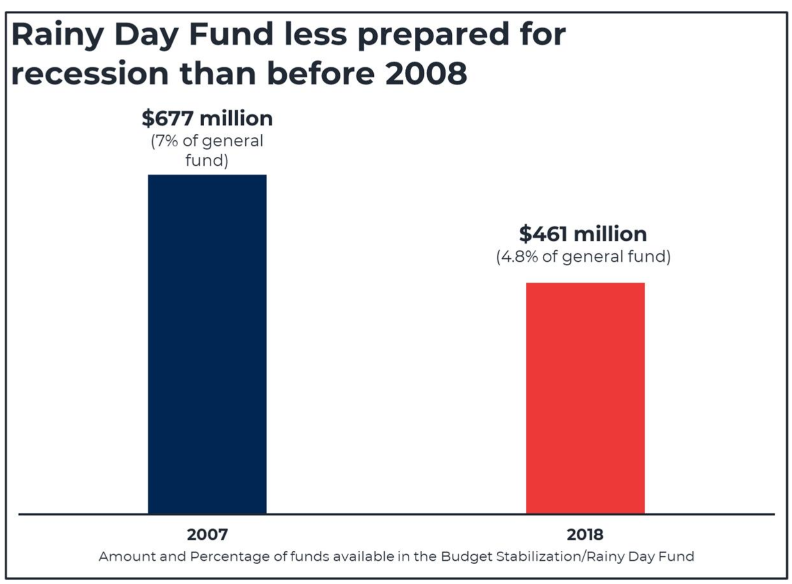
# Arizona Lawmakers Should Plan for Reduced Federal Funding When Responding to Federal Tax Changes

For purposes of calculating state individual and corporate income taxes, Arizona must annually decide whether to conform with any changes in the federal tax code during the prior year. Two recent reports show that conforming to the recent federal tax legislation will result in a net increase to Arizona's General Fund revenues in FY2019, although the two reports differed in the amount – the Joint Legislative Budget Committee estimates a $133.5 million net increase in state revenues while the Department of Revenue estimates an $236.2 million increase in state revenues.

Arizona should not buy into the approach of directing these additional revenues toward tax cuts which could put our state in a real fiscal bind down the road. Instead, Arizona should proceed with caution to this revenue boost and focus its response on preparing for the expected cuts in federal funding to our state, ensuring our state is better prepared for the next economic downturn, or directing some of these additional revenues to our public schools and other underfunded priorities.

## Federal tax cuts will come hand-in-hand with reduced federal funding for Arizona.

The federal tax cuts are expected to increase the federal debt by at least $1.2 trillion. Congress is expected to respond to the growing debt it has created by implementing sweeping budget cuts to key services such as Medicaid and food assistance that hold potential to shift large new costs to state taxpayers. Federal funds fuel one-third of Arizona's budget with five state agencies each receiving more than $450 million per year from the federal government and 11 state agencies receiving the majority of their overall funding from the federal government. Arizona would be wise to build up its reserves to offset these expected cuts rather than spending the revenue boost on tax cuts.




While a recession does not appear imminent, the current expansion is the second longest in American history, and in a few months will be the longest. Given this and the impossibility of predicting when the next recession will hit, Arizona should prepare for it. Arizona's rainy-day fund was created to substantially reduce, if not eliminate, the need for spending cuts or revenue enhancements during recessions. Spending reductions during recessions not only diminish the quality and quantity of public services at a time when many Arizonans are most in need of assistance, but also have a depressing effect on an already weak economy. At the end of FY17, the rainy-day fund was $194 million short of being fully funded. No deposit has been made to the fund since FY13. In addition, Arizona also has $1.6 billion in unfunded obligations, including delayed payments, rollovers and other gimmicks that were used to get us out of the Great Recession which have still not been reversed. Arizona should think of these additional revenues as an insurance policy against the uncertainties of federal budget cuts or a recession down the road.

### Uncertainty in how much revenue surplus it will produce in Arizona.

There is tremendous uncertainty and many questions about the impact of the recent federal tax changes. For example, it's hard to tell the rate at which people will continue to itemize deductions. Will businesses change their filing status from S-corps to C-corps to take advantage of changes in how taxes are applied to such structures? How will corporate taxpayer behavior change? The federal tax changes have altered the fiscal tax policy landscape so considerably, that it is hard to predict how everything will ultimately shake out. For all of these reasons, it is a difficult job for the Department of Revenue to estimate the total fiscal impact on the state of Arizona.

### Most of the federal tax cuts are temporary; wealthy people and corporations have permanent tax cuts.

The few tax cuts enacted by Congress in 2017 which directly affect families and individuals are mostly temporary, expiring after 2025, while a majority of the tax cuts that primarily help the wealthy and corporations are permanent. This makes the idea of using temporary state revenue gains to pay for permanent state tax cuts risky because we do not know what will happen to state revenues when the temporary federal tax cuts go away. While it would only take a simple majority of the state legislature to enact tax cuts, the state constitution requires a two-thirds vote of the legislature to raise revenue or reverse a tax cut.

### Dollars used for more tax cuts are unavailable for schools and other priorities.

Arizona has consistently shortchanged services and investments important to the economy and crucial to thriving communities. Arizona's public schools have $1.1 billion less in state funding than a decade ago. The disinvestment in our public schools has led to some of the lowest teacher salaries in the nation and one of the country's worst teacher shortages. Arizona's business leaders have consistently said that the lack of a skilled workforce is the biggest challenge to doing business in Arizona. Investing some of these additional revenues in our public schools has the ability to provide a far greater return on investment than another tax cut.