

ARIZONA SUPREME COURT

KAREN FANN, et al.,

Plaintiffs-Appellants,

v.

STATE OF ARIZONA, et al.,

Defendants-Appellees.

Arizona Supreme Court
No. CV-21-0058-T/AP

Maricopa County Superior Court
No. CV2020-015495

**BRIEF OF *AMICI CURIAE* ARIZONA BUSINESS LEADERS
IN SUPPORT OF PLAINTIFFS/APPELLANTS
WITH APPROVAL OF THE PARTIES**

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INTEREST OF *AMICI CURIAE*

Amici are Arizona business owners and leaders who seek to make Arizona one of the most business friendly and prosperous states in the nation. Amici include Craig Ahlstrom, Martha Knight, Stephen McConnell, John Smeck, Gabriel Woodruff, and Hannah Woodruff.

This brief is funded by Arizonans for Civic Participation (“ACP”). ACP is a 501(c)(4) Social Welfare Organization whose goal is to further the common good and general welfare of the community by bringing about civic betterment and social welfare. ACP does this by encouraging civic engagement and participation in critical issues facing Arizona. It seeks to increase awareness about public policy issues and encourage participation in our democratic process.

ACP and Amici believe that by increasing taxes by 77% for the wealthiest Arizonans—many of whom own small businesses that are the economic engine of the state—Proposition 208 (“Prop 208”) threatens Arizona’s competitiveness by dissuading businesses and individuals from moving into the state, encouraging high earners to leave the state or find other ways to avoid Prop 208’s tax increase, and generally creating an environment that is more hostile to business. And Prop 208 has done all that even though the initiative proponents have not explained how it will ensure improved student outcomes. Changing tax policy via the initiative process is a misuse of the people’s power in light of the Arizona

Constitution and is open to abuse by special interest groups—many of whom are unconnected to Arizona and do not need to live with the consequences of Prop 208.

ARGUMENT

Arizona champions itself as a pro-business destination for individuals who seek to start a business or pursue a profession. The Arizona Commerce Authority (“ACA”), which describes itself as “the state’s leading economic development organization,”¹ states that “Arizona offers one of the lowest costs of doing business in the United States, primarily because of low taxes and small state government.”² National organizations have recognized Arizona’s low taxes and the associated business growth. In 2019, the Small Business & Entrepreneurial Council (“SBEC”), a nonpartisan business advocacy organization, lauded Arizona for being a pro-business, low-tax state that encouraged small businesses to establish themselves in Arizona. The SBEC Small Business Tax Index for 2019 ranked Arizona as the 11th-best state for tax environments that are friendly to small

¹ Arizona Commerce Authority, “About the Arizona Commerce Authority,” *available at* <https://www.azcommerce.com/about-us/> (last accessed 03/01/2021).

² Arizona Commerce Authority, “Low Cost of Doing Business,” *available at* <https://www.azcommerce.com/business-first/low-cost-of-doing-business> (last accessed March 1, 2021).

business.³ The top 25 states in the ranking outpaced the bottom 25 states in economic and population growth by 38% and 107%, respectively.⁴

One year after praising Arizona for its pro-business and low-tax environment, the same organization cautioned that Prop 208 could devastate Arizona's positive attributes:

Let's be clear, hiking income tax rates is never a good idea, especially if you're concerned about investment, innovation, and economic productivity, and income growth, and therefore, job growth as well. But no matter which school of thought they happen to subscribe to, very few economists would seriously call for increasing taxes during a bad economy. Indeed, an ideal prescription for making a bad economy worse, or at best, for slowing or diminishing any economic recovery, would be to raise taxes during such times.⁵

Whether people agree that "hiking income tax rates is never a good idea," voters should agree that it is bad to increase taxes at the request of special-interest groups and through a constitutionally suspect process. Not to mention increasing taxes on

³ SBEC, "Small Business Policy Index 2019," May 2019, at 9, *available at* <https://sbecouncil.org/wp-content/uploads/2019/05/SBPI2019-Report.pdf> ("SBEC Tax Index") (last accessed March 1, 2021).

⁴ *Id.* at 3-4.

⁵ SBEC, "November Ballots in Arizona and Illinois Feature Big Proposed Tax Increases on Entrepreneurship and Small Business," Oct. 26, 2020, *available at* <https://sbecouncil.org/2020/10/26/november-ballots-in-arizona-and-illinois-feature-big-proposed-tax-increases-on-entrepreneurship-and-small-business/> (last accessed March 1, 2021).

a subset of taxpayers disproportionately affected by a global pandemic.⁶

Prop 208—both in procedure and substance—violates the will of the people and should be held unconstitutional.

I. Implementing tax policy via the initiative process is bad public policy and runs afoul of the Arizona Constitution

A. The initiative process is an important power for the people, but was not designed for making nuanced policy decisions like those required for tax policy

As the success of Prop 208 proves, any special interest group with enough financial support can forever change Arizona’s fiscal policy and the state’s future economic outlook. The initiative process has been an important power for voters throughout Arizona’s history. And while it works well when voters are asked to make a binary policy choice—such as whether to increase the minimum wage⁷ or

⁶ The fact that the initiative vote came in the middle of a global pandemic that has disproportionately harmed small businesses is another example of why the initiative process is a terrible vehicle for addressing budgetary and fiscal policies. See Levinson, Jessica A. & Robert M. Stern, “Ballot Box Budgeting in California: The Bane of the Golden State or an Overstated Problem,” 37 HASTINGS CONST. L.Q. 689, 700–01 (2010) (“The problem with budgeting by initiative is that it is done by an electorate that cannot amend proposals, but can vote only ‘yes’ or ‘no’ on isolated proposals drafted approximately one year before they reach the ballot, without regard to how they affect the rest of the budget.”). Voters were fixated on one issue without any ability to address changes in budgetary considerations brought about by COVID-19 and the ongoing attempt to address it.

⁷ “Fair Wages and Healthy Families Initiative,” Serial number I-24-2016, *available at* <https://apps.azsos.gov/election/2016/General/home.htm>.

allow medical marijuana use⁸—the initiative process was not meant to address nuanced issues like tax policy. A “yes” or “no” vote on a straightforward policy issue may accurately reflect the will of the people. But in the context of statewide tax policy, the initiative process fails.

“[B]udgeting decisions made via the initiative process . . . are half-choices [T]he initiative process does not and cannot engage voters in the trade-offs that are at the heart of a representative budget process.”⁹ Each year, the Legislature is faced with many competing budgetary requests. Raising taxes as a quick fix for education funding would likely fail in the Legislature because legislators must consider increases in education funding (and all other State services) in light of the whole budget and competing budgetary concerns. Even if each legislator wanted to increase education funding, the Legislature as a whole may not decide to increase funding because of other budgetary priorities that arise in real time. The Legislature does not work with static policy language drafted in a special-interest vacuum a year before an election. And unlike voters who may want to increase education funding right away for their own child or a teacher who is a

⁸ “Arizona Medical Marijuana Initiative,” Serial number I-04-2010, *available at* apps.azsos.gov/election/2010/info/PubPamphlet/english/prop203.pdf.

⁹ William M. Lunch, “Budgeting by Initiative: An Oxymoron,” 34 WILLAMETTE L. REV. 663, 670 (1998).

family member—no matter the cost—the Legislature must take into account the long-term and statewide effects of changing fiscal policy.

Prop 208 purports to be about solving Arizona’s education funding conundrum, which is a worthwhile goal that many Arizonans support. But the initiative process should not be used to address multi-faceted policy goals that affect so many Arizonans. It leads to negative and incomplete policy solutions. Indeed, Prop 208’s supporters did not seek a comprehensive fix to education funding—they sought a Band-Aid that would provide, at best, irregular amounts of funding without any assurance that student outcomes would improve. This is an improper use of the initiative process.

Initiatives are meant to address statewide policy goals, not to be a school fundraiser or capital campaign. Supporters of Prop 208 failed to account for, or chose to ignore, the many negative consequences of an ad-hoc tax increase. Many of those directly affected by the tax increase—including Amici—are small business owners or professionals who employ others. While small business owners may not make different decisions based on a small percentage increase in taxes, a 77% tax increase necessarily influences their decisions. And the employees of these businesses will quickly begin to experience the wide-ranging effects of the tax increase even if they do not pay the tax themselves.

These consequences and others like them were not considered because the initiative process is not designed and does not allow for such inquiry. In contrast, the legislative process requires deliberation and debate. Whether a law passes the Legislature or not, Arizona voters can follow the debate, see the committee hearings, hear the pros and cons, and, ultimately, hold their legislators accountable in the subsequent election. In the initiative process, Arizona voters cannot be confident that other voters have even read the initiative text, much less that they actually understand the ramifications of a “yes” or “no” vote on the measure.¹⁰

Using the initiative process to change tax policy imposes a long-lasting set of fiscal policies that are accountable to no one. Because of Arizona’s Voter Protection Act (“VPA”), legislators are powerless to amend the policy or change it entirely when budgetary priorities shift over time. The initiative process is not an appropriate or adequate vehicle to change tax policies.

B. Arizona’s Constitution requires that the Legislature approve tax increases by a supermajority vote, which should also apply when the people act as legislators in the initiative process

In 1992, Arizona voters passed Proposition 108, which added Article IX, section 22 to the Arizona Constitution. In enacting Prop 108, voters recognized

¹⁰ See Lunch, “Budgeting by Initiative: An Oxymoron,” at 669-70 (discussing research showing that “as many as one-third of . . . voters first encountered the initiatives and other measures the moment they stepped into the voting booth”).

that tax policy was different from other policies and that it had a more significant impact than other policies. To “ensure[] a [broad] consensus on the necessity of any future tax increases,” voters amended the Arizona Constitution and required a supermajority vote of both houses of the Legislature to enact tax legislation.¹¹

A supermajority vote ensures that the deliberation and debate discussed above takes place, and that a tax increase is considered within the context of other budgetary constraints. The supermajority requirement also prevents special interests taking over and pushing through a tax increase that benefits a pet project or small number of citizens. When a tax increase requires broad consensus and competes with other budget items, there is little place for special interests. At the very least, special interests will not control the process, as they did with Prop 208.

Allowing voters to enact tax policy through the initiative process unconstitutionally circumvents the very safeguards that voters imposed when they adopted Prop 108 and amended the Arizona Constitution. The Legislature and voters “share lawmaking power under Arizona’s system of government.” *Ariz. Early Childhood Dev. & Health Bd. v. Brewer*, 221 Ariz. 467, 469 ¶ 7 (2009). Because they share the legislative power, any restriction on the Legislature or the people should similarly restrict the other. Under article IX, § 22 of the Arizona

¹¹ Legislative Council Arguments Favoring Proposition 108, *available at* <https://azsos.gov/sites/default/files/pubpam92.pdf>, at 46.

Constitution, any “act that provides for a net increase in state revenues . . . is effective on the affirmative vote of two-thirds of the members of each house of the legislature.” And, “[i]f the governor vetoes the measure, it shall not become effective unless it is approved by an affirmative vote of three-fourths of the members of each house of the legislature.” Ariz. Const. art. IX, § 22. Although Prop 208’s supporters and the Superior Court believe that this provision is limited to the *Legislature*’s efforts to raise taxes, the text does not mandate that reading. In fact, that reading does not make sense in light of other safeguards that Arizona law contains.

The Constitution’s supermajority vote applies to tax increases—but not other policy choices—which underscores the importance of and various considerations contained in developing fiscal policy.¹² It also recognizes the long-lasting effect of tax increases on the State. The Constitution’s internal structure makes it difficult to change tax policy, and for good reason. Arizona’s tax policy has significant effects on the state budget, but it also is a policy statement for the State of Arizona—signaling to businesses and investors throughout the country whether Arizona is hospitable to new businesses and new investment. A statement like that should

¹² See Levinson, “Ballot Box Budgeting in California: The Bane of the Golden State or an Overstated Problem,” at 713 (“The biggest problem with ballot box budgeting is that voters do not have a complete view of the budget when deciding important issues which will affect the budget.”).

only be made by a supermajority of the Legislature or a similar supermajority of voters.

The supermajority requirement also recognizes that tax policy is not focused on a single issue, even important issues like education. Tax policy, rather, must take into account many considerations as part of an integrated budget process. The Constitution's requirement ensures tax increases have broad support throughout the state among elected representatives in light of varied economic and policy considerations. The same should be true of initiatives. *See Tillotson v. Frohmiller*, 34 Ariz. 394, 401–02 (1928) (stating that when they are “[a]cting in their capacity as lawmakers, the people are bound by the Constitution, the same as the Legislature”).

The interplay of competing fiscal policy interests, however, can only be addressed through the legislative process. The supermajority vote requirement forces legislators to go through that process of deliberation and negotiation to achieve an outcome that can garner the support of a supermajority of legislators. Legislative decisions are the process of several steps of inquiry and debate. When a bill is introduced, sponsors must seek support from other legislators to ensure that the bill is considered. The bill then goes through several committee hearings, private conversations between legislators, and open deliberation in two separate houses. This process is necessarily long and, at times, cumbersome—but that

process also ensures that legislators agree with the language of the legislation, amend it based on their discussions and deliberations, and believe it is good for their constituents. This is the give-and-take of policymaking.

As noted above, the initiative process contains no such safeguards. Voters may vote “yes” or “no” without understanding the policy ramifications, or without being able to temper certain negative consequences of the tax increase by adjusting other portions of the budget. Where the Constitution creates a process that ensures that long-term policies like tax increases will be given their due consideration, the initiative process utterly fails.

II. Prop 208 will have short- and long-term negative effects on Arizona’s economy

When voters passed Prop 108 in 1992, the Legislative Council recorded several arguments in favor of the supermajority vote. It stated that Arizona was considered by some to be “one of the highest taxed states in the nation. This reputation hinders economic development, discourages businesses from moving to this state, promotes migration of businesses from this state and places a competitive disadvantage on businesses remaining here.”¹³ The threats to Arizona

¹³ Legislative Council Arguments Favoring Proposition 108, *available at* <https://azsos.gov/sites/default/files/pubpam92.pdf>, at 46.

business that were present in 1992 are still with us. And Prop 208 will make it less desirable to do business here and will cause negative economic consequences.

A. Small business owners will be incentivized to leave or stay away from Arizona

Supporters of Prop 208 suggest that there will be no tax on business income. The General Election Publicity Pamphlet, which voters would have had the opportunity to review, includes arguments for and against Prop 208, including one by Invest in Ed Arizona, the organization behind the initiative. In its “pro” argument, Invest in Ed states:

4. How much does this tax small businesses?

Answer: Zero. \$0.00. Nothing. This initiative ONLY applies to personal income, not business income. This is worth repeating: There are no business-tax increases. This surcharge only applies to personal income.¹⁴

But this statement mischaracterizes what “business income” really is.

Because most small businesses are taxed as pass-through entities, “business income” is treated, for tax purposes, as “personal income.” For small businesses that are taxed as subchapter S Corporations, for example, the business’s profits and losses are reflected on the owner’s personal tax returns. If the *business* makes a profit, and the owner elects to keep that money in the business to invest in hiring

¹⁴ Arizona Secretary of State 2020 General Election Publicity Pamphlet, at 137, available at https://azsos.gov/sites/default/files/2020_General_Election_Publicity_Pamphlet_English.pdf (last accessed Feb. 22, 2021).

more employees or to provide additional employee benefits, the owner is still taxed on those profits. Thus, Prop 208 applies a surcharge on *business* income—even if it remains in the business—because it passes through to the owner’s *individual* tax return.

And because so many of Arizona’s small businesses are structured as pass-through entities, Prop 208 will be a significant blow to Arizona’s long-term economic outlook.

It’s also important to realize that most businesses in Arizona (mainly small and medium in size) pay their tax bill every year through the personal income tax system. According to U.S. Census Bureau data, “pass through businesses” – sole proprietorships, S-corporations, and joint partnerships – make up over 70% of the total number of private businesses in the state and around half of all private-sector employment. As such, the quality of the personal income tax system – both in terms of the tax rate as well as how that system treats income growth – can have a significant impact on job creation by employers as well as the economic well-being of the workers who earn a paycheck in those jobs.¹⁵

Seventy percent of the private businesses in the state may experience the tax surcharge from Prop 208, despite its proponents saying that there is no effect on business.

¹⁵ Stephen Slivinski, “Tax Reform Principles for Arizona in a Post-Pandemic World,” ASU Center for the Study of Economic Liberty (Feb. 2021), *available at* <https://csef.asu.edu/research/publications/February-2021-research-note>.

Prop 208 will gradually erode Arizona’s business-friendly tax environment and impact approximately half of Arizona’s private-sector employers. That means that employees who would never be subject to the tax based on their own income may still experience the effect of the tax surcharge because the business owner—their employer—is taxed 77% more than before.

Prop 208 forces many business owners to make a choice—pay a higher tax and absorb those costs, fire employees to cut costs, decide not to hire additional employees or expand operations, restructure the business so as to avoid the tax,¹⁶ or move operations out of Arizona. None of these outcomes are good for Arizona because they make the state less attractive for businesses and potentially lower the overall tax base. These are not considerations that could be weighed by voters in a simple “yes” or “no” vote.

In fact, many Arizona voters may have actually voted differently if they knew the full range of consequences that Prop 208 would bring. Many Arizonans probably voted “yes” because they wanted more funding for education and did not

¹⁶ At present, the language of Prop 208 codified in A.R.S. § 43-1013 does not encompass non-grantor trusts, including Electing Small Business Trusts (ESBTs), which are common estate-planning tools. Taxpayers who own small businesses—many of which are organized as S Corporations—may decide to hold the stock of a subchapter S Corporation in an ESBT. In such cases, the ESBT pays any tax liability at the trust level. *See* IRC § 641(c). ESBTs can operate so that the trust pays the tax, and because there would be no distributable net income, the beneficiaries of the trust—i.e., the business owners—can receive the money tax free and avoid the surcharge.

think they would be directly responsible for paying the tax. They did not understand that they will suffer the collateral consequences of the tax increase because of the burden Prop 208 creates for business owners, who most often pay their business's taxes under the tax code provisions dealing with individuals because they are pass-through entities—either limited liability companies, subchapter S Corporations, or partnerships.

It is likely that business owners will choose to leave Arizona or move their business operations out of Arizona as a result of the Prop 208 tax. As a result, Prop 208 will not produce as much revenue as originally suggested. Instead, it will incentivize businesses to establish themselves in states that reward business growth and success as an overall benefit to the state.

Business owners understand the distinction between “business” and “personal” income, and how those lines blur when you own a small business. The additional 3.5% Prop 208 surcharge on what is actually “business income” disincentivizes business owners from moving to Arizona, from remaining in Arizona, and from investing more in their businesses.

B. Each year, Prop 208 will have additional negative consequences on Arizona's economy

Over time, more small-business owners will be added to the number of taxpayers affected by Prop 208 because the initiative language failed to account for

inflationary increases in income. “Federal and state tax brackets are pegged to inflation and readjusted each year in order to ensure that gains in income but not in actual wealth don’t result in a backdoor increase by vaulting taxpayers into a higher tax bracket.”¹⁷ Prop 208, “however, did not include an annual indexing provision. As a result, the number of single filers earning more than \$250,000 and joint filers earning more than \$500,000 annually will grow each year even as their buying power diminishes with inflation increases.”¹⁸

Business growth may solely be the product of inflation. And if a business’s revenue grows because of inflation, it will eventually be subject to the Prop 208 tax even though its actual value has not increased. In fact, the business’s value may even decrease, but it would still be subject to the tax because the Prop 208 tax limits do not adjust with inflation.

As time goes on, Arizona entrepreneurs will be able to plan their exit from Arizona based on the growth trajectory for their businesses and when they may become subject to the Prop 208 tax. Entrepreneurs may take advantage of Arizona’s pro-business climate for their start-up phase only to leave when the

¹⁷ National Federation of Independent Business, “Failure to Adjust for Inflation Makes Prop. 208 Destructive,” Sept. 9, 2020, *available at* <https://www.nfib.com/content/news/arizona/failure-to-adjust-for-inflation-makes-prop-208-destructive/>.

¹⁸ *Id.*

long-term economic outlook is less favorable.¹⁹ This migration out of Arizona—and the decision of out-of-state business owners to not move to Arizona—is a certain consequence of Prop 208.²⁰ Whether an entrepreneur thinking of moving to Arizona would immediately be subject to the Prop 208 tax or not, the law itself is a sign to outside businesses that Arizona is closed for business.

C. The Voter Protection Act (“VPA”) prevents the Legislature from fixing Prop 208’s negative effects or unconstitutional provisions

“The Voter Protection Act, added to the Arizona Constitution by voters in 1998, limits the legislature’s authority’ to modify voter initiatives and referenda.” *Cave Creek Unified Sch. Dist. v. Ducey*, 233 Ariz. 1, ¶ 9 (2013) (quoting *Brewer*, 221 Ariz. at 469 ¶ 6). After the people enact an initiative, any change of the resulting statute requires a three-quarters supermajority vote in the Legislature and must “further[] the purpose” of the initiative. Ariz. Const. art. IV, § 1(6)(C); *Ariz. Citizens Clean Elections Comm’n v. Brain*, 233 Ariz. 280, ¶ 4 (App. 2013) (citing Ariz. Const. art. IV, pt. 1, § 1(6)(C), (14)) (“the VPA bars the Legislature from

¹⁹ See Slivinski, *supra* (noting how higher tax rates “can drive[] away people, deter others from moving to a state, and can also encourage excessive tax-planning maneuvers aimed at avoiding taxes instead of creating value for the economy”).

²⁰ See Cristobal Young et al., “Millionaire Migration and Taxation of the Elite: Evidence from Administrative Data,” *AMERICAN SOCIOLOGICAL REVIEW* Vol. 81(3) (2016), at 434 (“For the average state, a one-point tax increase leads to 12 fewer in-migrations and 11 additional out-migrations, for a total population loss of 23 millionaire households.”).

amending or superseding a voter-approved initiative unless the proposed legislation ‘furthers the purposes’ of the initiative and is approved by a three-fourths vote in the House of Representatives and Senate”).²¹

The VPA recognizes that the voters may enact legislation through the initiative process and protects that action from the Legislature’s action in subsequent years. In other words, the VPA limits the Legislature’s ability to take certain action because it “share[s] lawmaking power under Arizona’s system of government.” *Brewer*, 221 Ariz. at 469 ¶ 7.

Because of the VPA, the negative effects of Prop 208 will be felt in Arizona for many years to come. The Legislature cannot make reasonable changes to the law, or correct portions of the statutes that remain once others are found to be unconstitutional. As a result, Prop 208 should be held to be unconstitutional in its entirety.

III. Conclusion

Prop 208 will result in businesses leaving Arizona, individuals leaving Arizona, and others not coming to the State to avoid the tax surcharge. Rather than

²¹ Although the Legislature is hamstrung by the VPA, the Superior Court incorrectly concluded that the voters were not similarly restricted by Article IX, Section 22 of the Constitution. This disparate application of safeguards in the Constitution is a tendentious reading of the law meant solely to conclude that Prop 208 was constitutional.

solve an education-funding dilemma, Prop 208 supporters have merely incentivized wealthy Arizonans to take legally allowable steps to avoid paying the tax. For those taxpayers who are not able to shift their business income out of state or into another entity, they may change their corporate structure or find other ways to avoid the tax.

Had the Prop 208 supporters presented a plan to their representatives that provided for increased student funding in light of the myriad other budget considerations, it may have resulted in sustained, increased funding. But Prop 208's ad-hoc approach will likely result in little actual funding as people find ways to avoid or challenge the tax.

Voters were not informed about the actual effects of the law, and the Superior Court misinterprets the provision of Article IX, Section 22 to remove the supermajority safeguards that voters chose to impose through Prop 108. This Court should hold that Prop 208 is unconstitutional for the reasons stated here and in the Appellants' Opening Brief.

Dated: March 22, 2021

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