion biennial state budget, featuring the creation of a $1 billion Education Savings Account. This significant education reform provides families with funds to pay for private school tuition and home schooling, representing a shift toward a voucher-based system.

Texas concluded FY24 with a General Fund surplus (before transfers) of $9.7 billion, further strengthening its Economic Stabilization Fund (Rainy Day Fund), which stood at $23.8 billion as of FY24. These robust reserves position the state to address potential budget shortfalls and respond to natural disasters — particularly important given federal cuts to FEMA combined with Texas' vulnerability to tornadoes and flooding in its southeastern regions.

For more information, please visit us at nuveen.com.

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