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FLAT TAX & STATE BUDGET FACTS AND FICTIONS

**WHAT'S *REALLY* GOING ON WITH
ARIZONA'S FISCAL HOUSE?**

AUTHORS: GLENN FARLEY & THOMAS YOUNG

ABOUT THE AUTHORS



Glenn Farley is CSI Arizona's Director of Policy & Research. Before joining CSI in 2022, Glenn worked in the Office of the Arizona Governor, most recently as Gov. Doug Ducey's Chief Economist and a policy advisor. In that role he advised on issues of tax, fiscal, and regulatory policy, and was one of the Governor's lead architects of his two major tax reforms – including the 2021 income tax omnibus which phased in a 2.50% flat tax (the lowest in the country). Glenn also led the budget team that produced the Executive revenue forecasts and caseload spending numbers that have helped ensure the longest run of structurally balanced budgets in State history. Glenn has a Master's Degree in Economics from Arizona State University's WP Carey College of Business, as well as a B.S. from Arizona State University. He was born and raised in Arizona where he now lives with his wife and two daughters.



Thomas Young, Ph.D. brings a wealth of experience at the touch points of economics including economic forecasting, public policy and public finance, econometrics, investing, survey research, and cost-benefit analyses to name a few. He received his Ph.D. in Business Economics, Industrial Organization, Econometrics, and Finance from the University of Utah. Thomas currently lives in Salt Lake City, Utah with his wife and four wonderful daughters.

ABOUT COMMON SENSE INSTITUTE

Common Sense Institute is a non-partisan research organization dedicated to the protection and promotion of Arizona's economy. CSI is at the forefront of important discussions concerning the future of free enterprise and aims to have an impact on the issues that matter most to Arizonans. CSI's mission is to examine the fiscal impacts of policies, initiatives, and proposed laws so that Arizonans are educated and informed on issues impacting their lives. CSI employs rigorous research techniques and dynamic modelling to evaluate the potential impact of these measures on the Arizona economy and individual opportunity.

TEAMS & FELLOWS STATEMENT

CSI is committed to independent, in-depth research that examines the impacts of policies, initiatives, and proposed laws so that Americans are educated and informed on issues impacting their lives. CSI's commitment to institutional independence is rooted in the individual independence of our researchers, economists, and fellows. At the core of CSI's mission is a belief in the power of the free enterprise system. Our work explores ideas that protect and promote jobs and the economy, and the CSI team and fellows take part in this pursuit with academic freedom. Our team's work is informed by data-driven research and evidence. The views and opinions of fellows do not reflect the institutional views of CSI. CSI operates independently of any political party and does not take positions.

FICTION: THE FLAT TAX IS THE CAUSE OF THE STATE BUDGET WOES.

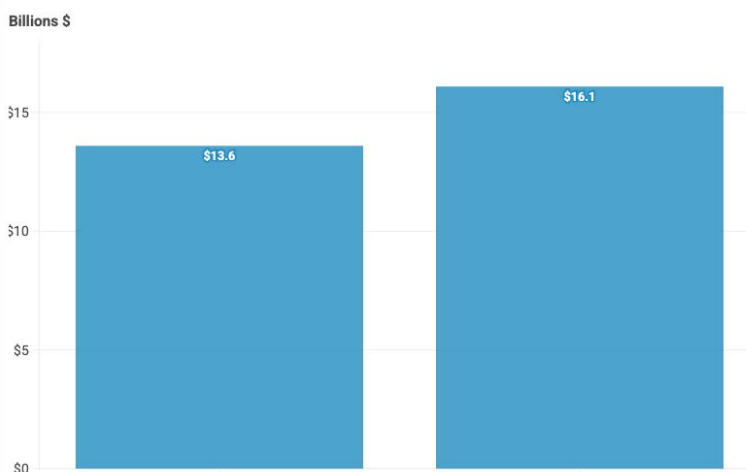
“Arizona is facing sweeping budget cuts thanks to the exorbitant costs of implementing a flat personal income tax and universal private school vouchers. Enacted one after the other, these policies have led to a nearly \$1.6 billion deficit through fiscal year 2025, an eye-popping figure and warning signal for legislators elsewhere.”ⁱ

FACTS:

- **Since passage of the flat tax, state spending has grown by almost \$2.5 billion (+18%),** up from \$13.6 billion to \$16.1 billion.
- **Arizona doesn't have a revenue problem:** Between 2010 and 2020, General Fund revenue grew at an average rate of 2.8%. Since 2020, the average annual revenue growth rate has been 9.3%. **General Fund revenues are \$3.3 billion higher today than they were prior to enacting the Flat Tax.**
- **State spending grew too quickly, and policymakers left just \$10 million in reserve funds on an \$18 billion budget – leading directly to the FY25 projected shortfall:** Between 2012 and 2022, annual General Fund spending growth in Arizona was 4.15%; in 2023 and 2024, spending grew approximately 40% (at an average annual rate more than four times the long-run rate).

The State Budget Since Passage of the Flat Tax

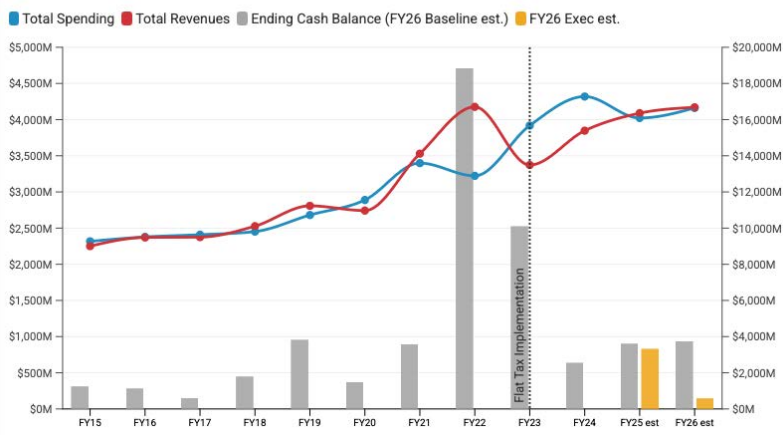
Since passage and implementation of the flat tax, the state budget is up another almost \$2.5 billion.



Source: CSI Research and Analysis

Total General Fund Revenues and Spending w/ Cash Balances, FY15 - FY26 Exec

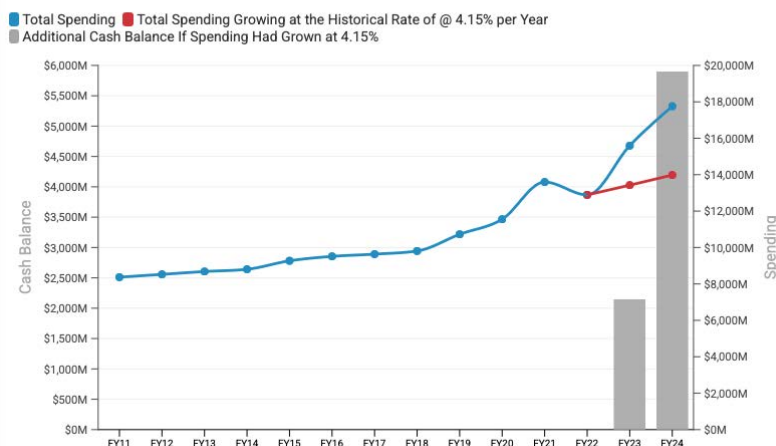
Following implementation of the 2.50% Flat Tax, revenue's experienced a reversion to more historical levels, but spending growth continued accelerating - exhausting the states cash resources.



- Had the state limited spending growth over these two budgets to the long-run trend, it would have spent \$5.9 billion less – **turning a \$1.6 billion cash shortfall into a \$4.3 billion surplus**. We still would have grown General Fund spending by over \$1 billion in this scenario.
- This assumes no change in revenue – *even after the 2.5% Flat Tax, the state still could have continued historic surpluses by moderating expenditure growth.*
- Even after the Flat Tax was passed, revenue growth has been robust. **Over the five years following the Flat Tax, average annual ongoing revenue growth has been 4.5%/year.** Over the five years after the Great Recession (FY12-FY17), average annual growth was 4.1%/year.

Total General Fund Spending (Actual and Hypothetical), FY11 - FY24

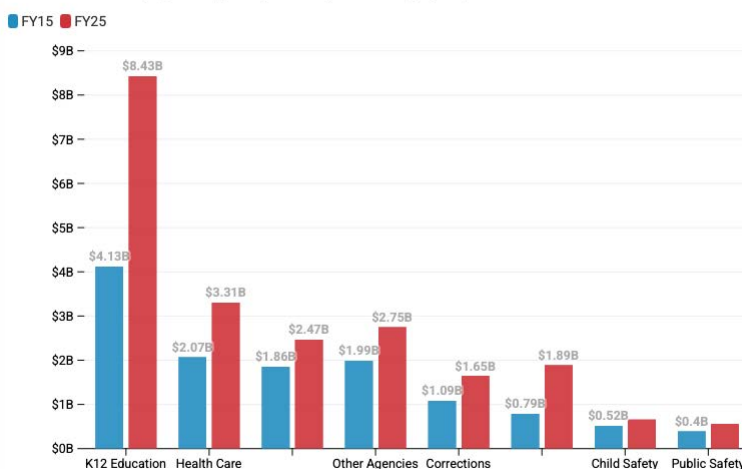
Had the state limited spending growth over FY 2023/2024 budgets to the long-run trend, it would have spent \$5.9 billion less – turning a \$1.6 billion cash shortfall into a \$4.3 billion surplus



Source: Arizona Joint Legislative Budget Committee, Common Sense Policy Institute Modeling and Analysis

Nominal Total Spending (All Funds)

Across the board, spending is up. It is up the most, by far, for K-12 education.



Source: Arizona Joint Legislative Budget Committee, Common Sense Policy Institute, Budget Then and Now

BOTTOM LINE

Arizona has seen its budget grow by almost \$2.5 billion since implementation of the flat tax. Policymakers should have anticipated a return to normal revenue trends after five years of unprecedented tax revenue growth beginning after federal and state tax cuts (the Tax Cuts & Jobs Act and the 2.5% Flat Tax). Instead, policymakers allowed spending growth to rapidly catch up with revenues over just two budget years, and exhausted cash reserves in a single budget – right as revenue growth had already started slowing.

FICTION: RAISING TAXES IS THE ONLY WAY TO RESTORE FISCAL STABILITY.

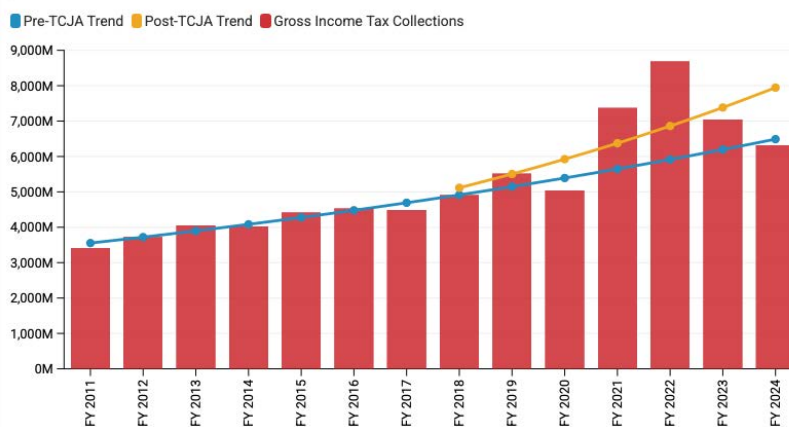
“The flat tax’s \$2 billion annual cost has had visible consequences and was a prime contributor to the budget deficits and cuts made during this legislative session”ⁱⁱ

FACTS:

- Without the flat tax, Arizona would not have seen the type of job and revenue growth we’ve seen. **While revenue forecasters thought the state would see a \$4 billion drop in revenue over 10 years from the flat tax, the actual cost was more like \$1.4 billion.**
- For perspective, General Fund revenue growth today is more than \$2 billion above long-run trends – meaning we’re bringing in more new money every year than the net cost of these policies over a decade.
- Originally, state budget forecasters expected the General Fund to hit \$12.8 billion in 2024 – triggering the 2.5% Flat Tax into effect during that taxy year. Instead, the General Fund revenue unexpectedly grew to nearly \$17 billion by the end of 2022 as the state economy surged.
- Expenditure growth hasn’t been constrained since the Flat Tax took effect on January 1, 2023. In fact, spending growth has continued to outpace long-run norms. Over the three years since the Flat Tax began to take effect, average General Fund spending growth was 8.49%, vs. 4.15% over the 10 years prior. This even accounts for the re-balancing FY 2025 budget.

Income Tax Trends Before & After 2017

State conformity to the Tax Cuts & Jobs Act dramatically accelerated income tax revenue growth; the recent income tax cuts have returned collections their long-run trend with faster income tax growth on the horizon because of the lower income tax rate.



Source: JLBC Tax Handbook • FY 2024 revenue projections are from the October FAC forecast.

- Prior research by CSI has highlighted the shortsightedness associated with policies that would repeal the 2.50% Flat Tax or add a new income tax surcharge on high-earners:
 - > The State's GDP would **drop by about \$11.9 billion** over a decade.
 - > Arizona would have about **58,800 fewer jobs**.
 - > Real **per capita disposable income would drop by \$684**.

Measure	Impact
State GDP	-\$11.9 billion
Jobs	-58,800
Real per capita disposable income	-684

Source: REMI, CSI Research and Modeling

BOTTOM LINE

Arizona has seen its budget grow by almost \$2.5 billion since implementation of the flat tax. Policymakers should have anticipated a return to normal revenue trends after five years of unprecedented tax revenue growth beginning after federal and state tax cuts (the Tax Cuts & Jobs Act and the 2.5% Flat Tax). Instead, policymakers allowed spending growth to rapidly catch up with revenues over just two budget years, and exhausted cash reserves in a single budget – right as revenue growth had already started slowing.

FICTION: IMPLEMENTATION OF THE FLAT TAX HAS HURT CITY REVENUES – AND ARE SPREADING OUR BUDGET PROBLEMS TO THE CITIES.

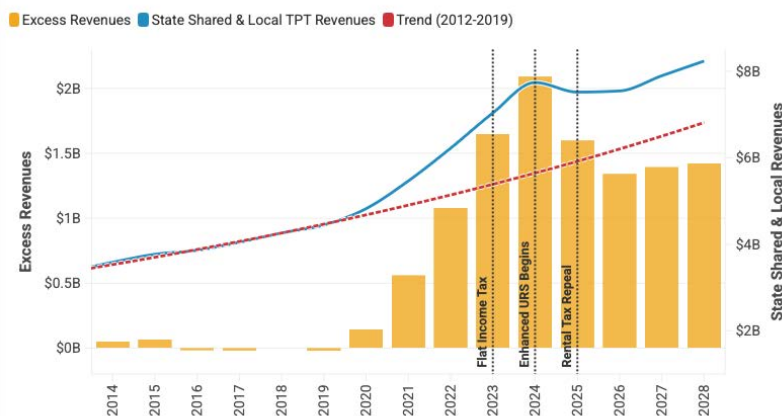
“Phoenix to increase sales tax to shore up budget shortfall. City getting less revenue because of changes in state law”ⁱⁱⁱ

FACTS:

- Since 2020, State Shared and City Sales Tax Revenue are Up Over \$7 Billion: After following a strong and stable 4.8% annual growth trajectory for nearly a decade, municipal and county revenues – both local and state shared – have surged (averaging 9.3% per year), leading to nearly \$7 Billion in cumulative revenues between 2020 and 2025 beyond what cities could have expected given prior trends. Based on revenue forecasts through 2028, the net cumulative “excess” revenues are expected to reach \$11 billion, even after state-imposed revenue cuts.
- The State has recently shared more revenue with cities and towns, not less. Without the implementation of the 2.5% flat tax (and the accompanying increase to Urban Revenue Sharing payments to cities and towns), municipalities would have received \$260.8M less in

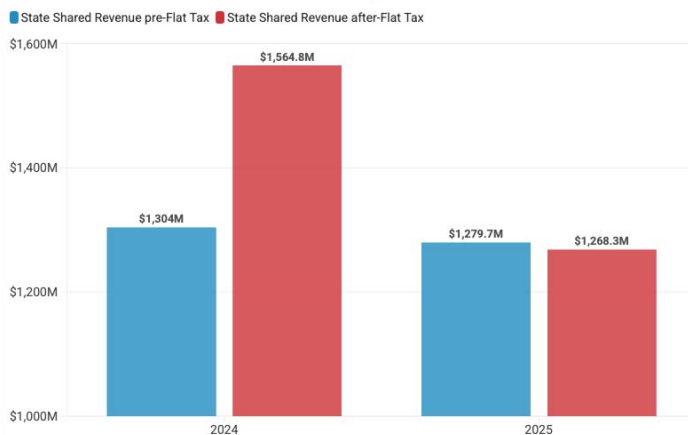
Local and State Shared Revenues Have Soared in Recent Years

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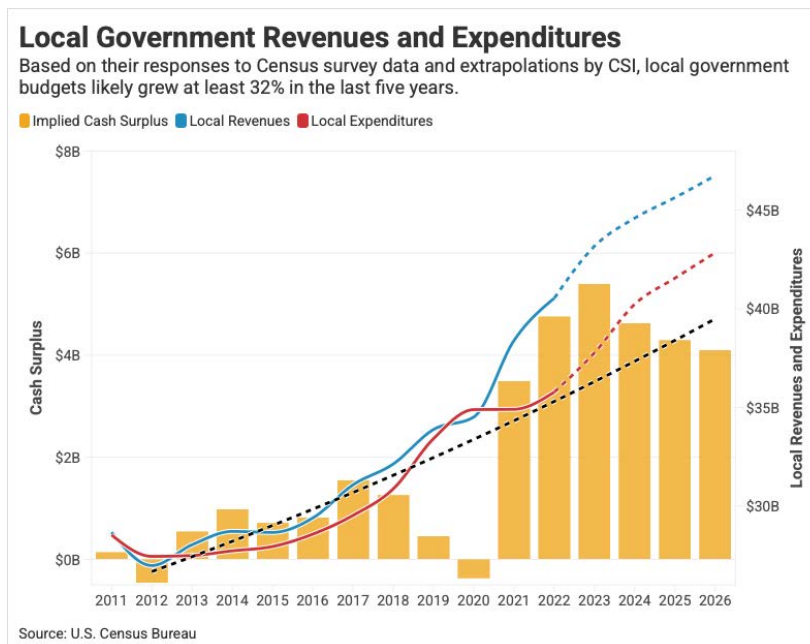
The State Has Shared *More* Revenues With Cities and Towns, Not Less

Without the implementation of the 2.5% flat tax (and the accompanying increase to URS payments to cities and towns), municipalities would have received \$260.8M less in State shared revenue last year, and only \$11M more this year. Meaning, cities and towns today have received \$249.4M more revenue as a result of the flat tax legislation.



State shared revenue last year, and only \$11M more this year. Meaning, cities and towns today have received a \$250 million cash-infusion due to the flat tax legislation.

- Policymakers increased the share of income tax revenues it gives to cities and towns from 15% to 18% to protect them from any revenue loss due to the Flat Tax: The increase was phased in ahead of the Flat Tax itself, to provide cities and towns with a temporary cash infusion to bridge the transition. This bridge is never acknowledged.
- Local governments have increased spending at historic rates. Over the past five years, local government budgets are up at least 32%. The ballooning of revenue to cities and towns over the past five years has led to much larger cash surpluses than the historical average. From 2011 through 2020, the average annual cash surplus was \$564 million. From 2021 through estimated 2026, that figure has exploded to \$4.4 billion—8 times higher than its historical annual average.



BOTTOM LINE

Arizona's local governments have enjoyed years of rapid revenue growth, despite any coincident changes to statewide tax policy. From 2020 through forecasted 2028, the net cumulative "excess" revenue cities and towns will have received from the State totals \$11 billion—far exceeding and reported deficits. Managing these surplus resources responsibly is central to keeping balanced budgets.

FICTION: BECAUSE OF THE FLAT TAX ARIZONA HAS BEEN CUTTING EDUCATION SPENDING.

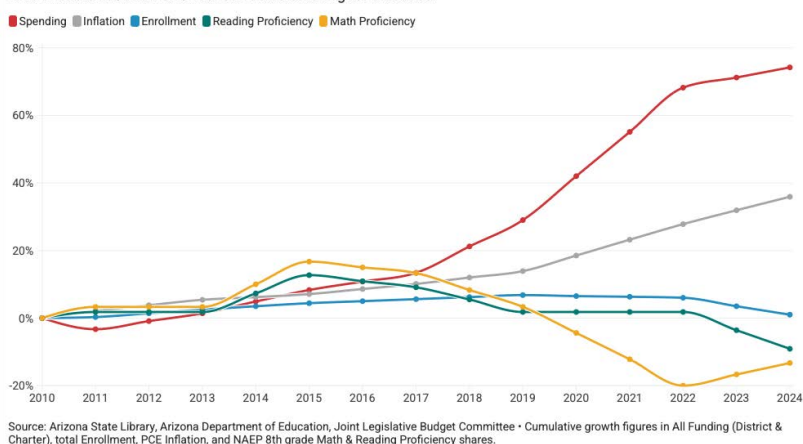
“The tax cuts in Arizona have been accompanied by spending cuts for public programs valued by businesses, such as education and transportation. The state’s business climate has suffered due to these expenditure cuts.”^{iv}

FACTS:

- Spending by Arizona’s K-12 Public Schools is up nearly 80% since 2010, enrollment is flat, and performance has been falling for a decade.
- Spending on education specifically since 2022– the year the Flat Tax was passed – has grown almost 14%.^v
- Arizona continues to invest in all types of education spending. For instance, since 2012, the State has allocated \$2.7 billion towards building renewal and new school facilities expenditures (the largest single-year investment ever).
- The COVID-19 pandemic altered education enrollment preferences in a profound way. Arizona public school enrollment is over 53,000 students below pre-pandemic projections. Because of funding formulas, fewer kids leads to less baseline

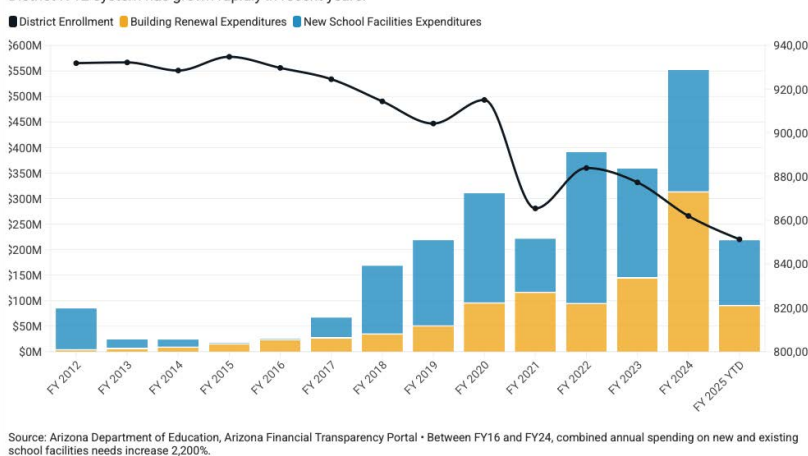
Why Are Public Schools Closing?

While Spending by Arizona’s K-12 Public Schools is up nearly 80% since 2010 (growing twice the rate of Inflation), Enrollment is flat and Performance has been falling for a decade.



State General Fund Spending for District School Capital

While enrollment in District public schools has been declining (-9% since FY12), state capital funding support for the District K-12 system has grown rapidly in recent years.

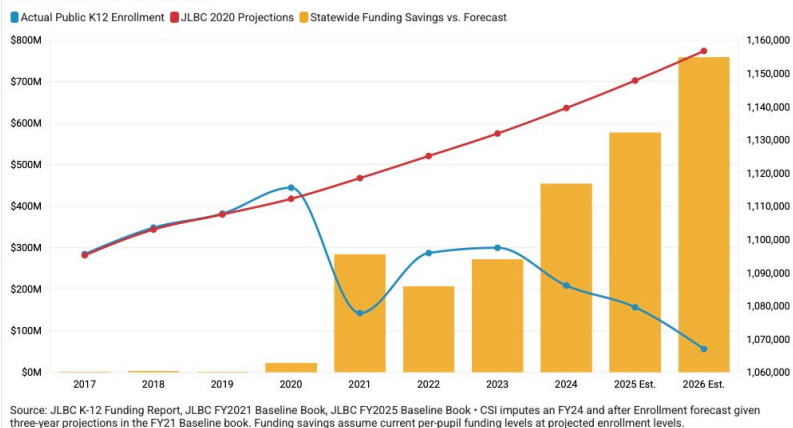


funding (approximately \$500 million annually), but policymakers have offset those reductions with discretionary funding increases.

- **\$15,100 per-student-per-year:** Arizona today spends more money per-pupil in public school than it ever has: over \$15,000. Even after accounting for the runaway inflation of the past two years, inflation-adjusted spending per student is up 30% since FY2016.^{vi}
- Had public school funding in Arizona grown only at the rate of enrollment and population since 2016, total funding today would be 21% less than it is – for an annual savings of over \$3.5 billion.^{vii}

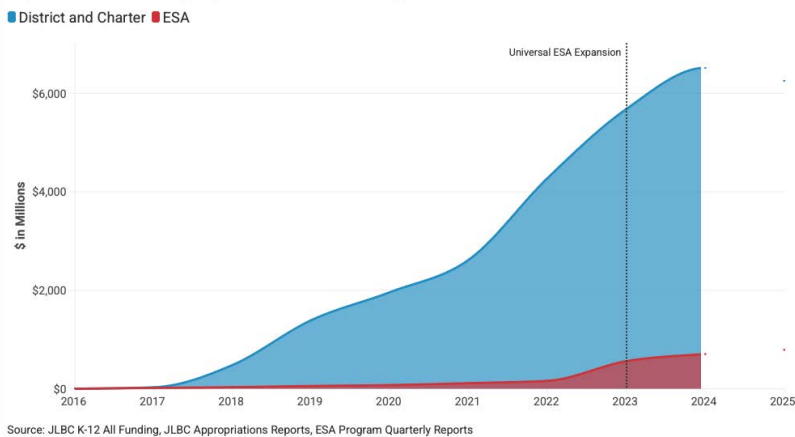
Public School Enrollment Trends Since 2020

Demographic and preference shifts continue to depress public school enrollment in Arizona relative to pre-pandemic projections. Today, enrollment is almost 90,000 students below the states last pre-pandemic forecast - creating an annual savings of \$760 million.



K-12 Cumulative Funding Increases FY2016-FY2025

The vast majority of K-12 funding increases have gone towards Arizona public schools. The expansion of the ESA program accounted for only 7.5% of those cumulative increases.



BOTTOM LINE

Arizona continues to invest in its future on many fronts, including by implementing a flat tax to draw in economic growth for future generations and investing in education. The State's financial commitment to education has continued to grow since passage of the flat tax and even though district enrollment is declining.

FICTION: THE FLAT TAX AND OTHER STATE ECONOMIC DEVELOPMENT POLICIES HAVEN'T MADE THINGS BETTER FOR THE AVERAGE ARIZONAN

"Everyday Arizonans don't want tax cuts for the rich."^{viii}

FACTS:

- The average annual income tax savings per Arizonan is about \$400^{ix}, nearly enough to cover the average monthly household grocery bill in Arizona.^x
- The state has experienced generational economic growth over the last 5-10 years, due in large part to both its deliberate pursuit of pro-growth, low-cost policies, while its neighbors have gone in another direction. As a result, the state is much richer today than it was in 2015 (per-capita personal income +68%).^{xi}
- This growth has supported a growing State Budget. In 2021, budget forecasters expected the General Fund to grow by ~\$3 billion over the next five years, and that the tax cuts would consume 2/3 of that growth.
- Actual growth: \$6.7 billion, or nearly \$4 billion in "extra" revenue Arizona received after implementation of the 2.5% flat tax. Should policymakers reverse these policies, the economic and historic evidence suggest fewer jobs, less GDP and personal income, and an ultimately smaller budget providing fewer services.

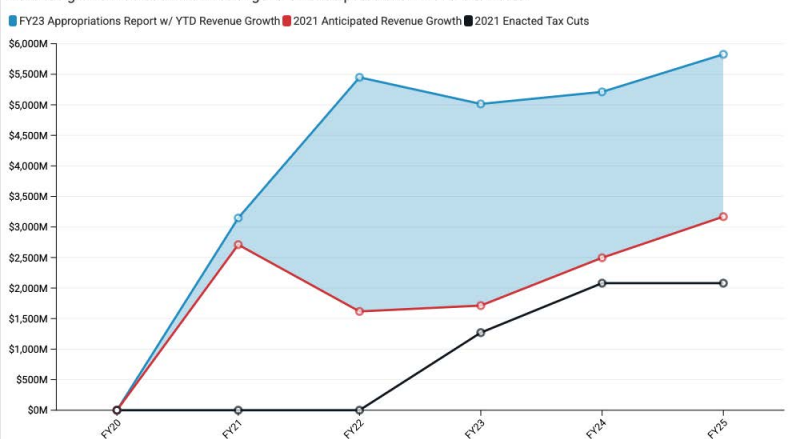
Flat Income Tax and Grocery Bills

The average household savings from the flat income tax covers almost all of the average household's monthly grocery bill.



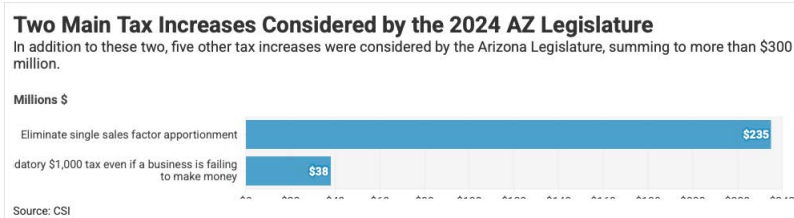
Cumulative Revenue Growth Since FY 2020

Revenue growth has been much stronger than anticipated even with the tax cuts.



- Arizona's business conditions were also improved by [HB 2822](#), which lowered and simplified the tax burden on new capital investments. In the process, the return-on-investment for a given asset rose, and the equilibrium level of investment increased, resulting in—
 - Approximately 3,000 more net jobs relative to current law, depending on the degree to which business capital cost savings are offset elsewhere by tax increases or government spending cuts.
 - Between +\$204 million and +\$438 million in state personal income.
 - Between \$263 million and \$452 million in Gross State Product, including up to \$264 million in new capital investment.
 - After accounting for increased revenues on new economic activity, total state and government revenue could increase in 2032 by up to +\$50 million on a dynamic basis.
 - Undoing HB 2822 would have the opposite, missing economic growth impacts.

- Arizona lawmakers considered seven bills during the 2024 legislative session that created new or significantly increased taxes, **summing to more than \$300 million**. The two bills with the largest fiscal impact were an



elimination of the single sales factor corporate apportionment (\$235 million) and a \$1,000 minimum corporate income tax even if the business is failing to make any money (\$38 million). Policymakers must continue to resist the allure of “easy money” through growth-limiting tax and regulatory policy. For example:

- A repeal of Right-to-Work (**an \$18.6 billion cost increase on businesses** with the consequences felt by job seekers).
- A tightening of schedule, breaks, and overtime standards that would have limited employees' and businesses' flexibility in accomplishing work (**a \$3.8 billion cost increase** for businesses).
- Up to \$2.7 billion in new fees** for agricultural use of groundwater.
- A cap on rental increases to 70% over the prior year, **resulting in a \$2.1 billion economic cost**. Harvard economist Greg Mankiw called rent control “the best way to destroy a city, other than bombing.”

BOTTOM LINE

The flat tax and other economic development strategies to create jobs for future Arizonans also create tax revenue in the coming years. The flat tax not only saves household money today to help alleviate the rising cost of living, but also leave more money in the hands of business owners who invest that money in workers and equipment—further improving the lives of everyday Arizonans.

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