

The Importance of Proper State and Local Cannabis Tax Rates

Issue: Establishing stable tax policy is a key component of state and local cannabis regulatory efforts. In an effort to maximize tax revenue, state and local governments often propose high tax rates on cannabis businesses, but the result of this will be (i) an increased illegal market, (ii) failure to attract high quality operators and (iii) ironically, significantly lower tax revenues for state and local governments. Tax policy may be the single biggest factor determining whether state and local governments can successfully generate tax revenue, stand up a stable regulated market and police the illegal market for marijuana.

Solutions:

- State and local governments should set tax rates at levels that appropriately balance tax revenue generation and illegal market reduction. Research shows that effective tax rates (inclusive of state, local, and supply chain taxes) exceeding 20% have diminishing returns for tax revenue generation but significantly increase the size of the illegal market.ⁱ
- Taxes should generally only be placed on the final point of sale to consumers to avoid multiplicative taxation through the supply chain.
- To the extent that state and local governments seek to generate revenue from up-supply chain operators (e.g. lab testing facilities, cultivators, manufacturers, and processors), a flat annual licensing fee model as opposed to a taxation model should be adopted for these operators. Data from cities across the US shows a strong correlation between inflated effective tax levels on these operators and outsized illegal markets. Keep such fees at \$15/sq.ft. or less for cultivators and large manufacturers and \$25/sq.ft. or less for processors or manufacturers. Allow such fees to be paid quarterly.
- Review tax and fee amounts frequently and adjust to the extent enforcement costs are rising rapidly, the illegal market rate is spiking or businesses are opting for nearby jurisdictions.

As Taxes Rise, So Do Illegal Market Levels

There is a growing body of research highlighting 1) that consumers in the legalized cannabis market are strongly price sensitive, 2) that taxes significantly increase the legal market’s price premium, and 3) that once this premium exceeds a certain threshold, consumers will shift their purchases from the legal to illegal market. As such, high effective tax rates can create a permanent and sizable illegal market on the state and local levels that police enforcement fails to adequately curb. The Washington Cannabis Consumption Survey found if the cost of legal marijuana sold for \$4 more per gram, legal sales would make up less than half of the total market.^{xi} The charts below demonstrate this effect in both cannabis and tobacco.

City	Est. Illegal MJ Market	Points of Sale per Person ⁱⁱ	Est. Net Effective Tax Rate
Portland, OR	35% ⁱⁱⁱ	1/4475	20% ^{iv}
Denver, CO	20-30% ^v	1/2152	37.15% ^{vi} <i>(35.05% prior to July 2017)</i>
Boulder, CO	20-30% ^{vii}	1/2300	38.5% ^{viii} <i>(36.4% prior to July 2017)</i>
Seattle, WA	50-60% ^{ix}	1/11938	47.1% ^x

Cigarette Smuggling Rises with Excise Tax Rates

Cigarette Smuggling vs. Cigarette Excise Tax Rates, 2014



Note: Positive smuggling percentages are inflow to a state; negative percentages are outflow.

Source: Mackinac Center for Public Policy; Tax Foundation.

Source: Tax Foundation. *Cigarette Taxes and Cigarette Smuggling by State, 2014* (published January 2017).

The Compounding Effect of State and Local Taxes: The Case of a State with a 20% Retail Tax Rate

Before any local taxes are assessed, marijuana products sold at dispensaries will be charged a baseline 20.00% state retail tax rate. A conservative local tax rate set at 2% of gross receipts for cultivation and retail sales increases the effective tax rate to 24.44%. An aggressive local tax rate at 10% of gross receipts for cultivation, retail sales, and distribution and a 10% retail excise tax increases the effective tax rate to 69.4%. The figure below demonstrates effective tax rates at different local taxes levels.

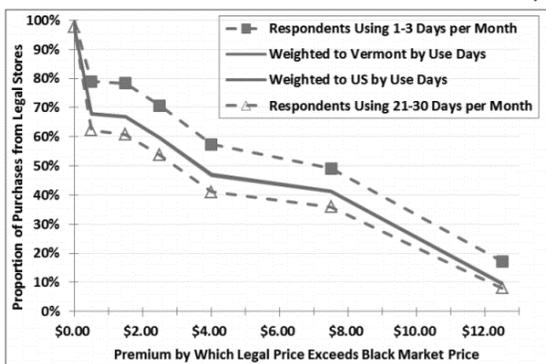


Multiplicative Taxation

One danger with gross revenue taxes on manufacturers, cultivators and processors is that these taxes multiplicatively add to product cost (i.e. as those products move through the supply chain, additional taxes now tax the already taxed amount). So, for instance, a 5% tax on upstream businesses can become a 27.6% net effective tax (without factoring in state, county and local sales and excise taxes) if product were to go from a grower, to a processor, to a manufacturer, to a distributor, and then to a retailer. If the processor uses a third party to fill vape cartridges or pre-process products intended for edibles, you can add even additional layers. For this reason, gross percentage taxes are disfavored up the supply chain.

High Effective Tax Rates above 20% Have Clear Diminishing Returns

Research by think tanks like the RAND Corporation and C.D. Howe Institute emphasizes that high effective tax rates increase the legal market’s price premium and drive consumers into the illegal market. In fact, RAND’s analysis of data from the Washington Cannabis Consumption Survey found that even modest price premiums for regulated cannabis can contribute to a large illegal market.^{xii} Moreover, the C.D. Howe Institute’s analysis highlights that once effective tax rates exceed 20%, there are clear diminishing returns for tax revenue generation while the illegal market continues to grow considerably. Beyond reduced tax revenue generation, high illegal market rates have the added downside of increased enforcement costs for state and local governments. Finally, there is a growing body of evidence that when illegal market rates approach 40-50%, law enforcement efforts become futile and slowly cease as police move on to more gainful enforcement efforts.



Source: Caulkins et. al (RAND). *Considering Marijuana Legalization*, 2015, p. 127.



Source: C.D. Howe Institute. “With Legal Weed the Government Must Choose Revenue or Regulated Market, Not Both,” in *Intelligence Memos*, April 2017.

Endnotes

- ⁱ C.D. Howe Institute. Intelligence Memos: With Legal Weed the Government Must Choose Revenue or Regulated Market, Not Both, April 10, 2017 https://www.cdhowe.org/sites/default/files/blog_Rosalie_0410.pdf.
- ⁱⁱ Number of dispensaries determined by the 2016 Census population figure divided by the number of listings on Weedmaps (unless otherwise noted).
- ⁱⁱⁱ Iboshi, Kyle. "Legal pot businesses struggle to compete with black market." KGW Portland. February 24, 2017. Accessed May 8, 2017. <http://www.kgw.com/news/investigations/legal-pot-businesses-struggle-to-compete-with-black-market/413653533>.
- ^{iv} This number is calculated by adding the 17 percent state marijuana excise tax and the 3 percent Portland marijuana sales tax. City of Portland Oregon. "Portland Marijuana Tax," Accessed July 24, 2017. <https://www.portlandoregon.gov/revenue/article/620894>.
- ^v David Downs. "The Economist: pot legalization is crushing black market in Colorado." SF Gate. February 17, 2016. Accessed May 8, 2017. <http://blog.sfgate.com/smellthetruth/2016/02/17/economist-pot-legalization-is-crushing-black-market-in-colorado/>.
- ^{vi} This number is calculated by adding the 15 percent state marijuana excise tax, the 15 percent state marijuana tax, the 3.65 percent Denver general sales tax, and the 3.5 percent Denver special tax. Colorado Department of Revenue, Taxpayer Service Division. Excise 23: Excise Tax on Retail Marijuana, June 2016 <https://www.colorado.gov/pacific/sites/default/files/Excise23.pdf>; Colorado Department of Revenue, Taxation Division. "Sales Tax Rates," June 2017 <https://www.colorado.gov/pacific/tax/sales-tax-rates>; and City of Denver. City and County of Denver, Colorado Tax Guide, Topic No. 95: Marijuana—Medical and Retail, April 2015 https://www.denvergov.org/content/dam/denvergov/Portals/571/documents/TaxGuide/Marijuana-Medical_and_Retail.pdf.
- ^{vii} David Downs. "The Economist: pot legalization is crushing black market in Colorado." SF Gate. February 17, 2016. Accessed May 8, 2017. <http://blog.sfgate.com/smellthetruth/2016/02/17/economist-pot-legalization-is-crushing-black-market-in-colorado/>.
- ^{viii} This number is calculated by adding the 15 percent state marijuana excise tax, the 15 percent state marijuana tax, and the 3.5 percent Boulder city excise sales and use tax, and the 5 percent Boulder city excise tax on cultivation. Colorado Department of Revenue, Taxpayer Service Division. Excise 23: Excise Tax on Retail Marijuana, June 2016 <https://www.colorado.gov/pacific/sites/default/files/Excise23.pdf>; Colorado Department of Revenue, Taxation Division. "Sales Tax Rates," June 2017 <https://www.colorado.gov/pacific/tax/sales-tax-rates>; and City of Boulder Colorado. "Recreational Marijuana Businesses," (accessed June 2017) <https://bouldercolorado.gov/tax-license/recreational-marijuana-businesses>.
- ^{ix} Washington State provides mid-range and high-end estimates for the overall market value of their cannabis industry of \$1.33 billion and \$1.61 billion, respectively. Unlike Washington State, we estimate that the actual market size was over \$2bn based on comparison of its population to those in parts of California and the consumption rate in those regions. In FY 2016, sales from licensed marijuana dispensaries totaled \$786.4 million. We estimate, as does Washington State, that remaining sales went to illegal and gray market operators. Washington State Liquor and Cannabis Board. "Marijuana Dashboard: Sales and Excise Tax Totals," <https://data.lcb.wa.gov/stories/s/WSLCB-Marijuana-Dashboard/hbnp-ia6v/>; and BOTEC. Estimating the Size of the Medical Cannabis Market in Washington State, December 2015, p. 2.
- ^x This number is calculated by adding the 37 percent state marijuana excise tax and the 10.1 percent Seattle sales and use tax. Washington State Department of Revenue. "Taxes due on marijuana," August 26, 2016. Accessed May 8, 2017. <http://dor.wa.gov/Content/FindTaxesAndRates/marijuana/Default.aspx>; and Washington State Department of Revenue. "Local Sales and Use Tax Rates by City/County, Tax Rates Effective July 1 – September 30, 2017," Accessed July 24, 2017 http://dor.wa.gov/Docs/forms/ExcTx/LocSalUseTx/LocalSlUseFlyer_17_Q3_alpha.pdf.
- ^{xi} Jonathan P. Caulkins et al. *Considering Marijuana Legalization: Insights for Vermont and Other Jurisdictions*, 2015, p. 126.
- ^{xii} Jonathan P. Caulkins et al. *Considering Marijuana Legalization: Insights for Vermont and Other Jurisdictions*, 2015, p. 127.