Market Insights

As of July 15, 2025

One Big Beautiful Bill Act's Impact on the Municipal Market

It's official, President Trump's One Big Beautiful Bill Act (OBBBA) has been passed. What does its passage mean for the municipal market? In our view, nothing that alters the opportunity in the asset class, but a few things to note.

- **Tax-exempt status eliminated?** No. The municipal market can breathe a sigh of relief. Tax-exemption remains intact and hopefully offers some clarity and confidence for municipal investors. Also, it's a win for infrastructure financing as state and local governments, as well as other municipal sectors, can continue to borrow at reduced interest rates relative to taxable yields.
- **Changes to SALT reduce muni demand?** Under OBBBA, the deductibility cap on State and Local Taxes (SALT) was raised from $10,000 to $40,000 for a five-year period. This will mainly be beneficial for residents in high tax states (*e.g.*, CA, NY, NJ). Does this tax benefit have an impact on municipal demand? The tax deductibility increase may at the margin reduce demand for municipal bonds, however, income phaseouts are likely to limit the degree of the reduction.
- **Alternative Minimum Tax (AMT) an issue again?** No. When the Tax Cuts and Jobs Act (TCJA) was passed in 2017, it increased the AMT tax-exemption, resulting in a significant reduction in the number of individuals impacted by AMT. For context, prior to the passage of TJCA in 2017, five million taxpayers were impacted by AMT. In 2018 it was 250,000, and continues to be a relatively low number today.[1] Under OBBBA, this tax-exemption was permanently extended, with index inflation calculation making AMT "risk" less of a concern for most taxpayers, in our view.
- **Any impact on the Higher Education sector?** Yes, but not all. Prior to OBBBA, university endowment investment earnings incurred an excise tax of only 1.4%. OBBBA added two new graduated rates (4% and 8%) that are based on the size of the endowment (measured on a per student basis). This tax doesn't impact all colleges/universities. It exempts institutions with fewer than 3,000 students from the tax (prior to OBBBA it was 500). The increase from 500 to 3,000 will save some institutions millions in taxes each year. The largest and wealthiest institutions are likely to be impacted the most by the increase in the excise tax. Examples of such institutions may include Duke, Harvard, MIT, Princeton, Stanford, Vanderbilt, Yale etc. These schools are most impacted, but they are also well positioned to make necessary adjustments.

- **Change to Medicaid?** We believe this is the item in the bill that will have the greatest impact on the municipal market, particularly for state governments and hospitals. Medicaid provides government-sponsored health care for low-income and disabled Americans. Approximately 20% of the US population is covered under Medicaid. OBBBA is expected to reduce spending on the program by nearly $1 trillion over the next decade and imposes work requirements for some able-bodied adults and more frequent eligibility checks. Given these funding cuts and work requirements, the Congressional Budget Office estimates that 11.8 million Americans would lose health care coverage under Medicaid over the next decade. Below details the changes will have on state governments and hospitals.

  States

  - Given this bill, we believe states have a decision to make:(1) allocate the same percentage of their budget to Medicaid and not fill in the funding gap once provided by the federal government, resulting in more uninsured individuals or (2) attempt to maintain the status quo on health care coverage by filling in the gap once funded by the federal government. The latter decision may be politically friendly for government officials in that state but would require budgetary tradeoffs.
  - Medicaid is typically a state government's largest expense so the changes under OBBBA are important. The response from state governments will vary, but those that decide to fill in the funding gap (partially or fully) will likely reallocate resources to maintain the health care coverage of their citizens that are dependent on Medicaid. The decision to allocate more of a state's budget to Medicaid may take away from other initiatives/programs that a state may have on its agenda. For example, infrastructure improvements may be postponed to a later date or eliminated altogether given this reallocation of resources.
  - We do not believe these budget adjustments will result in a significant increase in downgrades, given states have a number of budgetary tools with which to make these adjustments (raise taxes, reallocate spending, defer capital investments, etc.), and credit fundamentals, though peaking as the economy cools, are broadly in a position of strength.

  Hospitals

  - The mix of revenue sources for hospitals varies but, on average, Medicaid payments make up 15% of hospital revenues. We believe hospitals that have a larger dependency on Medicaid payments without any other support, such as the ability to fund raise, are most vulnerable to the changes under OBBBA.
  - There will clearly be hospitals that are more vulnerable to the Medicaid cuts, and others in stronger positions and selectivity will be paramount. Two key investment attributes MFS analysts look for in hospitals are: (1) a payor mix biased to commercial insurance, which has higher reimbursement rates than Medicaid or Medicare, and (2) dominant market share, which provides greater leverage in negotiations of reimbursement rates with commercial insurers. Higher reimbursement rates typically result in higher revenue for a hospital.

Although the passage of OBBBA will require adjustment for impacted municipal borrowers (*i.e.*, mainly states and hospitals), we believe broad credit degradation across the municipal asset class is unlikely. Looking ahead, we continue to believe firming flows, solid fundamentals and attractive absolute/tax-equivalent yields are supportive for performance through the second half of the year.

Endnotes

[1] Source: Tax Foundation. "How Did the Tax Cuts and Jobs Act Simplify the Tax Code?" August 7, 2024.