

Running on Empty: Federal Tax Conformity Breaks the State Budget

Summary of Findings

This analysis considers the costs of three different options for federal tax conformity with HR1 by the state of Arizona. Findings include:

- Not conforming would fund up to \$300 million in minimal agency priorities.
- Significant conformity (excluding SALT and auto interest deduction) would generate more than a \$300 million deficit and not fund any minimal agency priorities.
- Minimal conformity (broad change to standard deduction, tips, overtime and opportunity zones only) but not funding minimal agency priorities leaves a small surplus.

Introduction

The unfunded tax changes Congress approved in HR1 (a.k.a. The One Big Beautiful Bill Act) are expected to increase the federal government's budget deficit by \$600 billion in FY2027.¹ Arizona, however, must have a balanced budget, so conforming to HR1's tax elements comes at a significant cost to the state.

The Arizona Legislature's Joint Appropriations Committee hearing last week made clear that the Republicans have no interest in any revenue enhancements (beyond Prop. 123) to make up for the projected loss in income that will result from conforming to HR1. If that's the case, there is a contradiction between their stated desire to conform to the federal tax code (except for on the State and Local Tax deductibility issues²) and their constitutional responsibilities to fund critical aspects of the state.

Assumptions

This analysis assumes the legislature comes to a bipartisan agreement on renewing Prop. 123 without going to voters to increase distributions from the State Land Trust to fund K-12 education, which would generate \$300 million in FY2027. Another piece of legislation proposes a ballot referral to renew Prop. 123, but it would cut revenue in half since it would not go into effect until January 2027; something the state cannot afford.

¹ Committee for a Responsible Federal Budget (2025), "[House Reconciliation Bill Would Massively Increase Near-Term Deficits](#)," May 15. Lautz, Andrew (2025), "[What Does the One Big Beautiful Bill Cost?](#)" Bipartisan Policy Center, July 23.

² State and Local Tax abbreviated as SALT. HR1 increased from \$10,000 to \$40,000 the amount people could deduct from their taxable income. Only wealthy people pay state income and property taxes that exceed \$10,000. The [JLBC estimated](#) conformity on that provision would cost the state's general fund \$140 million across FY2026 and FY2027.

Even with a Prop 123 renewal, the state can only afford minimal conformity with HR1 and still have the resources to meet critical new expenditures. A better option might be to forgo conformity. The tax benefits of HR1 are not well distributed, e.g., if you don't earn tips or work overtime, you don't gain anything. The cost of conforming prohibits meeting minimal agency priorities, such as continuing funding for childcare or preventing a 4% salary reduction for Department of Corrections staff.

Analysis

This report uses the latest revenue estimates and ongoing expenditures for FY2027 from the Joint Legislative Budget Committee (JLBC)³ and examines three budget scenarios:

1. No Conformity
2. Significant Conformity (excludes SALT and auto interest deduction)
3. Minimal Conformity (broad change to standard deduction, tips, overtime and opportunity zones only)

Only the No Conformity and Minimal Conformity options are fiscally viable unless revenue sources are added or significant budget cuts from ongoing expenditures are made. Since the No Conformity option leaves a slight negative balance, about one-fourth of the minimal desired agency priorities would have to be forgone; these priorities are entirely cut from the Significant and Minimal Conformity options. Significant Conformity leaves a deficit of more than \$300 million.

Millions \$	No Conformity		Significant Conformity		Minimal Conformity	
	FY2026	FY2027	FY2026	FY2027	FY2026	FY2027
REVENUE						
Ongoing	\$ 17,066	\$ 17,612	\$ 17,066	\$ 17,612	\$ 17,066	\$ 17,612
One-Time	\$ 30	\$ 10	\$ 30	\$ 10	\$ 30	\$ 10
Total	\$ 17,096	\$ 17,622	\$ 17,096	\$ 17,622	\$ 17,096	\$ 17,622
Prop 123 renewal		\$ 300		\$ 300		\$ 300
Balance Forward	\$ 1,367	\$ 440	\$ 1,367	\$ 73	\$ 1,367	\$ 275
Federal Conformity	\$ -	\$ -	\$ (367)	\$ (263)	\$ (165)	\$ (100)
Total Revenues	\$ 18,463	\$ 18,362	\$ 18,097	\$ 17,732	\$ 18,298	\$ 18,097
EXPENDITURES						
Ongoing	\$ 16,543	\$ 17,401	\$ 16,543	\$ 17,401	\$ 16,543	\$ 17,401
Critical Additions		\$ 647		\$ 647		\$ 647
Minimally Desired		\$ 390		\$ -		\$ -
One-Time	\$ 1,247		\$ 1,247		\$ 1,247	

³ JLBC (2026), "[FY2027 JLB January Baseline](#)," January 16. See Appendix C for General Fund Balance Sheet.

Millions \$	No Conformity		Significant Conformity		Minimal Conformity	
	FY2026	FY2027	FY2026	FY2027	FY2026	FY2027
Supplemental	\$ 233		\$ 233		\$ 233	
Total Expenditures	\$ 18,023	\$ 18,438	\$ 18,023	\$ 18,048	\$ 18,023	\$ 18,048
Balance	\$ 440	\$ (76)	\$ 73	\$ (316)	\$ 275	\$ 49

Supplemental FY2026

Both the JLBC and Executive agree that there needs to be a supplemental appropriation for FY2026 to cover costs associated with developmental disabilities, AHCCCS, and the growth of Empowerment Scholarship Account (ESA) recipients. While the two do not agree on an amount, the developmental disabilities cost is likely to be closer to the Executive’s estimate of \$233 million, which GCI has used in this analysis, instead of the \$209 million estimated by the JLBC.⁴

Critical Additions FY2027

GCI divides new expenditures beyond baseline as either critical or minimally desired. These expenses are either required, such as employee health insurance or if not done would pose a significant risk to the state, either due to failure to comply with lawsuits or due to a federal financial penalty if the state’s SNAP error rate is not addressed. Fire suppression costs will be incurred regardless of whether or not the state chooses to fund them, so it’s better to be fiscally proactive rather than reactive. Collectively, these amount to \$646.5 million.

Critical Expenditures (millions \$)		
Agency	Amount	For What
Dept of Admin	\$272.8	Employee health insurance increases
Dept of Corrections	\$118.3	Healthcare injunction costs (lawsuit)
Dept of Econ. Security	\$26.3	Hire staff to reduce error rate in SNAP from current 10.39% to 6% (compliance deadline FY28)
Dept of Forestry and Fire Management	\$20.0	Continue added funding for fire suppression
Dept of Revenue	\$12.54	Continued IT upgrade (continue from FY2026)
School Facilities	\$196.65	New construction (lawsuit)
TOTAL	\$646.5	

⁴ Joint Legislative Budget Committee (2026), [“FY2027 JLBC Baseline with Executive Comparison,”](#) Jan. 19.

Minimal Agency Priorities FY2027

Minimal agency priorities should be weighed against federal tax conformity, as the state does not have the resources to afford both. Even with the no conformity scenario, about one-fourth of this \$390 million would not be able to be funded due to a lack of revenue.⁵

Minimal Agency Priority Expenses (millions \$)		
Agency	Amount	For What
AHCCCS	\$10.5	Crisis services due to higher non-Medicaid caseloads
Commission on the Arts	\$2.0	Maintain current grant levels
Commerce Authority	\$15.0	Establish job training program that reimburses employers
Community Colleges	\$34.7	Restore State Aid to Maricopa and Pima counties
Dept of Child Safety	\$43.8	Congregate care cost increase; Guardian data system; extended foster care caseload growth & coaching
Dept of Corrections	\$33.7	Cover increased utility costs; prevent 4% salary reduction
Dept of Corrections	\$54.3	Private prison rate increase (carryover from FY2026)
Dept of Econ. Security	\$45.0	Continue childcare funding
Dept of Econ. Security	\$18.0	Developmental Disabilities High-Need Client Supplement
Dept. of Education	\$5.6	Expand early literacy program, including math coaches to assist low-performing elementary schools.
Dept. of Education	\$66.0	Fund low-income opportunity weight in school funding formula
Dept. of Environ. Quality	\$9.5	Deposit in Water Quality Fee Fund to address revenue shortfall
Dept of Health Services	\$5.8	For heat-related health relief, including statewide heat call center, transportation to cooling centers, EMS worker training, cooling center grants, and mobile cooling centers.
Dept of Homeland Security	\$0.8	To continue Border Coordination Office, previously funded by federal American Rescue Plan
Dept of Housing	\$15.0	Finance Low-Income Housing Tax Credit projects estimated to create 2,000 low-income housing units (cost of \$7.500 per unit).

⁵ The items below were selected from the [JLBC Summary of FY2027 Agency Operating Budget Requests](#).

Minimal Agency Priority Expenses (millions \$)		
Agency	Amount	For What
Universities	\$30.0	Establish the Arizona Medical Professionals Loan Assistance Program (AMLAP) to provide loan assistance for medical professionals who work in Arizona for at least 4 years after graduation.
TOTAL	\$389.7	

Significant Conformity v. Minimal Conformity

Both the Executive and Legislative Republicans agreed that conforming to allow up to \$40,000 in SALT deductions would only benefit wealthy households and was not prudent to pursue. In addition, Legislative Republicans excluded the interest deduction on new car loans from their initial legislation to address conformity, SB1106. GCI's analysis also omits these items.

This analysis's Significant Conformity option takes SB1106 as the basis for conformity while excluding or changing elements in the legislation not related to conformity. GCI's analysis reflects straight conformity with a \$6,000 larger standard deduction for those 65+ (SB1160 lowered the age for this deduction to 60+). This analysis also excludes SB1106's child tax credit increase of \$25 and adding deductibility of Roth IRA contributions, which also are not part of HR 1.⁶

Millions \$	Significant Conformity	
	FY2026	FY2027
Increase Standard Deduction	\$ (65.0)	\$ (65.0)
Eliminate Tax on Tips (income limited)	\$ (23.6)	\$ (17.9)
Eliminate Tax on Overtime (income limited)	\$ (76.5)	\$ (59.8)
Raise Standard Deduction for 65+ by \$6K	\$ (53.7)	\$ (53.6)
0.5% Floor on Deduction of itemized Charitable Deduction	\$ -	\$ 11.0
Allow Non-Itemizers to Deduct \$1,000/\$2,000 of Charitable Contributions	\$ -	\$ (5.1)
All Other Provisions	\$ (0.4)	\$ 5.8
Full Expensing Business Property	\$ (31.8)	\$ (20.8)
Full Expensing R&D	\$ (50.5)	\$ (30.8)

⁶ Cost elements were taken from [JLBC Fiscal Note for SB1106](#) except for the additional \$6,000 standard deduction for those over 65. That cost estimate was taken from [JLBC Staff Analysis of the Federal Budget Reconciliation \(H.R.1\) on Arizona State Budget](#), September 18, 2025.

Millions \$	Significant Conformity	
	FY2026	FY2027
Higher Deduction on Business Interest	\$ (9.8)	\$ (9.3)
Double Small Business Expensing Allowance	\$ (10.0)	\$ (8.4)
100% depreciation allowance for certain non-residential production property	\$ (45.5)	\$ (51.7)
Make Opportunity Zone Permanent	\$ -	\$ 42.8
TOTAL	\$ (366.8)	\$ (262.8)

Minimal conformity represents only four elements of HR1: the larger overall standard deduction, but not the \$6,000 enhanced deduction for those 65 and over. It also only covers the income-limited exemptions on taxes on tips and overtime. Arizona already does not tax social security income, so those benefiting from the enhanced senior deduction in Arizona would already have additional non-social security income beyond the standard deduction, so it fails to target those who are most income-constrained. Opportunity Zones are included as well since they are a source of income in the short-term, as opposed to a loss in revenue.

Millions \$	Minimal Conformity	
	FY2026	FY2027
Increase Standard Deduction	\$ (65.0)	\$ (65.0)
Eliminate Tax on Tips (income limited)	\$ (23.6)	\$ (17.9)
Eliminate Tax on Overtime (income limited)	\$ (76.5)	\$ (59.8)
Make Opportunity Zone Permanent	\$ -	\$ 42.8
TOTAL	\$ (165.1)	\$ (99.9)

About

Dave Wells holds a Ph.D. in Political Economy and Public Policy and is the Research Director of the Grand Canyon Institute. He can be reached at dwells@azgci.org or (602) 595-1025 ext. 2.

The Grand Canyon Institute (GCI) is a nonpartisan, nonprofit organization dedicated to informing and improving public policy in Arizona through evidence-based, independent, objective, nonpartisan

research. GCI makes a good faith effort to ensure that findings are reliable, accurate, and based on reputable sources. While publications reflect the view of the Institute, they may not reflect the view of individual members of the Board.

Grand Canyon Institute
P.O. Box 1008
Phoenix, Arizona 85001-1008
GrandCanyonInstitute.org