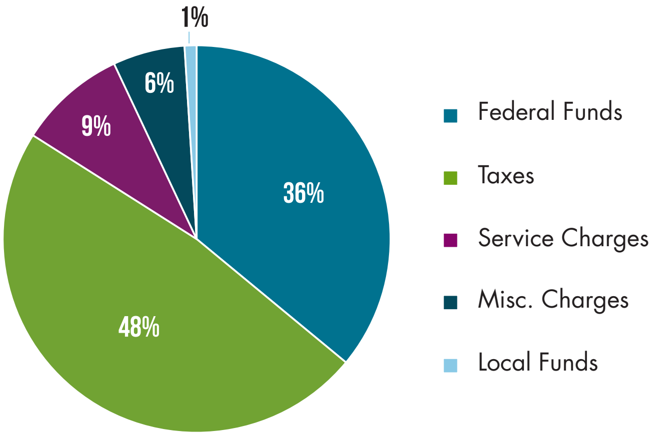
HOW RELIANT IS THE MUNICIPAL MARKET ON FEDERAL FUNDING?

JEFFREY T. DEVINE
Vice President
Director, Municipal Research

In response to recent federal proposals that reduce government funding, many municipal stakeholders are evaluating how potential cuts could weigh on the market's overall creditworthiness. We find comfort in the fact that most municipal issuers enjoy strong autonomy to preserve structurally-sound budgets. Many can raise taxes, cut expenses, and rely on locally-sourced revenues to maintain sound operations. Federal exposure differs across sectors, but in most cases an issuer's capacity to maintain stable finances remains consistent.

State governments have heavy exposure to federal transfers, at over one-third of their revenues, but these outlays do not often support core state services. Instead, most must be used to meet specific federal policy goals and come with rigid oversight and guidelines. States often function as intermediaries, acting as program administrators while distributing funds to the ultimate recipients. Medicaid is a prime example, providing healthcare coverage to low-income residents and making up nearly 60% of federal outlays to state and local governments. It functions as a matching fund program, whereby the federal government reimburses each state a certain percentage for every dollar spent on eligible services. These reimbursements make up about one-fifth of state budgets. Policy changes that reduce Medicaid reimbursements will likely prompt states to reduce benefits or find alternative funding through higher taxes or budget reallocations. Either way, this flexibility allows states to remain fiscally sound and record-high rainy-day reserves further mitigate near-term budget implications.

Share of Total State Revenue by Category (2022)



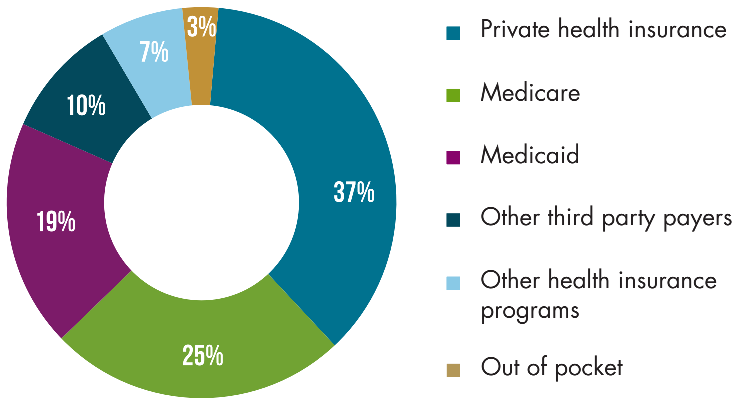
Source: PEW Charitable Trusts

HOW RELIANT IS THE MUNICIPAL MARKET ON FEDERAL FUNDING?

Local governments are far less reliant on direct federal funding, often less than 5% of budgets, and any reductions could be absorbed through revenue enhancements or prudent expense management. Nonetheless, federal cuts to state-administered programs could still affect local governments. Using the previous Medicaid example, states could shift aid away from local governments to preserve benefits. On average, state aid represents 30% of a municipality's budget and any cuts would likely pressure small and lower-rated entities that are already facing financial challenges, a group GW&K tends to avoid.

Healthcare systems could be directly affected by federal funding changes. Medicare and Medicaid account for 25% and 19%, respectively, of hospital spending, which serves as a fair representation of federal exposure given that revenue data is difficult to ascertain. These programs cover approximately 40% of the US population, and substantial reductions could be politically difficult. Notwithstanding, reductions to Medicare, which covers the elderly and those with certain disabilities, would have a direct impact on hospitals since the program is federally funded and administered. The situation varies for Medicaid, where the fiscal impact depends on whether states respond by increasing contributions to counteract cuts or allow hospitals to receive lower reimbursements. In any case, cuts to these programs would have the greatest impact on small systems with weak demographics, which tend to have high levels of governmental payers. This is another area where we limit our exposure.

Distribution of Spending on Hospital Care by Payer (2023)

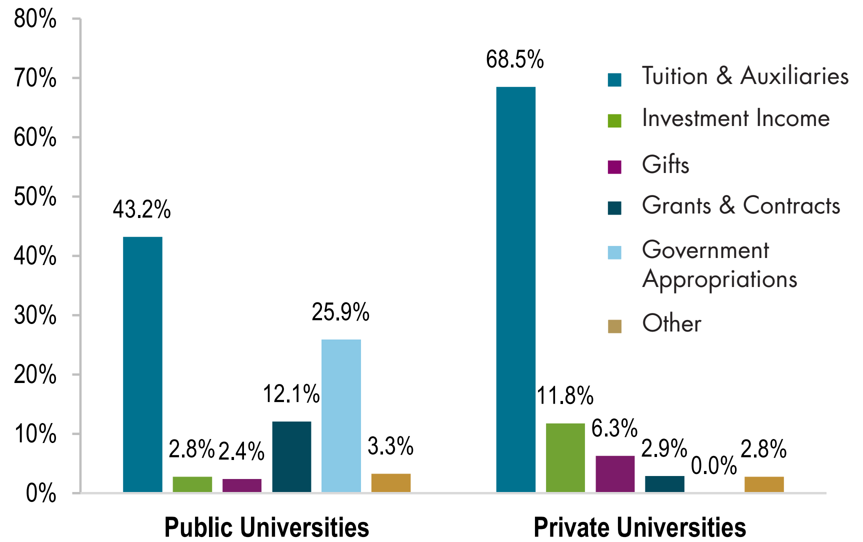


Source: Kaiser Family Foundation

HOW RELIANT IS THE MUNICIPAL MARKET ON FEDERAL FUNDING?

Colleges and universities also rely on a mix of direct and indirect federal funding, with government grants and contracts representing roughly 12% and 3% of public and private university revenues, respectively. Research-intensive universities often receive a large share of grants from various federal agencies, but these institutions generally have strong credit fundamentals based on their size, solid academic reputations, and healthy endowments. In response to funding reductions, they would likely reduce research expenditures to maintain financial stability.

Higher Education Contribution Ratios (2023)



Source: Moody's Ratings

Infrastructure-related issuers like utilities, toll roads, and airports rely on user fees to support day-to-day operations and are mostly insulated from direct funding cuts. Grant Anticipation Revenue Vehicles (GARVEEs), however, serve as an exception. These state-level debt programs finance highway-related projects and are backed by reimbursements from the FHWA's Highway Trust Fund. GARVEE programs can likely withstand funding reductions, however, since they typically collect reimbursements that greatly exceed annual debt service requirements. Additionally, some programs maintain backup pledges whereby states commit to service the debt in the absence of federal reimbursements.

Municipal issuers have repeatedly demonstrated resilience in times of fiscal stress, owing to the ability for many to independently adjust revenues and expenses. Our bottom-up research approach allows us to identify and avoid specific names that could be more vulnerable to federal funding cuts. We continue to evaluate the implications behind certain policy proposals and will adjust our exposure accordingly.

ENTREPRENEURIAL DRIVEN, CLIENT FOCUSED

GW&K is a Boston-based investment firm with $51.6 billion under management and half a century of creating long-term, trusted client relationships.

www.gwkinvest.com

Boston Headquarters
222 Berkeley Street
Boston, Massachusetts 02116
617.236.8900

Other Location
Winter Park, Florida