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Is Public Finance Entering an Era of Adversity?

The preceding five years have been characterized by a period of strength in municipal credit as government finances flourished amid extraordinary federal stimulus and favorable economic conditions. Yet many changes loom on the horizon, which could threaten the financial stability of state and local governments.

Federal Policies

The Trump administration hit the ground running with tariffs, immigration enforcement, talks of dismantling the Department of Education (DOE) and the Federal Emergency Management Agency (FEMA), and a new tax and spending bill —the One Big Beautiful Bill Act (OBBBA). Moody's sees Medicaid, disaster aid, and federal grant changes as the policies that may have the most severe credit impact to municipalities.

- Medicaid
  - — The OBBBA shifts more Medicaid costs to states while also limiting state revenue from healthcare provider taxes, which is credit negative for states.
  - — Medicaid changes are expected to reduce insurance saturation and provider reimbursement rates, which will be negative for healthcare providers, particularly rural healthcare entities who typically have a high proportion of Medicaid patients.
- Disaster Aid
  - — The price tag associated with cleaning and rebuilding after a natural disaster can be enormous. Reduced federal funding for disaster aid creates urgency for states and localities prone to extreme weather to plan for alternative funding in the aftermath of natural disasters and to implement mitigating systems pre-disaster. Going forward, issuers hit by natural disasters will face greater uncertainty and possibly much greater burden.
- Federal Grants
  - — Issuers reliant on federal grants and reimbursements may face funding cuts and budget pressure. Higher education and healthcare issuers are notable examples, but all sectors could be impacted.
- Other
  - — Tariffs could increase expenses and pressure revenues for state and local governments, especially those with an economic concentration in trade related activities.
  - — Immigration enforcement may increase labor expenses, slow economic growth, and cause enrollment declines. Labor-intensive sectors such as healthcare are particularly vulnerable to workforce shortages.
  - — Changes at the DOE may disrupt grants and loans in the higher education sector.
  - — Federal workforce and office space reductions could impact local governments in areas where those employees and offices are located, as well as bonds backed by federal leases.

Revenue Pressure

The overarching theme of recent federal policies is to push costs downstream to state and local governments while certain changes may lower revenues. At the same time, state and local revenues may be pressured by the end of pandemic-era federal stimulus, state and local tax cuts, and possibly an economic downturn.

Since the COVID-19 pandemic began, major federal stimulus bills totaling more than $5 trillion have bolstered the economy. To put that amount into perspective, total state and local tax revenue was just over $2 trillion in 2024. As a result, many municipalities have experienced tremendous growth in their rainy-day funds, which has led to significant political pressure to cut taxes. Some states have already enacted tax cuts, and some

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seek additional tax reform. Reigning in property taxes, the primary funding source for most local governments, is a popular topic right now as valuations and property tax bills have skyrocketed. K-12 schools are vulnerable to changes in property tax law as property taxes are about 80% of local funding for schools, on average. Further, states may receive lower income taxes due to formulas using federal taxable income, absent legislation to alter state income tax formulas.

The combination of lower taxes and the end of federal stimulus will likely stress budgets for many state and local governments, particularly those who were relying on the stimulus to fund recurring expenses. A decline in economic activity will exacerbate this effect as a recession would likely depress state sales and income tax revenue, which may lead to cuts in state support for local governments as well.

Infrastructure Needs

The OBBBA thankfully preserved the municipal bond tax exemption, which is positive for municipal credit quality and will help to reduce financing costs. However, long-term debt is likely to increase as capital projects delayed due to elevated interest rates cannot be put off indefinitely, and construction costs have soared in recent years. Fewer federal grants are expected to offset these costs.

Securities to Watch

In light of expected deterioration in revenues, growing expenses, and further uncertainty surrounding federal aid and policies going forward, investors should analyze their holdings to identify bonds that may be adversely impacted by these changes. Fortunately, the recent period of strength resulted in many municipalities being in a good position to withstand these changes, but the rapidly changing landscape may lead to idiosyncratic impairment. Issuers who have thin reserves and a reliance on federal funding may be vulnerable, and issuers in disaster-prone areas face greater uncertainty in the long-term. Healthcare, K-12 schools, and higher education sectors face significant headwinds and should be cautiously evaluated.

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