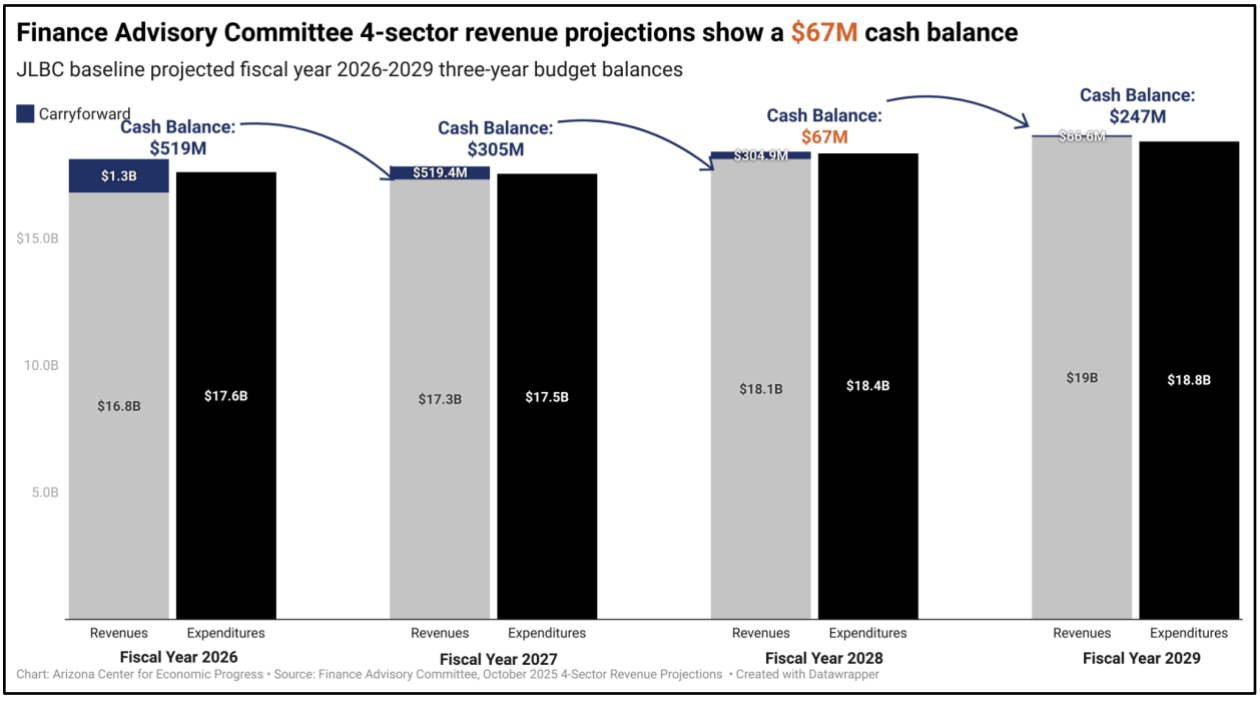
Karma's a Budget: 3 Fiscal Consequences Lawmakers Must Confront

Arizona entered the current fiscal year (FY2026) with what appeared to be a strong position: $148 million above forecast in year-to-date revenues and a $519 million cash balance projected by the Finance Advisory Committee (FAC).

But these headline numbers obscure the real story.

Once delayed FY2025 obligations and required future spending are factored in, economists estimate the state has just $67 million truly available this year with $723 million in spending changes for FY2027 looming.

The following deeper dive examines the three major categories of pressures that will shape budget negotiations this session — pressures created by past decisions, one-time fixes, and federal shifts already set in motion.



1. Less Revenue Formula-Driven Cost Growth (The Largest Structural Pressure)

Due to 30 years of state tax cuts, including the enactment of the flat 2.5 percent state individual income tax, Arizona has less revenue to invest in critical services. Yet Arizona's budget automatically grows as the cost of providing essential services increases. Prior to the start of budget

negotiations, the Joint Legislative Budget Committee (JLBC) is required to update spending costs for programs based on formulas. K-12 education, Arizona Health Cost Containment System (AHCCCS)/Medicaid and the Division for Developmental Disabilities (DDD)/Medicaid programs are the three main program formulas updated. This year, JLBC also included the Supplemental Nutrition Assistance Program (SNAP) increased administrative and new benefit issuance cost shifts from the federal government as a formula adjustment. This year's updates reveal **significant and unavoidable cost growth** across multiple systems.

- **Division of Developmental Disabilities (DDD)/Medicaid**
  DDD provides health care services to Arizonans diagnosed with Down Syndrome, Cerebral Palsy, Autism, Epilepsy or a cognitive disability. Over 45,000 DDD members receive health care through the state's long-term care Medicaid program, called the Arizona Long-term Care System (ALTCS). DDD members who qualify for ALTCS require higher funding supports.

  Last year, DDD experienced a $109 million budget shortfall due to unexpected growth of new members, higher cost of payments to health care providers and high demand for the Parents as Paid Caregivers Program, which allowed parents to become paid caregivers. This shortfall was resolved not with funding from the General Fund but from the Prescription Drug Rebate Fund.

  Based on the FAC October Update and the Department of Economic Security (DES) budget request, it appears DDD will again require additional funding this year. The General Fund *shortfall amount so far ranges from $41 million to $56 million* mainly due to higher enrollment growth and health care provider payment costs.

  The DDD program is also expected to *need between $226 million to $236 million more ongoing* funding to support an additional 9,000 members by FY2027. Of the higher amount, about $207 million is needed for the ALTCS program.

- **AHCCCS/Medicaid**
  While the AHCCCS/Medicaid program doesn't require supplemental funding, long-term pressures are looming, and it is expected to need at least $191 million more in ongoing funding beginning FY2027. This increased cost is due to a decrease in federal-dollar match from 64.34 percent to 63.81 percent, higher health care provider costs and a $100 million shift back to the General Fund of one-time costs covered by the Hospital Assessment Fund.

- **ESA Vouchers**
  The formula cost for K-12 education is also expected to increase by $234 million in FY2027. $154 million of this increase is due to estimating 12,000 more Empowerment

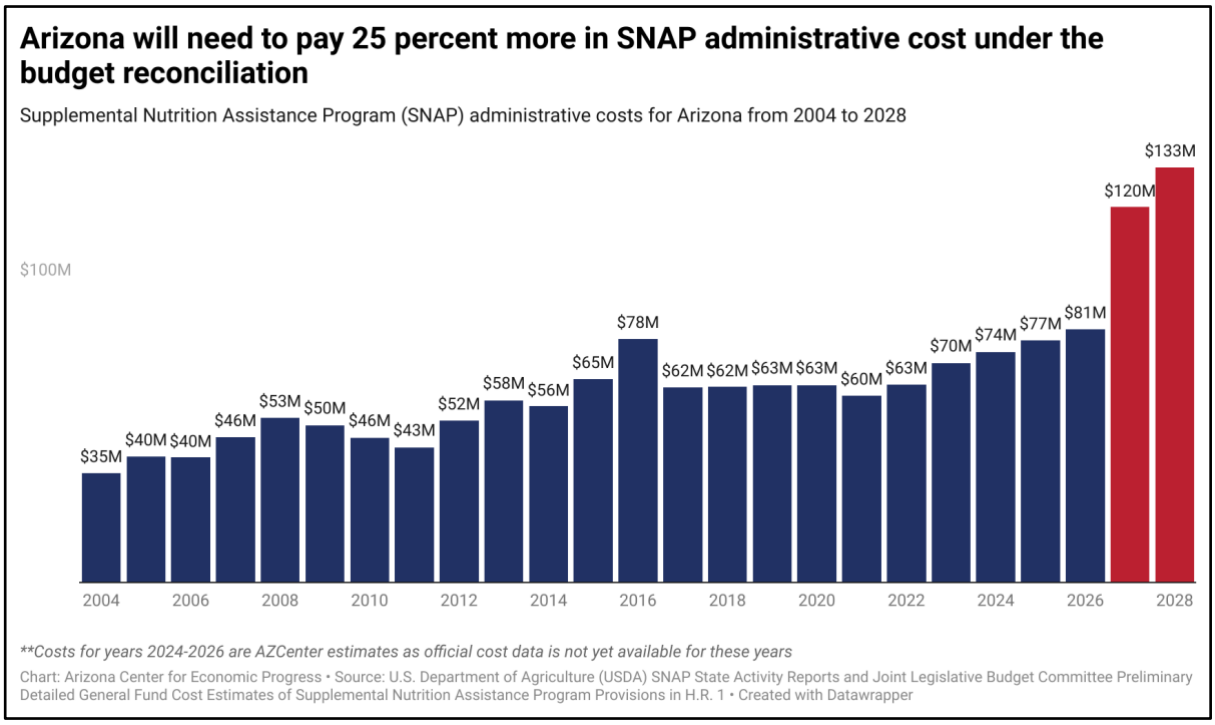
Scholarship Account (ESA) students bringing the total to 109,195 students – a $1.18 billion total cost for ESAs. Concerns remain over whether ESA funds are being used properly as well as frustrations that the universal expansion of the program has primarily benefited wealthier households, thereby operating as a de-facto tax credit.

- **K-12 Education**
  Two K-12 education funding pressures added back to the ongoing spending beginning FY2028 are $37 million for the low-income weight, which provides more funding to schools with higher shares of students with low-incomes, and $29 million for additional assistance. Both ongoing items were temporarily cut from the ongoing budget from FY2025-FY2027. While the FY2025 and FY2026 budgets funded these items one time, policymakers will need to find revenue for this important investment for FY2027.

- **Supplemental Nutrition Assistance Program**
  As a result of the federal budget reconciliation bill (H.R. 1, which was formally titled the One Big Beautiful Bill) passed in July, Arizona will be required to pay a higher share of administrative expenses and likely a new share of cost for benefit issuance. The FAC budget update treats these upcoming SNAP changes as formula adjustments.

  Arizona is currently responsible for paying 50 percent of SNAP administrative costs but beginning October 2026, the state will need to pay 75 percent. This additional 25 percent will cost Arizona $33 million in FY2027 and at least $44 million beginning FY2028.

  Due to the H.R. 1 federal cost shift to states, the other cost factored into the budget forecast is the possible new state share of SNAP benefit issuance cost. Currently, the federal government pays 100 percent of SNAP benefits. Starting October 2027, Arizona may be on the hook to pay a part of SNAP benefits depending on the state's error rate, a measure of how correct the state determines SNAP eligibility and benefit amounts. Based on the most recent information, the budget assumes Arizona may need to pay a 10 percent share or $139 million in FY2028.



With the increasing costs of health care, the number of children needing DDD services, rising costs of the ESA program, and the need to prepare for federal cost shifts such as that for SNAP, policymakers should not entertain any proposals to cut tax revenues. Today, more than ever, Arizona needs to consider long-term revenue solutions to meet growing needs.

2. One-Time Funding Masking Ongoing Needs Puts Essential Programs on Chopping Block
While the FAC provided a $67 million spending amount, this does not consider investments previously funded as one time costs. Many of these investments have been included in the budget for multiple years, almost as if they are "ongoing." If these are included with current revenue projections, we would have a budget deficit. Simply restoring two of these repeated one-time items — state employee health insurance and school building renewal — would create a $311 million shortfall.

- **Traditional one-time ongoing items**
  There are two large ongoing needs that have been included in the budget with one-time funding in the last few years: *State Employee Health Insurance* and *K-12 Building Renewal Grants*.

  State Employee Health Insurance provides health care to about 136,000 state employees. Cost for health coverage increased by 15 percent in FY2024. State employee health insurance was funded at $195 million in FY2026 and $140 million in FY2025.

Funding for school buildings is the other large need not included in the FAC budget outlook. Per a court ruling in 1998, policymakers created a formula to ensure the state met its constitutional responsibility of funding all school-building needs in an equitable manner. Yet, the state has failed to fully fund this formula. Despite not fully funding school buildings, the budget has included one-time funds in the last few budgets including $183 million in FY2026.

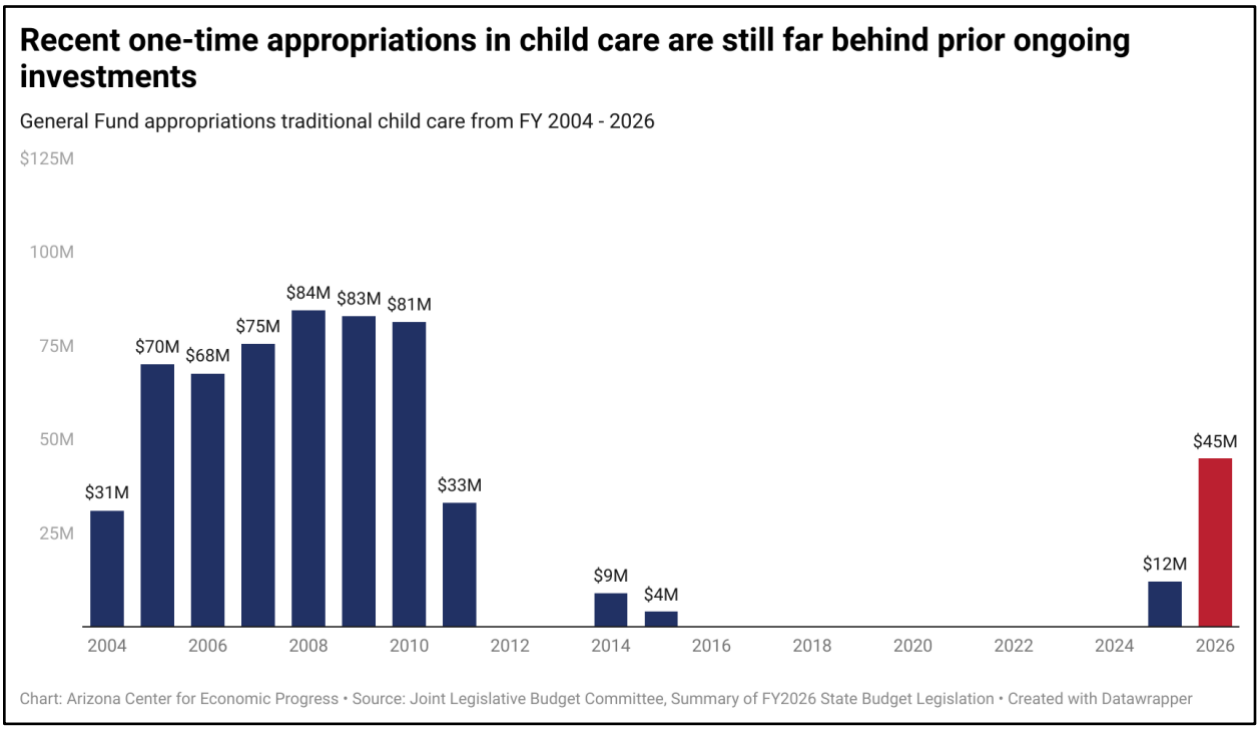
Just by including these two budget items, the budget would be short $311 million.

- **Child care**

  Prior to the great recession, Arizona was investing between $31 million to $84 million ongoing General Fund dollars in child care. This investment was reduced to $0 from FY2016 to FY2024.

  Last year, $12 million in one-time funds allowed Arizona to continue enhanced payment rates to providers and child care assistance to families with low-incomes. This year, about $45 million was invested in affordable child care, the highest investment in more than a decade. The funding could have allowed Arizona to reduce the child care waitlist by 50 percent and increase provider payments, but this plan was cut short by a loss of federal funding.

  The upcoming budget negotiations will tackle child care funding once again. Providing at least a $45 million investment would maintain the current level of access to Arizona's child care assistance program.



- **School meals**
  After the waiver to provide free school meals during the pandemic expired, Arizona invested $6.75 million American Rescue Plan Act (ARPA) dollars to provide about 12,000 free meals to children who qualified for reduced-price meals from January 2023 through June 2024. The last two budgets continued funding school meals with a historic allocation of $3.8 million of one-time General Fund dollars. Funding the ongoing need for school meals will be brought back to the negotiation table this upcoming legislative session.

These are just a few of a long list of programs, services and other one-time investments our budget has made that require ongoing funding. Policymakers need to consider long-term revenue solutions to fully fund state budget responsibilities and continue progress of recent one-time investments.

3. Federal H.R. 1: A Major Cost Shift With Significant State Implications

Shortly after the state FY2026 budget was passed, Congress passed a federal budget reconciliation (H.R. 1) that expanded tax cuts for the wealthy, largely paid by significant cuts in federal funding for Medicaid and SNAP. Cuts to these two programs will not only cause a significant number of Arizonans to lose services, but they will also shift at least $1.2 billion in cost from the federal government to Arizona over the next few years.

While most direct cost shifts for these programs will not hit our state budget immediately, tax cut provisions will. Policymakers will face two budget dilemmas related to H.R. 1 this legislative

session: (1) Should Arizona invest in resources to help prevent future higher cost shifts? And (2) should Arizona adopt federal tax cuts?

In answering these questions, it's important to keep in mind the prior two budget pressures this year and the budget deficit we are likely facing.

- **Invest to prevent higher future costs?**
  In preparation for H.R. 1 changes to AHCCCS/Medicaid and SNAP programs, administering agencies are requesting state investments. Making these proposed investments this year could help lower or even eliminate a future share of cost for SNAP benefit issuance.

  AHCCCS/Medicaid – Among the numerous H.R. 1 changes to the AHCCCS/Medicaid program, states will be required to redetermine eligibility twice a year for programs that currently require annual redeterminations. There will also be a new work requirement. AHCCCS anticipates needing about 320 more staff in the next couple years to begin and maintain programs needed for member and provider eligibility, information system, legal, administrative and eligibility system contractor needs to implement these changes. As such, AHCCCS is requesting $11 million in supplemental funding and $18.8 million ongoing funds.

  SNAP – In a similar manner, DES is requesting funding for the SNAP program. The H.R. 1 SNAP provision changing the work requirement that limits SNAP benefits to three months within a three-year period unless exempt or meeting the requirement went into effect immediately. Changes to this work requirement now put at risk food assistance for 140,000 Arizonans, including seniors ages 55-64, parents with children who are 14-18 years old, veterans, people experiencing homelessness, former foster care youth and Arizonans living outside of Maricopa County. As such, $7.5 million in supplemental funding is being requested to cover administrative costs to implement these work requirement changes.

  This $7.5 million supplemental investment would not only help implement new work requirements, but also contribute to reducing the state's error rate, a measure of how correct the state determines SNAP eligibility and benefit amounts. Arizona's SNAP error rate will determine the share of cost amount Arizona may be required to pay for food assistance benefits beginning October 2028. Based on Arizona's most recent error rate of 8.8 percent, the state may be required to pay 10 percent of benefit cost, in other words $139 million. Arizona could lower its error rate these next two years and dodge paying a share of the cost. DES hopes to achieve this goal with $1.8 supplemental and $26.3 ongoing investments.

- **Adopt federal tax cuts?**
  H.R 1 permanently expanded several tax cuts for businesses and the wealthy. It also introduced temporary individual tax cuts that would mainly benefit those with more resources and prioritize certain people over others with similar needs. These tax cuts not only mean states will have to pay a larger share of health care and food assistance programs but could further reduce state revenues should states decide to match their tax code. For Arizona, this means losing at least $1.1 billion in the next three years.

  Given Arizona's difficult budget situation, we cannot afford to match any of these tax cuts. Furthermore, policymakers should consider unmatching most of the business tax breaks, as it would mean giving away state dollars benefiting other states and not Arizona's economy.

  Tax cuts that would cause the greatest harm to Arizona's budget while doing nothing for our state's economy:

  - **Bonus Depreciation for Business Property** – Permanently allows businesses to immediately write off 100 percent of costs for machinery and equipment. Depreciation costs should instead be spread over the life of these assets. It impacts individual income tax revenue in Arizona, reducing ongoing revenues by at least $68 million in the next three years and ongoing thereafter. Arizona would be better off investing this amount in keeping the child care program afloat with a goal of releasing more children from the waitlist.

  - **Bonus Depreciation for Manufacturing Plants** – Provides a new temporary write off of 100 percent of costs for manufacturing plants. It impacts both corporate and individual income tax revenue in Arizona, reducing revenues by at least $148 million in the next three years. This amount should instead be saved to fund one year of the new SNAP share of cost for benefits.

  - **Research and Development Expenses** – Restores the ability to immediately write off domestic research and development expenses. H.R. 1 also allows businesses with less than $31 million in receipts to retroactively write off research and development to 2022. Prior law required the deduction of research and development expenses over five years. Adopting this provision would impact state corporate and individual income tax revenues by at least $102 million in the next three years. The $51 million to be lost in the first year alone could instead supplement health care services for children in the Division of Developmental Disabilities.

Tax cuts that are just bad policy and would only break our budget:

- **No Tax on Tipped Income** – Allows certain employed and self-employed workers to deduct up to $25,000 of tipped income from 2025 through 2028. This tax cut prioritizes about 5 percent of workers in Arizona over 95 percent of other workers earning the similar low-level incomes. At the same time, it would result in the loss of at least $60 million individual income tax revenues in the next three years.

- **No Tax on Overtime** – Permits deduction of up to $12,500 ($25,000 for couples) of certain overtime pay from 2025 through 2028**.** Similar to the tax cut for tipped income, tax deductions for overtime income leaves out many workers who do not receive overtime pay such as gig workers and salaried workers.

  It also comes with an expensive price tag of at least $190 million over the next three years. This estimate could easily multiply as it did for Alabama whose state policy ended up costing 10 times more than its projected cost, leading the state to eventually sunset this tax deduction.

Arizona Needs Long-Term Revenue Solutions

Arizona's current state budget situation is such that revenue growth will not be enough to fund growing needs and investments we should be able to otherwise afford. Policymakers should wisely consider the return on investment for every dollar spent or cut.

Our state has already cut more taxes than it can afford. Adopting any of the H.R. 1 federal tax breaks would further hurt our ability to meet state budget needs while bringing zero benefits to Arizona's economy.

Arizona's budget challenges are not the result of government inefficiency. They are the consequence of:

- Structural obligations
- Repeated one-time patches
- Rapidly growing program costs
- Federal cost shifts
- And years of tax cuts that have eroded the state's ability to meet basic responsibilities

To maintain fiscal stability and meet the needs of Arizona's people — especially those who rely on education, child care, disability services, health care, and nutrition supports — lawmakers must:

- Reject new tax cuts
- Avoid conforming to H.R. 1's costly federal provisions
- Invest now to prevent larger future liabilities
- Stabilize essential programs with ongoing funding
- Adopt long-term revenue solutions, such as reversing the flat tax, that align with Arizona's real needs

Arizona's past budget decisions are catching up fast. This session is an opportunity to correct the course — and ensure the state can meet its obligations to the people who call Arizona home.