RIPEC

The Governor's FY 2025 Budget Proposal

A Transitional Budget as the State Faces More Constrained Revenues

Executive Summary
May 2024

Governor Daniel J. McKee's proposed budget for fiscal year (FY) 2025 is his first spending plan constrained by more limited revenues. However, by relying on surplus dollars and, to a lesser extent, federal funding to pay for state operating expenses, the governor's FY 2025 budget represents a transitional budget between plentiful revenues of the last few years and more challenging fiscal times ahead. Despite tighter revenue projections, demand for significant spending increases persist, even after dramatic expenditure growth over the past few years. As a transitional budget, the policy choices contained in the governor's budget carry important short-and long-term implications.

Revenues

Governor McKee's FY 2025 budget plan recommends spending based on general revenues of $5.45 billion, an increase of $135.8 million, or 2.6 percent, over the revised FY 2024 estimated revenues of $5.32 billion. The 2023 November Revenue Estimating Conference (REC) increased estimates for FY 2024 by $42.1 million over the 2023 May REC—a relatively modest upward adjustment compared to the much larger current year revenue adjustments from the previous two November RECs. This FY 2024 revenue increase, along with lower projected expenditures for FY 2024 and a surplus for FY 2023, has left the state with an anticipated opening surplus of $195.9 million for FY 2025. While substantial, the surplus is the smallest since FY 2020.

The governor's FY 2025 budget proposes no major changes to the state's broad-based taxes but includes some significant revenue measures. The governor recommends increasing the amount of pension and annuity income that is untaxed from $20,000 to $50,000. As with his last budget, the governor has proposed a cut in the corporate minimum tax. The governor also has proposed to extend the period that taxpayers may carry forward net operating losses to 20 years. In a proposal to raise revenue, the governor is recommending a reduction in the tax credit offered to members of pass-through entities who pay taxes under the state's elective pass-through entity tax.

Expenditures

Governor McKee's FY 2025 budget plan proposes total expenditures of $13.68 billion—$334.8 million, or 2.8 percent, less than the FY 2024 enacted level. This reduction is driven by the drop-off in federally funded expenditures, which are $713.8 million lower than the FY 2024 amount. The governor's budget proposes state general revenue spending for FY 2025 of $5.50 billion, an increase of only $74.9 million, or 1.4 percent, over

the FY 2024 enacted level. While the variability of state spending by fiscal year can be affected significantly by the allocation of surplus funds, expenditure growth has slowed considerably over the past couple of fiscal years; general revenue spending increased by $1.10 billion between FY 2021 and FY 2023, but only by $325.9 million from FY 2023 to the spending level proposed in the governor's FY 2025 budget.

The governor's FY 2025 budget proposes four separate bond referenda to be placed on the ballot for voter approval in November 2024: higher education ($135.0 million), housing and community opportunity ($100.0 million), state archive and history center ($60.0 million), and green economy ($50.0 million). At $345.0 million, the total amount of the ballot initiatives proposed by the governor is less than the total for each of the last three referenda presented and approved by the voters, is roughly equivalent to the state-supported principal debt coming off the books in the next two years, and is well within state borrowing benchmarks.

The governor's proposed budget includes American Rescue Plan Act (ARPA) funding, which was fully appropriated in the FY 2024 enacted budget. Funding for most projects in the governor's budget is unaltered, although in a key proposed change, the governor seeks authority to direct funds at risk of not meeting obligation and spending deadlines to the unemployment insurance trust fund. In a departure from the general practice followed by both the governor and the Assembly to utilize the State Fiscal Recovery Fund (SFRF) monies for one-time purposes, the governor's budget proposes to reallocate $40.0 million in SFRF funds to cover operating expenses.

Health and Human Services

Representing 45.2 percent of total expenditures and 39.1 percent of general revenue spending, health and human services is a fast-growing component of the state budget, a trend that the governor's FY 2025 budget continues. State general revenue spending on Medicaid, which alone encompasses 75.1 percent of human services expenditures and nearly one-third of all general revenue expenditures, has grown at an average annual rate of 9.0 percent since FY 2019—significantly higher than overall general revenue spending growth. For FY 2025, the governor is seeking to increase general revenue spending on Medicaid by $107.5 million, or 6.7 percent, over the FY 2024 enacted level. Another driver of spending increases in health and human services is the Division of Developmental Disabilities, which has seen a spending increase of 82.2 percent since FY 2021 despite a stable population of those served by the Division. As a result, the annual cost per person has jumped sharply, from $73,379 in FY 2021 to $132,828 in the governor's proposed FY 2025 budget.

K-12 Education

The governor's proposal to fund K-12 education includes a major revision to the funding formula for education in the form of a cap on annual increases to the core instructional amount—the amount considered to be the minimum amount to educate one student—to the five-year average annual inflation rate. For FY 2025, the increase would be 3.9 percent under the governor's proposal (from $11,876 to $12,335), compared to a 6.2 percent increase under current law. The governor also proposed to increase the categorical funding bonus for multilingual learners from 15.0 percent to 25.0 percent of the core instructional amount. More

robust March 2024 student enrollment figures would enhance the governor's education aid proposal, which was based on lower October student counts. Applying the updated March 2024 enrollments results in an increase of $13.8 million for all public schools and $12.6 million for traditional district schools over the governor's original proposal. Under the updated student counts, school districts would receive $26.9 million more in total aid than received in the FY 2024 enacted budget but would receive $7.9 million less than under current law. The urban core districts of Pawtucket, West Warwick, and Woonsocket would be particularly disadvantaged, collectively receiving $2.9 million less in total aid under the governor's proposal than under current law. However, Providence and Central Falls—due to their high concentrations of multilingual learners—would receive respective increases of $2.7 million and $400,000 over current law.

Transportation

While a much smaller proportion of the state budget, transportation funding presents a critical long-term fiscal challenge. Significant increases in federal transportation funding under the 2021 Infrastructure, Investment, and Jobs Act requires increases in the state's matching contributions. The potential for an additional state expense to match funding for replacement of the Washington Bridge and a sizable deficit at the Rhode Island Public Transportation Authority (RIPTA) add to the demands for increased state spending on transportation. Adding to this challenge are declining revenues from the gas tax—the state's largest funding source for transportation—despite planned rate increases, and a suspension of the state's truck toll program pending the state's appeal.

Affordable Housing

Rhode Island continues to face significant challenges with affordable housing. The state has historically invested relatively little toward the production of affordable housing but starting in 2021 the General Assembly made historic investments of $361.2 million in affordable housing, funded in large part by $259.8 million in ARPA dollars. However, based on updated data, RIPEC estimates that this investment will produce only 1,616 net new affordable units, reflecting rising development and state subsidy costs that are now approaching an average of $500,000 and $150,000 per unit, respectively. In his budget, the governor has proposed a $100.0 million housing bond, by far the largest ever presented to the voters. Based on RIPEC's analysis of spending under the most recent bond issue, the $85.0 million of the proposed $100.0 million bond dedicated to the production or preservation of affordable housing is projected to produce 431 net new affordable rental units and 193 net new affordable units for homeownership.

Corrections

In the last few years, Department of Corrections spending has overrun authorized spending levels. In FY 2023, Department spending exceeded its budget by $35.2 million (13.7 percent). For FY 2024, the governor is proposing in his revised budget to add $27.9 million (9.6 percent) over the enacted level—largely funded through an allocation of $20.0 million in SFRF funds. The main drivers of the spending increases appear to be increased overtime costs due to staff shortages and a delay in reconfiguring the density of housing to pre-pandemic levels. This is taking place in the context of a declining prison population and has left Rhode

Island with per prisoner costs ($132,866) that are 43.1 percent greater than in FY 2019. As of 2020, Rhode Island's cost per prisoner was among the highest in the nation.

Fiscal Outlook

The governor's budget projects significant deficits for future fiscal years, beginning with a deficit of $244.3 million in FY 2026 and reaching $265.4 million in FY 2027 before declining to $218.4 million in FY 2029. The governor's use of one-time surplus and, to a lesser extent, federal dollars to fund continuing operating expenses contributes to these structural deficits. The projected future deficits also are driven by slowing revenue growth combined with relatively high levels of projected expenditure growth in certain areas.

Recommendations

Based on this analysis, RIPEC makes the following recommendations for consideration:

The General Assembly should curtail spending growth in crafting the FY 2025 budget. The Assembly should seek to limit the use of one-time revenues to fund continuing operating expenses in FY 2025, and thereby reduce the structural deficit for FY 2026 and beyond.

Policymakers should manage the growth of health and human services spending. Given the sheer size of health and human services expenditures and constrained state revenues, it will become more challenging to prevent crowding out other state spending priorities.

The Assembly should allocate state education aid to better support urban core districts. The state's K-12 funding formula should be reformed to better support students in poverty and multilingual learners, and to assist urban core districts facing the most serious fiscal challenges.

Policymakers should develop a sustainable finance plan for transportation. Given the increasing demand for state funding for transportation and the projected decline in dedicated revenues, policymakers should consider revenue alternatives to finance the state's transportation needs.

The state should dedicate greater resources to affordable housing while also improving its return on investment. Given the magnitude of the problem, the state should devote greater resources to affordable housing. At the same time, the state should improve its return on investment by curtailing the cost of developing and subsidizing affordable units.

The General Assembly should seek to continue to improve the state's business climate. Consistent with the governor's budget, the Assembly should continue to resist proposals to increase broad-based taxes and should approve reform to Rhode Island's carryforward period for net operating losses—which is the shortest among states. The Assembly also should approve the transfer of unused ARPA funds to the unemployment insurance trust fund.