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# Municipal credits navigate a complex policy and budget landscape

Recent federal and state policy changes are reshaping municipal credit fundamentals across multiple sectors. From Medicaid reform affecting hospitals to budget impasses in Pennsylvania and tax restructuring in Indiana, issuers face varied challenges requiring careful credit analysis and differentiation.

## **HIGHLIGHTS**

- OBBBA cuts federal Medicaid spending by \$900 billion, reducing coverage for 7.5 million people and pressuring hospital margins.
- Pennsylvania's second-longest budget impasse strains local government liquidity; school districts tap short-term borrowing to cover cash needs.
- SEPTA faces operational pressures, but bondholders remain protected by continuously appropriated revenues providing over 6x debt service coverage.
- Federal workforce reductions create modest economic headwinds in Mid-Atlantic region; strong reserves buffer D.C., Maryland and Virginia credits.
- GSE privatization proposals and Indiana tax reforms introduce new uncertainty for housing bonds and local government funding structures.

## MEDICAID CUTS WILL RESHAPE HOSPITAL FINANCES

The One Big Beautiful Bill Act (OBBBA), enacted earlier this year, includes sweeping changes designed to significantly reduce federal Medicaid spending beginning in 2027. The legislation is expected to cut federal Medicaid expenditures by more than \$900 billion through tighter eligibility requirements, new work requirements, and stricter verification processes. Approximately \$326 billion in savings will come directly from eligibility restrictions alone. As a result, an estimated 7.5 million fewer people are projected to have Medicaid coverage.

#### **Provider taxes face new restrictions**

A critical element of state Medicaid financing—and a key mechanism for drawing federal matching funds—has been the use of provider taxes. These are taxes paid by hospitals and other healthcare providers to the state, which then uses the revenue to generate larger federal contributions. The new legislation limits how states can use provider taxes to maximize federal funding, further reducing Medicaid dollars available to hospitals, particularly those serving high volumes of Medicaid patients.

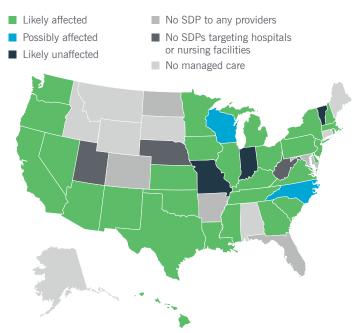
#### State-directed payments are capped

In many states, Medicaid funds are administered through managed care programs in which insurance companies pay hospitals and nursing facilities. While states typically allow insurers to set reimbursement rates, they can also mandate certain payment amounts known as "state-directed payments" (SDPs). These payments often use Medicare rates as benchmarks to support policy goals, such as bolstering safety-net hospitals.

The new legislation caps these state-directed payments, which in most cases will require states to reduce reimbursement to hospitals and nursing facilities. Approximately 29 states are expected to be affected, as their current payment levels exceed the new caps. (Figure 1)

## Figure 1: Hospital and nursing facility payments to decline in most states

States affected by state-directed payment caps



Data source: KFF analysis of Medicaid Approved State-Directed Payment Preprints; RAND Price Transparency Study, Round 5.1.

# Hospital margins should compress but credits remain stable

Nearly all hospitals will face reduced Medicaid funding, which will compress margins and increase uncompensated emergency care—especially in communities with large uninsured or Medicaid-dependent populations. However, most hospital credits in the municipal bond market are expected to remain stable. Medicaid typically accounts for only 10%–20% of hospital revenues and approximately 15% of patient volume. Most hospitals derive the majority of their income from private insurance and Medicare.

Hospitals are already adapting to these changes, and states may offset some funding gaps by using their own resources or restructuring provider tax strategies. Strong hospitals serving commercially insured populations are well-positioned to weather these changes. In contrast, hospitals in weaker markets with high Medicaid exposure face greater risk and may experience more pronounced financial strain.

# Focus on hospitals with strong market positions

Bond investors should focus on identifying essential hospitals with strong market positions that can reasonably expect local governments or commercial payors to absorb some of the financial pressure. Hospitals operating in weaker markets—particularly those with thin financial margins and heavy reliance on Medicaid revenues—are more likely to bear the full impact of funding cuts and may face credit pressure.

Overall, most hospitals are expected to adapt to the legislative changes with minimal effect on credit quality. The sector remains broadly resilient, though targeted challenges will persist for at-risk providers.

### PENNSYLVANIA PASSES BUDGET, ENDING STALEMATE

On 12 November, Pennsylvania lawmakers approved the commonwealth's fiscal 2026 budget, 134 days past the state's 30 June deadline. The adopted budget totals \$50.1 billion, a 4.7% increase over the revised fiscal 2025 budget. While the budget draws on reserves accumulated in prior years, it notably does not tap the state's \$7.4 billion rainy-day fund. Lawmakers remained divided on several contentious issues - including school vouchers, transit funding, and potential sin taxes - but the compromise budget sidestepped these debates and largely maintained the status quo.

During the budget impasse, the state remained legally obligated to pay debt service and fund essential services, but other appropriations were frozen. School districts, counties, state universities, community colleges, and other government service providers went more than four months without their fiscal 2026 state aid payments. Many local governments issued tax and revenue anticipation notes (TRANs) to address cash flow needs. School districts - particularly those with low reserves and heavy reliance on state aid - faced the most urgent liquidity pressures. For example, the Philadelphia school board increased its short-term borrowing to \$1 billion, nearly double its typical \$550 million, to bridge its near-term funding gap.

Late budgets are not uncommon in Pennsylvania; the state has missed its 30 June deadline in 13 of the last 20 years. However, this year's delay was the second-longest in state history. The longest impasse, in 2015-2016, lasted nine months and triggered negative outlooks from rating agencies on the commonwealth's general obligation rating, along with downgrades for several school districts.

The commonwealth is currently rated Aa2/Stable by Moody's, AA/Stable by Fitch, and A+/Positive by S&P. During the 2015 -2016 impasse, most downgraded school districts were A category or lower credits already facing financial stress; the state aid delays intensified their existing challenges. This time, school districts entered the impasse better prepared, with higher reserves than in 2015, and we have not observed an increase in downgrades beyond typical levels.

## SEPTA'S OPERATIONAL PRESSURES SHOULDN'T IMPACT BONDHOLDERS

The state budget impasse created significant operating stress for the Southeastern Pennsylvania Transportation Authority (SEPTA), which projected a \$213 million budget gap for fiscal 2026. In response to the funding shortfall, SEPTA planned a 21.5% fare increase and significant service cuts to balance its budget. However, a court ruling required SEPTA to fully restore service, negating the planned reductions.

The fare increase alone was insufficient to close SEPTA's budget gap, prompting the commonwealth to authorize the authority to redirect \$394 million in capital funds to operating expenses over the next two years. Republican lawmakers proposed making this shift permanent, while Democrats strongly opposed the idea, seeking new dedicated funding sources for transit instead. Ultimately, both parties dropped further changes to SEPTA's funding structure, though the issue will need to be revisited in future budget negotiations. Diverting capital funding to operations is unsustainable and will increase SEPTA's deferred maintenance backlog, eroding its financial health over time.

Despite these operating challenges, SEPTA's revenue bonds are well-insulated from operational

stress due to strong security features and healthy debt service coverage. SEPTA's Asset Improvement Program (AIP) bonds are secured by a statutory share of statewide motor vehicle sales taxes and other fees, while its Public Transportation Assistance Fund (PTAF) bonds are secured by a portion of the state's general sales and use taxes along with other taxes and fees.

The revenues securing SEPTA's bonds are continuously appropriated, meaning the state does not need to pass a budget for these dedicated funds to flow automatically --directly to the bond trustee, bypassing SEPTA --for debt service payments. Additionally, debt service is funded nearly a year in advance of payment dates. In 2024, revenues pledged to the largest portion of SEPTA's bonds (AIP Bonds) provided over 8x debt service coverage.

Revenues pledged to SEPTA bondholders are subject to legislative changes, and proposals to redirect some of the authority's funding have been made in the past. However, given the strength of pledged revenues, such proposals would only modestly reduce debt service coverage.

## FEDERAL LAYOFFS CREATE MODEST PRESSURE IN MID-ATLANTIC

Recent federal layoffs and furloughs stemming from budget cuts and the federal government shutdown have the potential to impact the economies and finances of communities in and around Washington, D.C. Fortunately, most issuers in the region remain resilient, and the impact on credit quality has been relatively muted.

# Washington, D.C., maintains a solid financial position

Total employment in Washington, D.C., declined by 5,000 jobs in July 2025 compared to the same period in 2024, down just 0.7% year-over-year. Despite this decline, officials still expect near-term revenue growth for the district.

Based on September 2025 estimates, fiscal 2025 revenues are projected to increase 7% year-over-

year, followed by a modest 2% decline forecast for fiscal 2026. The District entered the year on solid financial footing, with strong reserves equal to 45% of General Fund revenues, and has capacity to make budgetary adjustments as needed.

# Maryland faces greater federal employment exposure

Many Maryland residents are also affected by changes to the federal workforce, particularly in cities and counties within commuting distance of downtown Washington, D.C. The federal government accounted for approximately 6% of state employment last year, compared to 2% nationally. Maryland's employment growth remained positive as of August 2025 at 0.4%, though it lags the U.S. overall at 0.9%.

The state has historically maintained solid reserves, with a strong General Fund balance equal to 24% of revenues at the close of fiscal 2024. In fiscal 2025, unaudited state revenues came in approximately \$700 million, or 3%, above budget, driven by better-than-anticipated capital gains from tax year 2024.

# Virginia's diversified economy provides cushion

While northern Virginia is also located near Washington, D.C., the commonwealth's economy is comparatively more diversified. Federal employment in Virginia is concentrated in defense-related positions, which have been less susceptible to recent federal employment reductions.

## FANNIE AND FREDDIE PRIVATIZATION MAY IMPACT SINGLE-FAMILY HOUSING BONDS

Recent proposals to privatize Government Sponsored Enterprises (GSEs) Fannie Mae and Freddie Mac could affect single-family housing bonds issued by state Housing Finance Agencies (HFAs) and their single-family mortgage portfolios.

State HFAs issue municipal bonds to finance affordable mortgages for low- and moderateincome borrowers. Some HFAs package these loans into mortgage-backed securities guaranteed by Ginnie Mae, Fannie Mae, or Freddie Mac. Ginnie Mae is fully backed by the U.S. government. Fannie Mae and Freddie Mac, though not technically guaranteed by the United States, have operated under federal conservatorship since 2008 following the subprime mortgage crisis. Both GSEs maintain credit ratings comparable to the U.S. government due to an implicit federal backstop. This implicit guarantee has been critical to market confidence in these securities.

Trump administration officials have recently considered removing Fannie Mae and Freddie Mac from conservatorship and privatizing these entities. This process would be lengthy and complex and could extend until 2027 or later.

Any move toward full privatization that eliminates or weakens the implicit federal guarantee backing Fannie Mae and Freddie Mac could negatively impact the credit ratings of these entities. In turn, state HFAs with exposure to Fannie Mae or Freddie Mac mortgage-backed securities on their balance sheets could face lower ratings and higher financing costs.

However, the actual impact could vary considerably across HFA programs. Many HFAs maintain robust financial structures with total assets substantially exceeding debt obligations. This overcollateralization provides a cushion that could limit potential rating downgrades even if GSE credit quality deteriorates. Should privatization efforts gain momentum, investors should monitor for potential rating downgrades, but since this process would take years to implement, bondholders have time to assess and respond.

## NEW INDIANA LAW RESHAPES LOCAL INCOME TAX STRUCTURE

Indiana lawmakers have enacted several measures this year that will reshape local government and school district funding, potentially introducing new revenue uncertainty and credit pressure.

The state's Local Income Tax (LIT) framework will change beginning in 2028. Under the current system, Indiana counties levy a local income

tax and distribute revenues to underlying local governments based on a formula. Counties and municipalities often issue income tax bonds secured by these revenues. Countywide income taxes will be replaced by individual income tax levies for each entity.

The law also introduces new rate limits, modifies allowable uses and requires annual recertification of local rates. Requiring annual reauthorization for the local income tax rate could create significant revenue volatility. Importantly, the law includes a safeguard preventing LIT rates from being reduced below the level needed to provide a minimum of 1.25x maximum annual debt service coverage, meaning the minimum levy needed for income taxes pledged to outstanding bonds should be insulated from annual reauthorization risk.

For some issuers, the shift to local income tax levies could result in a smaller revenue base. Wealthier communities could see revenues increase as they will no longer subsidize smaller local governments within their county and may benefit from retaining a larger share of locally generated income tax revenues. Conversely, municipalities with narrower revenue bases could see lower annual debt service coverage ratios, potentially leading to rating pressure. With more than two years until implementation, the legislature is expected to clarify or amend the law, likely ahead of the next biennial budget cycle for fiscal years 2028–2029.

## INDIANA SCHOOL DISTRICTS FACE MOUNTING FUNDING PRESSURES

Indiana's K-12 education funding system continues to evolve as policymakers pursue property tax reform, expanded school choice, and limits on referendum flexibility. The current biennial budget (fiscal 2026–2027) provides 2% annual tuition support increases, below inflation, and expands universal voucher eligibility in 2026. School vouchers, projected to draw nearly \$93 million in fiscal 2026 and growing thereafter, are funded from the same resources as traditional public schools. This dynamic may gradually erode the state's per-pupil allocations for districts already operating with limited flexibility.

New legislation also reduces school property tax revenues by an estimated \$544 million over three years through new homestead credits, deductions, and phased-in revenue sharing with charter schools. Aggregate property tax growth is now projected at only 1.5% annually through 2028, compared to 4% under prior rules. New caps on referendum levy growth (3% annually) and restrictions on election timing further constrain districts' ability to raise supplemental revenues.

These shifts come as federal COVID-19 relief dollars expire, creating additional budget pressure.

Growing suburban districts may remain resilient, but urban and rural districts with stagnant enrollment or heavy reliance on referendum funding face greater exposure to rating pressure.

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

#### **Endnotes**

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