

Running on Empty: Federal Tax Package Conformity Leaves \$1 Billion State Budget Deficit

Summary of Findings

Federal HR1, also known as the One Big Beautiful Bill Act, made significant changes to federal tax law. Now it is up to states to decide whether to align their tax laws to conform with the federal changes. States are not required to, but it's generally easier for taxpayers if their state returns rules are similar to the federal government. Regulatory provisions related to government programs that were part of HR1 states must comply with.

Because HR1 was retroactive to Jan. 1, 2025, if Arizona conformed its tax laws, it would impact the already-ended FY2025 as well as FY2026. The costs of the related tax cuts would get rolled into FY2026. FY2027 would also bear significant costs. If Arizona fully conforms to HR1, it could cost a total of \$800 million in tax revenue.

The Grand Canyon Institute (GCI) uses estimates from the Joint Legislative Budget Committee (JLBC) as well as identifying critical or required spending from the JLBC's summary of budget requests from agencies. The table below leaves out many spending areas—so it's a fairly bare bones budget.

But between lost revenues from Prop. 123, the 2.5% Flat Tax passed in 2021 as well as the added net cost of Empowerment Scholarship Account (ESA) vouchers, the state confronts a more than \$1 billion deficit starting the legislative session for FY2027 if the state fully conforms with HR1.

	FY2026	FY2027
	Millions \$	
Revenue	\$ 16,862.64	\$ 17,377.76
Balance forward	\$ 1,092.09	\$ (75.08)
Total	\$ 17,954.73	\$ 17,302.69
Ongoing Expenses FY2026	\$ 16,531.95	\$ 16,531.95
Required/Critical Increases		\$ 992.83
Minimal Agency Priorities		\$ 161.61
One-Time (JLBC)	\$ 1,039.25	\$ 282.57
Total	\$ 17,571.20	\$ 17,968.96

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	FY2026	FY2027
	Millions \$	
Budget Balance	\$ 383.52	\$ (666.27)
HR1 added costs (JLBC)	\$ (20.30)	\$ (62.40)
Hobbs EO on HR1	\$ (210.60)	\$ (213.40)
Republican Full HR1 Conformity	\$ (227.70)	\$ (122.70)
Net Full Conformity	\$ (75.08)	\$ (1,064.77)

The state has revenue options that total more than \$2 billion to cover this deficit.

Reintroduce a Progressive Income Tax on Wealthier Taxpayers (\$1 Billion+): The Flat Tax costs the state more than \$2 billion annually and 80% of the benefit goes to households with incomes above \$200,000. Reintroducing some version of a progressive income tax on higher-earning households could raise at least \$1 billion.¹

Renew Prop. 123 (\$300 million): In 2025, the General Fund absorbed the cost created by the expiration of Prop 123 in June 2025 and the failure of the legislature to renew it. This meant backfilling an allocation from the State Land Trust that was reduced from 6.9% to 2.5% with the expiration of the proposition.

Sweep Unspent ESA voucher accounts (\$440 million): Each year a significant portion of ESA voucher amounts are not spent and accumulate in accounts. The legislature could sweep these funds to recover almost a half a billion dollars.²

Limit ESA vouchers for homeschooling and non-accredited schools to \$2,000 (\$290 million): When Texas passed its universal voucher program, it limited awards for homeschooling to \$2,000.³ This is the area that has been abused the most. GCI estimates one-third of recipients are homeschooling. Limiting their vouchers to \$2,000 would save an estimated \$290 million in FY2027.

Eliminate Sales Tax Exemption for Data Centers (\$60 million): Data centers are already profitable, are not particularly strong providers of jobs, and are not effectively lured by incentives.⁴ Arizona has a sales and use tax exemption that was specifically created for data centers. Its cost has exploded from

¹ Wells, Dave (2025), "[State Budget: The Flat Tax Failure](#)," Grand Canyon Institute, June 18.

² Harris, Craig (2025), "[Families hoard ESA funds as Arizona public schools face low funding, records show](#)," 12 News I-Team, July 8. Earlier report: Cardine, Curt and Dave Wells (2024), "[ESA Voucher Accounts had \\$360 Million Unspent, While the State Pulls Funds from the Opioid Settlement](#)," Grand Canyon Institute, Sept. 17.

³ Texas AFT (2025), "[Final Rules for Texas Voucher Program Released](#)," December 5.

⁴ On Profitability: "[Investing in the rising data center economy](#)," McKinsey and Company, January 17, 2023. On Jobs: Tozzi, Christopher (2025), "[How Many Jobs do Data Centers Create? It Depends](#)," DataCenter Knowledge, August 25. On Incentives: Franklin, Avery Ruyer (2026), "[Data center location decisions focus on cost and proximity, not job centers, study shows](#)," Rice University News and Media Relations, January 7. Studies find incentives do not pay for themselves: Tarcynska, Kasia (2025), "[Clouded Judgment: Data Center Subsidies Don't Add Up](#)," Good Jobs First, May 8.

\$1.4 million in 2020 to \$19 million in 2024 and \$38.5 million in 2025.⁵ GCI estimates the FY2027 cost to be at least \$60 million, if not higher.

HR1 Conformity Elements and Compliance Costs

The rationale for conformity is to simplify the tax filing process for individuals and businesses, and to reduce the administrative burden for the Arizona Department of Revenue.

Governor Hobbs issued an executive order for tax forms to be published that complied with part of HR1. This included the elements of HR1 that impact a broader group of more typical Arizonans and are the elements of HR1 that have received the most publicity. These elements are subject to income limitations and include:

- An additional \$6,000 additional standard deduction for seniors through 2028
- No Income Tax on Tips through 2028
- No Income Tax on Overtime through 2028
- New auto loan interest deduction

Collectively, these changes along with an increase of the standard deduction by a modest amount for all taxpayers is estimated to cost Arizona \$210.6 million in FY2026 and \$213.4 million in FY2027 as estimated by the JLBC.⁶

Republican legislative leadership has pushed for full conformity which includes a number of elements that have received less publicity and focus primarily on wealthy taxpayers or businesses. These include the following:

- Increase State and Local Tax Deduction from \$10,000 to \$40,000 through 2029. This benefits only those people who pay more than \$10,000 in state income and local property taxes. At an estimated \$79.7 million in FY2026 and \$67.3 million in FY2027 it is the most expensive provision of tax conformity according to the JLBC.
- Business deductions:
 - Full expensing of certain business property (this means it gets fully deducted as a business expense immediately instead of over time).
 - Higher deduction of business interest (formerly limited to 30% of earnings).
 - Full expensing of Domestic Research and Development Expenditures.
 - Doubling small business expensing allowance.

Collectively these and other business-related provisions are estimated by the JLBC to reduce revenues by \$227.7 million in FY2026 and \$122.7 million in FY2027.

HR1 also has compliance costs related to changes in Medicaid and the Supplemental Nutrition Assistance Program (SNAP).

For Medicaid (Arizona's program is known as AHCCCS - the Arizona Health Care Cost Containment System), HR1 reduces the ability of the state to use hospital assessments to partially fund the program, though this impact does not begin until FY2028. It also introduces work requirements for the Affordable Care Act expansion population (generally adults without dependent children age 18 or under). The federal government pays 90% of their Medicaid costs and the remainder is mostly picked up by the

⁵ Details on exemption: Arizona Commerce Authority, "[Computer Data Center Program](#)." Annual amounts of revenue foregone found in Arizona Dept. of Revenue [Annual Tax Expenditure Reports](#).

⁶ "[JLBC Staff Analysis of the Federal Budget Reconciliation Bill \(H.R.1\) on Arizona State Budget](#)," September 18, 2025.

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Hospital Assessment with the General Fund only covering behavioral health costs. So any lost eligibility will have minimal impacts on the General Fund. However, the state administrative costs rise significantly to monitor heightened work and eligibility requirements.

For SNAP, HR1 increases from 54 years of age to 64 years of age, the upper age-limit for those adults subject to a work or volunteer requirement of 80 hours per month. HR1 also removed exemptions from work requirements for veterans, homeless individuals, and former foster youth. This will make some current participants ineligible. Previously work requirements were waived if there was an "insufficient number of jobs" in the area. In practice, this meant that work requirements were only applicable in Maricopa County. Now the threshold is an unemployment rate exceeding 10%, a threshold only breached by Yuma County. So the applicability of work requirements expands significantly. The state will now have to verify whether or not more current recipients are meeting that requirement each month—which adds a bureaucratic burden on both the state and recipients.

For SNAP, starting in October, the state's share of the costs of administering the program rises from 50% to 75%.

By FY2028, the state must reduce its SNAP error rate to 6% or less or it will be penalized. The state's current error rate is 10.39%. So the state will need to devote staffing and other resources to meet this requirement or face a significant financial penalty.⁷

Revenue up 3.9% for FY2027 but Labor Market Slowing

GCI used revenue projections from the JLBC. As of November, estimated FY2026 revenues have exceeded projections by \$184 million.⁸ GCI added this to the FY2026 projection as a starting point. The FY2027 estimate was then upwardly adjusted to reflect the same growth rate expected by JLBC for FY2027, but on a base that was \$184 million higher based on the current amount revenues have exceeded the FY2026 estimate.⁹

While revenues may continue to grow beyond the FY2026 estimate, GCI did not project added growth beyond the \$184 million due to increasing signs that the national economy may be slowing. The unemployment rate has been rising and job growth has been sluggish. These impacts have included Arizona's year-over-year job growth as of November 2025 was about 21,300. By contrast the year to year growth for November 2023 was 57,000 jobs, though it was only 25,000 jobs for November 2024.¹⁰ Likewise, the state's unemployment rate has risen from 3.7% in the fourth quarter of 2024 to likely around 4.2% for the fourth quarter of 2025. From November 2024 to November 2025, the growth in the number of unemployed Arizonans is about 20,500—almost exactly the same as the number of Arizonans who filled new jobs.¹¹

National growth has largely been driven by AI investments and expenditures of wealthier households, the so-called K-shaped economy where the vast majority of households struggle with affordability. The possibility of refunded tariffs, interest rate cuts by the Fed, and lower taxes from HR1 lead most economists to expect continued moderate growth. The range of Blue Chip forecasters from the St.

⁷ ["JLBC Staff Analysis of the Federal Budget Reconciliation Bill \(H.R.1\) on Arizona State Budget,"](#) September 18, 2025.

⁸ Joint Legislative Budget Committee, ["Monthly Fiscal Highlights,"](#) December 2025.

⁹ Joint Legislative Budget Committee (2025), ["Statement of General Fund Revenues and Expenditures with One-Time Financing Sources,"](#) FY2026 Appropriations Report.

¹⁰ ASU Seidman Institute, ["Job Growth by State."](#)

¹¹ Arizona Office of Economic Opportunity, ["Unemployment."](#)

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Louis Fed put real growth at 1.9%, similar to this year, with a range of 1.2% to 2.5%.¹² Notably, economists also see warning signs such as the historically high cyclically adjusted price-to-earnings ratio in the stock market and the potential of an AI investment bubble leading to much uncertainty and about a one-third chance of a recession.¹³

Required/Critical Increases for FY2027: \$993 million

GCI uses the ongoing FY2026 budget as a starting point and then reviewed agency budget requests, added estimates for impacts on base student funding in K-12 education as well as the gross cost of the ESA voucher program.

The results are summarized below.

Required Critical Increases FY2027 (millions \$)		
Agency/Program	Amount	For What
AHCCCS	\$429.9	Primarily Medicaid State Contributions
Dept. Child Safety	\$45.2	Critical Needs for At-Risk Children
Dept. of Corrections	\$48.4	Inmate Healthcare (lawsuit-related)
Dept. of Economic Security	\$257.5	Developmental Disability, Medicaid, Childcare providers
Dept. of Forestry & Fire	\$27.0	Fire Suppression
K-12 Funding Formula	\$78.3	2% inflation adjustment
ESA Vouchers	\$106.5	Growth in Program
TOTAL	\$992.8	

These figures only represent part of the requests that came in from state agencies.¹⁴ These are identified because they are either statutorily required, such as Medicaid, the K-12 funding formula and ESA vouchers, or they are meeting critical needs or expected heightened costs. The \$27 million for fire suppression, for instance, is likely critical, as though much of the state is bathed in a wonderful green from recent rains, as the summer hits, fire danger will increase and the state, whether it budgets for it or not, will need to pay for costs of fires that originate on state lands.

Figures on Average Daily Membership (ADM) for the 100th day, which the K-12 funding formula is based on, are not yet available. Based on ADM count (not weighted), GCI projects that ADM count will decline by 0.8% in line with the last few years.¹⁵ Assuming the weighted ADM count decreases proportionately with a 2% inflation adjustment, the state's General Fund cost is estimated to rise by \$78.3 million. For ESA vouchers, the distribution across groups has stabilized, meaning that special

¹² Gascon, Charles (2025), "[Revisiting Professional Forecasters' Past Performance and the Outlook for 2026](#)," Federal Reserve Bank of St. Louis, December 18.

¹³ Baab, Catherine (2025), "[What the biggest banks are predicting for the U.S. economy in 2026](#)," Quartz, December 29.

Thanks to Nikhil Mohta for research on economic forecasts.

¹⁴ "[JLBC Summary of FY 2027 Agency Operating Budget Requests](#)," Sept. 22, 2025.

¹⁵ JLBC Staff (2025), "[K-12 Funding \(M&O, Capital and Other\)](#)," Sept. 15.

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education enrollment is growing at the same proportional pace as universal enrollment. The Quarter 1 FY2026 report indicated overall enrollment at 93,993 up from 79,593 at the same point last year.¹⁶ GCI estimates next year enrollment will grow somewhat slower to 102,496 and by quarter 2 (the half year point) enrollment will be 106,722. Assuming per student costs here also grow by 2%, then the added estimated cost to the General Fund will be \$106.5 million.

Minimal Agency Priorities for FY2027: \$162 million

The list provided earlier in this analysis likely leaves out some critical needs as well as areas where more state funding would be highly advisable. GCI went through budget requests from state agencies and pulled one illustrative priority from 12 of them as compiled in the table below. Even under austerity circumstances, given we are not in a recession, we would expect the budget to contain at least these aspects, even though this represents a very limited illustration of possible spending options.

Illustrative 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 Corrections	\$6.5	Cover increased utility costs
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 Education	\$5.6	Expand Early Literacy program including math coaches to assist low-performing elementary schools
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)
Universities	\$30.0	Establish Arizona Medical Professionals Loan Assistance Program (AMPLA) to provide loan assistance for medical professionals who work in Arizona for at least 4 years after graduation
TOTAL	\$161.6	

¹⁶ Arizona Dept. of Education, [“ESA Quarterly Reports: Executive and Legislative Quarterly Reports.”](#)

FY2027 One-time: \$252.6 million

One-time carryover commitments are fairly sparse in the FY2027 budget and are summarized below.¹⁷

JLBC One-Time Funding FY2027 (Millions \$)		
Agency	Amount	For What
Dept. of Revenue	\$ 12.5	Integrated Tax System
School Facilities	\$ 196.7	New Construction
Dept. of Corrections	\$ 54.3	Private Prison rate increase (contracted)
Dept. Public Safety	\$ (10.9)	Repurpose unused border security funds
TOTAL	\$ 252.6	

Foregone Revenue and Revenue Opportunities (\$2 billion)

Reintroduce a Progressive Income Tax (\$1 billion+): The state has a number of options to improve its revenue. GCI provided a June 2025 analysis that noted that the elimination of progressive individual income taxes and replacing it with a 2.5% flat tax cost the state in excess of \$2 billion annually with 80% of that going to households with incomes of \$200,000 or more.¹⁸ Reintroducing some version of a progressive income tax on higher-earning households could raise at least \$1 billion.

Renew Prop. 123 (\$300 million): In the last legislative session, lawmakers failed to renew Prop. 123, as a consequence the proceeds from the state land trust which had gone up to 6.9% for the last decade returned to only 2.5%. This change will cost the state about \$300 million in revenue for FY2027. Lawmakers should simply renew Prop. 123, but would need to have a two-thirds vote in both the House and Senate for this to impact FY2027 in a meaningful way. If they only refer it to voters, then it will only bring in half as much for FY2027.

Sweep ESA accounts for Unspent Amounts (\$440 million): GCI released a report that after FY2024 an estimated \$360 million was left unspent in ESA voucher accounts. Craig Harris of Ch. 12 News reports that after FY2025 the figure had increased to \$440 million. GCI advocated then that these funds should be swept annually and placed in the General Fund to benefit all Arizona school children. Such a sweep would require legislation, however.¹⁹

Limiting Homeschooling ESA vouchers to \$2,000 like Texas (\$290 million): Limit ESA payments to accredited schools and certified special education services only and other expenses, including homeschooling, to no more than \$2,000 similar to what Texas has done.²⁰ GCI estimates that one-third

¹⁷ Joint Legislative Budget Committee (2025), "[Summary of One-Time General Fund Adjustments](#)," FY2026 Appropriations Report.

¹⁸ Wells, Dave (2025), "[State Budget: The Flat Tax Failure](#)," Grand Canyon Institute, June 18.

¹⁹ Harris, Craig (2025), "[Families hoard ESA funds as Arizona public schools face low funding, records show](#)," 12 News I-Team, July 8. Earlier report: Cardine, Curt and Dave Wells (2024), "[ESA Voucher Accounts had \\$360 Million Unspent, While the State Pulls Funds from the Opioid Settlement](#)," Grand Canyon Institute, Sept. 17.

²⁰ Texas AFT (2025), "[Final Rules for Texas Voucher Program Released](#)," December 5.

of ESA users are homeschooling assuming this is evenly distributed across ESA recipients regardless of voucher amount, then the estimated savings for FY2027 would be \$290 million.²¹ Since homeschoolers are the primary cause of questionable ESA purchases, this would also mitigate the current possible fraud in the program. In addition, restricting ESAs to accredited institutions and certified special education services would provide a minimal additional step toward educational quality in the absence of a testing requirement. Proponents of vouchers such as Professor Wolf of the University of Arkansas have emphasized its requirement that schools be accredited as a key attribute of Arkansas' program.²²

Eliminate Sales Tax Exemptions for Data Centers (\$60 million): Data centers are already profitable, are not particularly strong providers of jobs, and are not effectively lured by incentives.²³ Arizona has a sales and use tax exemption that was specifically created for data centers. Its cost has exploded from \$1.4 million in 2020 to \$19 million in 2024 and \$38.5 million in 2025.²⁴ GCI estimates the cost for FY2027 to be at least \$60 million, if not higher.

About

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²¹ ESA Quarterly reports Tables 9 and 10 indicate expenditure categories. The number of tuition payments to qualified schools, tuition payments for life skills and vocational education for students with a disability, and tuition payments to post-secondary institutions were summed to estimate the portion of students who were not engaged in home schooling.

²² DiPerna, Pat (2025), "[Arkansas' ESA Program Is Thriving: A Q&A with University of Arkansas' Dr. Patrick Wolf on a New Comprehensive Annual Report](#)," Ed Choice, October 21.

²³ On Profitability: "[Investing in the rising data center economy](#)," McKinsey and Company, January 17, 2023. On Jobs: Tozzi, Christopher (2025), "[How Many Jobs do Data Centers Create? It Depends](#)," DataCenter Knowledge, August 25. On Incentives: Franklin, Avery Ruyer (2026), "[Data center location decisions focus on cost and proximity, not jobs centers, study shows](#)," Rice University News and Media Relations, January 7. Studies find incentives do not pay for themselves: Tarcynska, Kasia (2025), "[Clouded Judgment: Data Center Subsidies Don't Add Up](#)," Good Jobs First, May 8.

²⁴ Details on exemption: Arizona Commerce Authority, "[Computer Data Center Program](#)." Annual amounts of revenue foregone found in Arizona Dept. of Revenue [Annual Tax Expenditure Reports](#).