Local Cannabis Taxation in California: The Key to Sustainable Economic Development

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Executive Summary

Following the passage of the MCRSA in October 2015, local governments in California have been granted broad authority to tax and regulate cannabis businesses. Cities and counties that have chosen to allow commercial cannabis activity have typically enacted gross receipts taxes of between 2-10% on cannabis businesses at each step in the supply chain. In general, this taxation is levied on between four and seven steps in the supply chain, involving some combination of nurseries, cultivation, extraction, manufacture, distribution, testing, and retail. These taxes have been imposed in addition to flat local regulatory fees that are calculated to cover the costs of permitting, inspection, and enforcement.

This paper argues that taxes on the non-retail cannabis supply chain, and gross receipts taxes in particular, are an unsustainable approach to local tax policy and should be replaced by a local sales tax at retail only. While supply chain taxes may appear as common sense in the context of the dominant "tax and regulate" approach to cannabis, local governments – unlike California's state government – must effectively compete with 482 cities and 58 counties in attracting successful and stable cannabis businesses. As the cannabis industry matures and becomes more competitive, businesses will quickly be incentivized to either seek out jurisdictions that do not levy supply chain taxes, or to vertically integrate in a way that avoids these taxes.

These risks are intensified by additional factors that are too frequently ignored. Crucially, a 5% gross receipts tax – often articulated as a "moderate" tax – amounts to a tax of 20-35% once its effects on each step in the supply chain are taken into account. Further, the gross receipts tax is frequently criticized by both left-wing and right-wing tax analysts as regressive, non-transparent, and skewed to strongly favor vertically-integrated and high-margin businesses which can avoid or absorb the tax.

Successful local cannabis regulation will require that governments set realistic expectations for how commercial cannabis activity will impact municipal budgets and economic growth. Cannabis will not be a "gold rush" or a panacea for resolving local budget deficits over the long-term. Cities like Adelanto and Desert Hot Springs that have closed budget deficits with liberal permitting and high taxes have benefited from their status as first movers under the MCRSA, a historically unique circumstance that is rapidly reaching its expiration date as more and more cities offer permits under more favorable terms.

That cannabis permitting is not a panacea is not to say that it cannot provide substantial benefits to local communities and municipal budgets. With thoughtful planning, local governments can raise revenue through a cannabis retail tax; attract stable businesses that will establish roots in their community; provide good job opportunities for local residents; and promote an economically vibrant community.

Failure to understand these dynamics, however, risks a very different outcome: an initial rush of interest in newly-available cannabis permits, followed by a boom-and-bust cycle where new businesses shut down or move upon realizing that they cannot compete with businesses in more favorable jurisdictions. A forward-thinking approach that envisions how the cannabis industry is likely to develop over time will be crucial to develop sustainable local policy that maximizes benefits to the community.

Introduction

The legalization of cannabis in California has created both opportunity and challenges for local governments. State legislation for regulating medical and adult use cannabis businesses has consistently emphasized local governments' authority to prohibit, permit, or regulate businesses in whatever way they choose. With this authority, however, comes a major burden. With the state required to begin issuing licenses by January 1, 2018, local governments have been put under pressure to quickly enact wide-ranging local regulations with little direction, guidance, or precedent.

Deciding upon tax structure is one major component of this process. Existing analysis on cannabis tax policy, however, has been conducted disproportionately at the state level. California's Blue Ribbon Report, written under the direction of Lt. Governor Gavin Newsom and published in July 2015, summarizes the generally-understood cannabis tax dynamic: high taxes will increase retail prices and discourage overconsumption, but an excessive tax rate will discourage entrance into the legal market and enable the continuance of the black market.[1]

While important at the state level, discussions along these lines do not fully capture the dynamics affecting specifically *local* taxation policy. A key difference is that, unlike state-level policies, local policies are not uniform: each of California's 482 cities and 58 counties will have a different regulatory and tax policy, placing local governments in competition with each other for non-retail businesses operating in a state-wide marketplace.

With this principle in mind, this paper assumes that there are basically two overarching considerations for local governments. The first is obvious: generating tax revenue. The second, however, is less frequently acknowledged: creating a policy environment that encourages the development of *sustainable* local businesses that are positioned to develop roots in their community, employ locals, and contribute to local economic development. This latter goal requires a long-term perspective that considers what will be necessary for cannabis businesses to succeed as the cannabis market and state and federal cannabis policy rapidly evolve.

This paper argues that both of these goals can be best achieved by enacting a moderate tax on cannabis retail – both storefront and delivery-only – while avoiding taxes on supply chain activities including cultivation, manufacture, distribution, extraction, nurseries, and laboratory testing. To this point, most local governments have chosen to heavily tax these activities, and such an approach may appear common-sense given the broad consensus that cannabis should be "taxed and regulated" as an alternative to prohibition. Over the medium-to-long term, however, these supply chain taxes threaten local governments

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[1] Newsom, C., Keith Humphreys, and Abdi Soltani. *"Pathways report: Policy options for regulating marijuana in California."* Blue Ribbon Commission on Marijuana Policy (2015). Page 54.

with a boom-and-bust cycle in which non-retail businesses will be driven to jurisdictions with the lowest local tax rates in order to meet retail demand for low-cost products.

Section One begins by establishing some basic assumptions regarding California's current and future cannabis industry. Inaccurate assumptions about the cannabis market – for instance, the assumption that most or all cannabis businesses will enjoy perpetually high profit margins – are likely to lead to poorly-developed regulatory structures that are not sustainable over the long term.

Section Two analyzes and critiques the gross receipts tax, the form of taxation that most local governments have chosen to levy on cannabis businesses. It identifies common criticisms of the gross receipts tax from both left-wing and right-wing policy analysts, and analyzes the impact of existing gross receipts taxes on the cannabis supply chain. Washington State's experimentation with gross receipts taxes, quickly abandoned in favor of a retail-only tax as its negative effects became apparent, is explored as an example of how supply chain taxation is self-defeating from both a revenue-generation and regulatory perspective.

Section Three concludes by envisioning what successful local regulatory policy would look like over the long term. In focusing on sustainability and continuity, it envisions a future significantly more modest than popular predictions of a cannabis "gold rush" would suggest. At the same time, however, it is argued that this future is both more realistic and more concrete in its benefits to the community than alternatives that seek to "cash in" on cannabis to the maximum extent possible.

1. California's Cannabis Market: Current and Future Dynamics

In the nineteen years between the passage of Proposition 215 in 1996 and the passage of the MCRSA in 2015, most cannabis businesses operating in compliance with state law lacked permitting and regulation at the local or state level. When combined with continuing federal hostility towards cannabis, this situation created a perception of risk that artificially inflated cannabis prices and margins.

With the implementation of a bona fide regulatory system in California – in combination with federal policy changes such as the Rohrabacher-Farr amendment and Cole Memo that decrease perceived risk to cannabis businesses – it's important to acknowledge how the cannabis market has changed and will continue to change. Some of the major dynamics include the following:

- **Most cannabis businesses, once permitted and regulated, will not have especially high profit margins.**

Cannabis' reputation as a high-profit business stems from prohibition, not from any quality inherent to the plant. Under California's state-legal framework, cannabis businesses will face a number of challenges that will substantially depress margins. These include:

1. A substantially more competitive marketplace than under the Proposition 215 framework.

2. State taxes including a 15% excise tax, a $9.25/ounce tax on cannabis flower, a $2.75/ounce on trim, and a 8.25-9.25% state sales tax.

3. Federal tax issues centering on IRS Section 280E, which prevents cannabis businesses from taking normal deductions for business expenses. Inability to take these deductions produces a typical effective federal tax rate of 40-70%.[2]

4. State and local licensing and permitting fees, typically in the tens of thousands to hundreds of thousands of dollars.

5. The requirement to comply with several hundred pages of new state regulations.

6. Requirements to meet strict state testing requirements for each cannabis batch.

7. New requirements to operate through a longer supply chain that includes a distributor as a middleman.

8. Inflated real estate prices for the limited property zoned for cannabis operations.

9. Difficulties in planning long-term operations given local, state, and federal regulatory uncertainty.

10. Extra costs associated with cash-handling due to lack of banking availability.

Local governments that approach cannabis as a “green rush,” and imagine cannabis businesses as profitable enough to absorb any tax burden, will quickly be disappointed by the realities of the regulated marketplace.

- **While retail businesses serve a local or regional market, the market for supply-chain activities is statewide – and may eventually be nationwide.**

The market for cannabis flower and manufactured products has always been statewide, with (for example) North Coast cultivators and Bay Area manufacturers distributing large amounts of product to retailers in Southern California throughout the Proposition 215 era. With MAUCRSA ushering in variable local tax rates, greater competition, and fully permitted transportation, incentives for retailers to source state-wide will only increase.

- **High variance in local tax rates will incentivize businesses to seek out tax-friendly jurisdictions.**

At the low end, Humboldt County taxes outdoor cultivation at $1/square foot and does not tax manufacturing, and Los Angeles and Santa Rosa levy taxes from zero to 2% on supply chain businesses. At the high end, Monterey County taxes outdoor cultivation at $15/square foot, and Long Beach taxes manufacturing, distribution, and testing businesses at 6%. Differences of this magnitude will be far too large for businesses to ignore over the long-term.

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[2] Huddleston, Jr., Tom. *The Marijuana Industry's Battle Against the IRS.* Fortune, 15 Apr. 2015, fortune.com/2015/04/15/marijuana-industry-tax-problem/

The initial impulse for many local governments is to align local tax policy with the typical tax in other areas. As the appendix to this document demonstrates, however, there is enough variance in local tax rates that it would be inaccurate to speak about any "typical" rate. Instead, local governments have pursued a wide variety of tax options in accordance with perceived local needs or assumptions about what is "reasonable." Accordingly, thoughtful cities and counties will need to set tax policy with a mind to long-term goals for local economic development, rather than simply following the example of other jurisdictions.

2. Gross Receipts Taxes: A Counter-Productive Approach

For the most part, local governments in California have chosen to tax cannabis businesses through a gross receipts tax: a flat percentage tax on revenue, rather than profit, levied on businesses at each step in the supply chain. Gross receipts taxes have the advantage of being easy to administer and easy to communicate to voters who are required to approve tax measures at the ballot.

Because the gross receipts tax is assessed at each stage in the supply chain, however, it produces cascading effects that quickly turn a moderate-seeming tax into a major tax burden. In Oakland, for instance, medical cannabis businesses are taxed at 5% of gross receipts, and adult use cannabis businesses are taxed at 10% of gross receipts. Under the MAUCRSA, cannabis products will be legally required to pass through at least four different points in the supply chain: cultivation, distribution, testing, and retail. In practice, many cannabis products will need to pass through six to seven points in the supply chain: nurseries, cultivation, extraction, manufacture, distribution, testing, and retail. A local tax rate of 5%, then can create an effective tax rate of 20-35% if implemented for all cannabis businesses, even before state and federal taxes are taken into account.

When viewed from the perspective of any individual business, a 5% gross receipts tax may appear relatively marginal. When assessed from a retailer or distributor's perspective, however, the situation looks quite a bit different. A retailer can effectively slash 25% or more off their wholesale costs simply by sourcing from businesses in low-tax jurisdictions or vertically integrating to avoid supply chain taxes. Retailers which are not judicious about decreasing their costs in this manner will not be competitive with other local retailers, and cultivators and manufacturers who cannot meet retail requirements will quickly be driven out of business.

That the gross receipts tax snowballs in this way is one of several dynamics that contribute to its poor reputation among tax analysts on both the left and the right. The Institute on Taxation and Economic Policy and the Tax Foundation – generally considered to be a left-wing and right-wing think tanks, respectively – each criticize gross receipts taxes as regressive, non-transparent, punitive on low-margin businesses, and skewing business incentives towards vertical integration[3]. Each of these criticisms is discussed briefly below.

- **The gross receipts tax is regressive.**

[3] "*Gross Receipts Taxes: A Counterproductive Approach to Addressing Tax Regressivity,"* Institute on Taxation and Economic Policy, www.itep.org/wp-content/uploads/ilgrt032907.pdf.

Because the gross receipts tax is assessed on business revenue, not profits, it can be more easily passed along to consumers. The Institute on Taxation and Economic Policy cautions against the error in assuming that the gross receipts tax is "progressive" simply because it is levied on business:

> *"From the consumer's perspective, the major distinction between gross receipts taxes and retail sales taxes is that gross receipts taxes are not necessarily itemized on customers' bills – though they are nonetheless paid by customers in the form of higher prices... worst of all, many lawmakers erroneously view GRTs as replacements for state corporate income taxes, simply because businesses are responsible for remitting these taxes to the state. But since GRTs are levied on sales, rather than profits, they are ultimately passed through to consumers like a sales tax, with all the same regressive effects."*[4]

Large regressive taxes are a particular problem for low-income patients who require cannabis to meet their medical needs. Despite the increasing recognition that cannabis is an essential medical tool in treating a number of serious conditions, policy has often moved directions that make medical access more difficult for the sake of achieving other regulatory goals. The gross receipts tax adds to this burden.

- **The gross receipts tax is non-transparent.**

Voters, and even many businesses, are likely to assume that a 5% tax on cannabis businesses will lead to a 5% increase in the price of cannabis at retail. Similarly – and unlike a sales tax alone – patients or customers purchasing cannabis at retail are unlikely to understand how the gross receipts tax contributed to the price they pay at the register.

- **The gross receipts tax is punitive on low-margin businesses.**

Fair taxes should be based on the ability to pay. The gross receipts tax, however, effectively turns profitable but low-margin businesses into highly unprofitable ones; punishes smaller start-up businesses that cannot immediately turn a profit and lack access to capital; and falls disproportionately on lower-margin businesses that operate on the production end of the supply chain.

- **The gross receipts tax leads to excessive tax burden through pyramiding.**

As described earlier, a 5% gross receipts tax levied at each step in the supply chain will amount to an effective tax rate of 20-35% over the full life of a cannabis product.

In reality, however, the effective tax rate is even larger given the "pyramiding" of taxes through the supply chain. Because the first step in the supply chain (cultivation) must increase wholesale prices to cover the cost of the tax, the manufacturer/distributor effectively pays a tax on a tax: first on the baseline wholesale cost of the cultivated product, and again on the increased wholesale cost due to the tax on cultivation. These costs continue to pyramid at each step in the supply chain. The longer the supply chain, and the greater the tax, the more pyramiding occurs.

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[4] "*The ITEP Guide toFair State and Local Taxes,"* Instiute on Taxation and Economic Policy, https://itep.org/wp-content/uploads/guide.pdf. Page 14.

Below is a tax model that estimates these effects concretely at current market prices and mark-ups for cannabis products. The model assumes a current market retail price of $4,255 for one pound of cannabis flower and $2,280 for manufactured product derived from one pound of cannabis trim. Average mark-ups for added value and profit margin at each stage in the supply chain are estimated at 60% for manufacturing, 25% for distribution of manufactured goods, 15% for distribution of flower, and 100% at retail. It is assumed that testing is not taxed locally, although this is a conservative assumption given that many jurisdictions levy the same tax on testing as other supply chain activities. Effects of testing on mark-up are also excluded as this is difficult to estimate before state testing regulations are clarified.

At variable levels of gross receipts taxation, the results are as follows:

	Retail price of 1lb flower	Percentage increase from GRT	Retail price of product from 1lb trim	Percentage increase from GRT
0% Gross Receipts Tax	$4,255	0%	$2,280	0%
2% Gross Receipts Tax	$4,502	6%	$2,485	9%
5% Gross Receipts Tax	$4,855	15%	$2,820	24%
10% Gross Receipts Tax	$5,556	31%	$3,455	52%

These numbers rely on a number of assumptions which may change over time; however, they give a sense for the advantages that will accrue to retailers who are able to source their products from a supply chain that does not pay gross receipts tax.

The model also does not assume the 15% state excise tax , $9.25/ounce flower tax, and $2.75/ounce trim tax that will become effective on January 1, 2018. These taxes will add additional burdens on cannabis businesses, particularly in terms of their competitiveness with the black market.

- **The gross receipts tax artificially spurs vertical integration.**

By effectively selling to itself at low or no cost, a vertically-integrated business can avoid gross receipts taxes. This dynamic adds to other structural factors that tend to privilege consolidated businesses and disadvantage the small, independently-owned businesses which have historically constituted the California market.

Many California cannabis businesses will vertically integrate for any number of reasons. The question, however, is whether businesses will effectively be *required* to vertically integrate by a tax structure which heavily subsidizes this business model.

The state of Washington, which initially levied a 25% gross receipts tax on each step in the supply chain, is an example of these incentives at work. The severe inefficiencies under Washington's initial system quickly led to state to abolish the gross receipts tax and instead levy a 37% tax on retail only.

A 2017 paper published by researchers at the University of Oregon and National Bureau of Economic Research titled "The Taxation of Recreational Marijuana: Evidence from Washington State" explores these dynamics in detail[5]. The paper, which is the first empirical investigation of the effect of widespread gross receipts taxes on the cannabis industry, is worth reviewing in full. In brief, however, its conclusions include the following:

- Following the passage of the gross receipts tax, 94% of transactions were carried out between vertically integrated businesses.
- Widespread vertical integration led to very low tax collection rates on the supply chain.
- Cultivators and processors often did not want to vertically integrate, but felt that they were required to in order to optimize their tax position. Further, cultivators and processors were strongly disincentivized from working with external businesses, such as specialized extractors, that would have otherwise increased their product quality.
- The initial Washington system was economically inefficient and produced substantial deadwight loss.

The paper's authors conclude that the Washington experience provides empirical support for widespread theoretical criticisms of the gross receipts tax.

- **Tax burden from the gross receipts tax will boost the black market and discourage transition into the regulated marketplace.**

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[5] Hansen, Benjamin, Keaton Miller, and Caroline Weber. *The taxation of recreational marijuana: Evidence from Washington state*. No. w23632. National Bureau of Economic Research, 2017.

There is broad agreement that the black market will continue in some form even after California's regulatory structure goes into effect[6]. The size of the black market, however, will depend largely on how difficult it is for existing businesses to transition into the regulatory framework. In combination with other challenges discussed earlier, local gross receipts taxation will discourage compliance with California's regulatory framework. To the extent that upstream businesses do not evade gross receipts taxes through vertical integration or flight, they will also increase the retail price of legal cannabis, increasing the incentive for consumers to buy on the black market.

As has been described above, gross receipts taxes fall disproportionately on low-margin businesses, businesses without access to capital, and businesses that are unwilling or unable to vertically integrate. Unfortunately, these are precisely the businesses most likely to experience challenges in securing a state and local permit. Excessive local taxation will add to other factors pushing these businesses to operate on the black market.

- **A retail-only sales tax avoids the problems with the gross receipts tax, while still raising substantial tax revenue.**

A tax on retail sales only avoids the most significant problems associated with gross receipts taxes. Retail sales taxes are transparent, provide no incentive for vertical integration, and don't pyramid in ways that create an excessive tax burden. Most importantly, retail markets are local or regional rather than state-wide, and therefore do not need to position themselves to be competitive with businesses located in other areas.

In setting retail tax rates, local governments will need to consider tax rates in neighboring jurisdictions, the impact of the tax on consumer prices, and goals for revenue generation. Within these boundaries, however, cities and counties governments have wide latitude to set a tax rate that best meets local needs.

3. A Path Forward: Building a Sustainable Local Cannabis Industry

There is no one-size-fits-all regulatory or tax policy solution that applies uniformly to local governments. Each city and county will need to develop tailored policies that fit a particular vision for what a successful cannabis regulatory structure will look like.

Rural areas with substantial existing activity, such as the Emerald Triangle counties, have steered policy towards retaining their existing community of small businesses, while encouraging them to enter a regulated marketplace that includes restrictions on environmentally damaging practices. Continuity and sustainability have tended to be the primary values for these areas. Tax rates will need to account for the risk of continued black market activity due to the cost of entering into the aboveground market.

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[6] McPhate, Mike. *"What if Legal Pot Costs More Than Black-Market Pot?"* New York Times, 19 Sept. 2017, www.nytimes.com/2017/09/19/us/california-today-a-marijuana-conundrum.html.

Diverse urban hubs like Oakland, San Francisco, and Los Angeles, which have historically served as centers of California cannabis culture, will likely work towards retaining their leadership status while ensuring that business opportunities are available to disadvantaged populations and victims of cannabis prohibition. These cities are likely to envision a future that involves a vibrant, diverse, and equitable landscape of cannabis businesses. Tax rates will need to ensure that these areas remain competitive in the context of the statewide market, and that the market is made accessible to victims of cannabis prohibition who often lack the advantages of larger and better-capitalized businesses.

Small rural or exurban towns that face economic challenges, such as Adelanto and Desert Hot Springs, have built policies that are largely geared towards maximizing tax revenue. These areas are likely to emphasize policies that maximize economic activity and revenue generation, either from small numbers of large businesses, or large numbers of smaller businesses.

The priorities for each of these areas are not identical, but they do share certain key principles. All of these goals require that governments attract or retain significant numbers of quality, sustainable businesses. All of these goals require that local businesses remain at parity with competitors in other jurisdictions. And all of these goals require that local governments set policies which remain sensible as the cannabis market rapidly develops and changes.

Gross receipts tax revenue is not the only way that cannabis businesses can contribute to local governments and communities. Like other businesses, cannabis businesses pay property tax, employ locals, and indirectly contribute sales tax revenue to the extent that they boost overall economic activity in a region. Like other businesses, cannabis businesses that form roots in their community have the ability to become part of the fabric of their communities. This is especially true for smaller local businesses which many local jurisdictions have made it a goal to encourage and retain. Local governments need to give thought to what will be necessary to enable these businesses not just to receive permits, but also to succeed into the future.

The frequent comparison of the emerging cannabis industry to California's gold rush is ironic. Gold rush towns boomed – and then disappeared. Cannabis, unlike gold, is a renewable resource, and in the best case cannabis businesses will be able to contribute to their community's economic vibrancy indefinitely. Tax policy which is sustainable over the long term will play a large role in enabling that future. If local governments want to realize the promise of a sustainable cannabis industry, they should start planning now for tax policies that achieve those ends.

Appendix: Cannabis Tax Rates in California Cities and Counties

Tax rates are current as of September 2017.

City	Gross Receipts Tax	Notes
Desert Hot Springs	$25/sqft on first 3,000 feet of cultivation, $15/sqft for remainder. 10% retail.	
Long Beach	$12/sqft cultivation, others at 6%	
Grover Beach	$25/sqft on first 5,000 feet, $10/sqft for remainder. Other activities at 5%.	10% for adult use
Monterey County	$15/square feet on cultivation, others at 5%.	Tax set to increase to $25/sqft on cultivation and 10% on other businesses
Adelanto	$5/sqft cultivation tax, or 5% gross receipts.	Cultivators given choice between square footage and gross receipts tax.
San Diego	5%	Planned increase to 8% by 2018
Oakland	5%	10% for adult use
Richmond	5%	
Sonoma County	Progressive square footage cultivation tax ranging from $0.50-$18.75/sqft. 5% manufacturing tax. No tax on other acitivies.	
Sacramento	4%	
Berkeley	2.5%	10% for adult use
Santa Rosa	2% cultivation, 1% manufacturing, 0% distribution and testing	$5/square foot alternative cultivation tax for vertically integrated businesses
Los Angeles	2% cultivation and manufacture, 1% testing and transportation	
Mendocino County	2.5% cultivation and retail, $2,500 flat fee for other businesses	
Humboldt County	$1-$3/sqft cultivation, 0% other activities	