Ace in the Game: Revenue from Legalized Marijuana
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Abstract

After marijuana is legalized, the costs of producing and selling it will collapse. What will happen to prices? A windfall economic gain will be up for grabs. Policymakers might allow that gain to go to consumers (encouraging use) or to cannabusinesses (encouraging production). Or, through revenue measures, they might direct the gain elsewhere, or to society as a whole. New revenue for government does not justify legalization of marijuana. New revenue may not cover the costs that legalization creates, and a revenue stream gives government a permanent stake in intoxication. Revenue is only one card in a large deck of drug policy options. But it is the most powerful card.

How to play it? The safest, correctable way to distribute an intoxicant is government monopoly, Uruguay style. Retail-only monopoly can match or beat bootleggers’ wares. But monopoly breeds cronyism and corruption, unless power is spread around and transparent. In the United States, states might need to tweak the monopoly model to keep state control over location and price while assigning sales concessions to businesses.

A riskier plan is taxed commercial distribution, Colorado and Washington style. In the inevitable price war, bootleggers will act in a New York minute; Legislatures will not. That is a handicap. And no tax is perfect. Taxing by THC potency is theoretically appealing, but unworkable. A price tax base has several pitfalls. Even a weight base is problematic.

Three other models are possible: auctioning licenses, collective farming, and sales by non-profits.

Since no one really knows how to legalize, flexibility to change course is of the utmost importance.

Controlling a Light but Pungent Weed

Any legalization1 model2 – monopoly, tax, or whatever – must result in prices high enough

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1 To be sure, decriminalization, removing penalties for possession while retaining penalties for distribution, does not entail revenue. But that’s not legalization.
2 This article is limited in scope. More comprehensive treatment may be found in an overview, “Laws To Tax Marijuana,” 59 State Tax Notes 251-280 (January 24, 2011), online at http://ssrn.com/abstract=1741735 with Table of Contents; without Table at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2214910 (hereinafter “Laws To Tax”);
for public approval. But it must use either low prices or enforcement to solve the problem of bootlegging—selling by the illegal sector that competes with the legal sector. Marijuana will be easier to bootleg than both alcohol and tobacco.

**Compared to alcohol**

Some factors make marijuana easier to bootleg than alcohol, another psychoactive intoxicant. First, marijuana is lighter and more compact by value.

Second, it’s harder to transport a liquid than a solid. A sloshing liquid can tilt a partly filled, rolling bulk container over, or at least slow it down. A small hole can bring ruin.

Third, processing is more exposed for alcohol than for marijuana. It takes time to distill spirits (which requires observable heat), ferment wine, and brew beer. Marijuana processing is simple and portable.

Fourth, consumers understand that moonshine liquor can kill them on the spot; bootlegged marijuana may provide more mold and pesticides than regulated product, but not instant death. So bootlegged marijuana is more marketable than bootlegged liquor.

Other factors tend to make marijuana harder to bootleg than alcohol. Marijuana tends to be pungent. That makes it easy to find. Corn and other raw materials for beverage alcohol are legal as they grow in the field; investigation can’t succeed before harvest. Contraband marijuana needs to be hidden while it grows; for outdoor operations, aerial surveillance is a threat; for indoor operations, excess electricity consumption can be monitored. Marijuana takes months to grow, and the grower must keep it in hiding all along.

**Compared to tobacco**

Marijuana is easier to bootleg than tobacco, another plant that people smoke or consume by mouth, though marijuana is more pungent while it grows. First, marijuana’s light weight and low bulk make it easier to hide. Second, tobacco is notoriously hard to grow. Some marijuana grows easily: Primitive strains, at least, have the nickname weed. That factor


makes marijuana harder to control and easier to bootleg (but does not apply to finicky hothouse strains). Third, the process of converting sticky fresh tobacco into consumable form requires either air-drying, which takes a long time, or artificial heating. Both processes may be detectable by law enforcement. Post-harvest processing of agricultural marijuana is simpler than that of tobacco, so there is less time and there are fewer clues to find contraband during that phase.

**Government Monopoly**

In Uruguay, the government will be the sole seller of retail marijuana. Government monopoly can be a bootlegger’s nightmare, and the most flexible and robust legalization model overall.

**Advantages of Monopoly**

The game-over first reason to pick marijuana monopoly over a private-enterprise model is that governments get only one chance to set up a monopoly. You can always switch from monopoly to a private model, but not the other way (private businesses would have a powerful and valid complaint). Having a Plan B is reassuring.

Second, a public seller can tweak prices more quickly than a Legislature can change tax rates, the better to battle bootleggers in the inevitable price war.

Third, a state monopoly limits the profit motive for distribution of marijuana. As John D. Rockefeller said about liquor, as U.S. Alcohol Prohibition ended: “Only as the profit motive is eliminated is there any hope of controlling the liquor traffic in the interests of a decent society. To approach the problem from any other angle is only to tinker with it and to ensure failure.”

Fourth, public monopoly offers more regulatory control. A mayor of Juarez, Mexico, expresses that view this way: “If you want to end the violence and the corruption it creates, . . . you only need to turn the business over to governments.”

Fifth, monopoly offers more stable long-term control. As the marijuana industry matures, it can be expected to gain power and seek tax cuts – as the U.S. alcohol industry has done, if only by watching unindexed dollar-denominated taxes erode through inflation.

Sixth, the public may favor monopoly. At least it did in my state of North Carolina, in March 2013, by 58 percent to 19 percent (with 23 percent having no opinion).

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Seventh, here, finally, is a factor not involving drug policy: Government monopoly should tend to maximize net revenue generally. That is, government gets more of the proceeds from monopoly than from any other scheme.6

**Disadvantages of Monopoly**

First among monopoly’s disadvantages is the evil twin of the last advantage mentioned: A government that benefits from sales of undesirable goods tends to become compromised in its opposition to them. The more money for government, the greater the pull to condone those goods. Monopoly’s revenue advantage over taxes becomes a disadvantage as government condones harm.

Second, private industry is ordinarily more consumer-friendly than a state monopoly, though consumer-friendliness does not appeal to members of the public that oppose marijuana.

Third, state monopoly can lead not only to inefficiency and waste but also to conflicts of interest, sweetheart deals, and corruption. In North Carolina, for instance, state monopoly of liquor for off-premises consumption has proved prone to embarrassing scandal.7

Fourth, putting government into the monopoly business may seem more provocative to treaty partners8 than tolerating private sellers. By analogy, in the United States, legalizing states are not selling marijuana themselves. That way, they avoid directly violating federal law.9 Because of federal illegality, no U.S. state laboratories even perform tests on marijuana; no state is thinking of hiring cashiers to sell it. To seek the advantages of monopoly, U.S. states might need the kind of work-around described in the next section.

**Implementing Monopoly**

State monopolies face dangers of corruption and cronyism. Those dangers might be addressed by transparency and division (separation) of power. Presumably, a board would be in charge of setting policy and hiring employees. Members of that board might be reined in by short terms of office, perhaps nonrenewable. Appointees to the board might be named by members of different branches of government.10

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6 The work of Robin Room, [http://www.robinroom.net](http://www.robinroom.net), could be a starting point for more thinking about monopoly for marijuana.
8 Given the complexity of tax law, new U.S. tax statutes that override, or, less euphemistically, violate, tax treaties now and then are noticed only by insiders. [http://newrevenue.org/2013/09/25/treaties-are-not-special-here/](http://newrevenue.org/2013/09/25/treaties-are-not-special-here/).
10 In a typical state of the United States, members of a seven-member board could be named by seven different individuals: the Governor, the Lieutenant Governor, the Chief Justice of the State Supreme Court, and the leaders of the majority and minority parties of each house of a bicameral legislature. (That model does not translate well to countries where a two-party system does not
State monopoly might best extend to only the retail level of enterprise. The marijuana industry has developed a wide variety of products or strains with different appealing characteristics. But Uruguay might cede the advantage of product differentiation to bootleggers: "[President] Mujica said the marijuana would be cloned to reproduce the same genetic code, which would give the plants a clear identifier for tracking."11 The analogy in the liquor market is going to a government liquor store and being able to buy only one brand of bourbon whiskey -- no gin, no rum, no vodka, no rye, no tequila, no Scotch. The bootlegger can provide wider product choice – a competitive advantage.

A government liquor monopoly that provides more choice for consumers is at work in many countries, especially Nordic countries, including Sweden,12 and in 17 U.S. states, including North Carolina. That model lets private firms supply product to a state monopsony (sole buyer), which is also a retail monopoly. So consumers choose among a wide variety of competing products.

For the unique case of the United States, to attempt to work around federal law, a state could assign possession and the functions of producing and selling to contractors.13 The state could still set prices, fix locations, and restrict advertising. Constitutionally, that plan may be no more provocative than the local marijuana taxes collected in Oakland, California, since 2010, and the state excises already collected in Colorado this year.

As we move from monopoly to the next model, taxation of private enterprise, there is overlap: A Sweden/North Carolina monopoly model can combine retail monopoly sales with taxation of producers.

**Taxing Private Enterprise**

The U.S. states of Colorado and Washington, along with many localities where medical marijuana is legal, collect excise14 taxes from private companies that do the selling. While a complete examination of the issues involved in the taxation of marijuana sold by private enterprise would exceed the length limit for this Conference,15 there is room here for a discussion of the tax base and for listing of other issues.

**What Base?**

operate.) The author is a tax man, and has hardly begun to study techniques to battle corruption in monopoly.

13 This approach would address only the problem of federalism, not those of cronyism and corruption.
14 An excise tax applies only to designated goods or services. Its base may be weight, price or something else.
15 For a more complete examination, see the sources listed supra note 2.
What bases – what measuring sticks – could be used to tax marijuana? Possible bases for marijuana taxes include weight, potency, percentage of sale price, number of plants, square footage of production areas, or abnormally high electricity use that is associated with indoor growing. All but the first two, weight and potency, are already taxing marijuana in the United States, but weight and potency are likely to prove the most useful in the long run. Two or more tax bases may be used simultaneously.

This paper does not address application of a Value Added Tax to marijuana; presumably regular VAT rules will apply to marijuana, with an appropriate rate selected.

**Potency**

For marijuana, “Ideally, the tax rate per ounce should be proportional to THC potency.” Indeed, potency is a rough proxy for the tax base of the whole U.S. federal alcohol scheme. The federal tax on liquor is directly proportional to alcohol content. And the federal scheme taxes alcohol in hard liquor at a higher rate per ounce than in its less powerful competition. The tax on wine is linked to potency, too. Only the tax on beer, $18 per barrel of 31 gallons, does not turn on potency.

Potency-based taxation requires chemical analysis. Chemical analysis is easy for beverage alcohol, but impractical for a solid vegetable product. For solid vegetable marijuana, different labs routinely report wide variances in measured potency (THC content) from a single sample.

For now, even processed marijuana, which at least passes through a liquid or concentrate form, does not yield replicable testing results. Technology and openness may one day yield standards allowing test results that are accurate enough to base taxes on – for concentrates. But it’s hard to imagine that testing will ever be reliable enough to tax unprocessed marijuana by potency. Unreliable testing: That’s why no one taxes cigarettes by tar and nicotine content.

Here’s a fallback potency idea: a minimum tax. Jurisdictions could base a minimum tax on stated or claimed weight-adjusted potency (in terms of numerical THC content) -- in addition

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18 Alcohol and Tobacco Tax and Trade Bureau, U.S. Department of the Treasury, “Tax and Fee Rate [Table],” available at [http://www.ttb.gov/tax_audit/afftaxes.shtml](http://www.ttb.gov/tax_audit/afftaxes.shtml) (last visited Dec. 13, 2010). The tax rate is determined by proof gallon, which is the equivalent in alcohol content of a gallon of 100 proof (50 percent alcohol) liquor.

19 Id.

20 Id.


to a primary tax, maybe based on weight. That fallback idea presupposes that (1) industry will voluntarily run some not-close-enough-for-government-work test for potency, or (2) regulations will require that packages disclose THC content, however inaccurate, as a warning or as ordinary consumer information. In those cases, relatively high stated (reported) THC levels may tend to entice consumers to buy. Taxing stated potency creates a healthy tension for marijuana sellers who look to soup up the results of potency testing by shopping for a lab that will over-report THC.

But taxing only stated potency could prove unwise. If the industry is not well regulated, shrewd sellers seeking to defeat the purpose of the minimum tax could deliberately understate THC – and substitute a different claim (3 percent XYZ cannabinoid! The secret ingredient for getting high!). True or false, such a claim might lure buyers. So a more prudent approach might be to make a tax on stated potency an add-on, or an alternative minimum, rather than the primary tax.

**Weight**

Weight is an obvious option for the base of a tax on marijuana.

Anachronistically, “Twenty-one states have laws on the books that tax the sale of marijuana (and other illicit drugs)” on the basis of weight, though these dead-letter gotcha taxes are really fines. Weight is used to tax cigarette tobacco regardless of tar and nicotine.

Once moisture content is accounted for, a weight-based tax is relatively easy to impose. A weight-based tax, though, will tend to drive less potent, cheaper product out of the market.

Colorado is collecting a de facto weight tax of 62 cents per gram ($281 per pound) of potent flowers and 10 cents per gram ($44 per pound) of less intoxicating and less valuable trim. Regulators will restate those rates every six months to reflect ongoing market prices. Other pending proposals in U.S. states follow Colorado’s lead in proposing higher weight-based taxes. The short life of that tax provision may serve as a warning for this proposal: In tax policy, it often makes sense to use tried and true models.

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24 A tax on the potency that sellers claim (accurate or not) could work like the short-lived minimum tax preference item of book income reported to shareholders -- a tax burden for a quantified claim, tangential to the principal tax base, that impresses a company’s stakeholders. [http://www.taxpolicycenter.org/taxtopics/encyclopedia/alternative-minimum-tax-corporate.cfm](http://www.taxpolicycenter.org/taxtopics/encyclopedia/alternative-minimum-tax-corporate.cfm). The short life of that tax provision may serve as a warning for this proposal: In tax policy, it often makes sense to use tried and true models.

25 State and Federal, supra note 9 at 258. Those so-called taxes are supplements to enforcement schemes. Some have been found unconstitutional as self-incriminatory.

26 “On cigarettes, weighing not more than 3 pounds per thousand, [the tax rate is] $19.50 per thousand.” Internal Revenue Code section 5701(b)(1).


taxes for flowers than for trim. And New York State Senator Liz Krueger proposes a higher rate for potent concentrates (the typical end-product that comes from trim), $200 per ounce, than for plant material, $50 per ounce.\(^{29}\)

The easiest question here is whether to index currency amounts (dollars, francs, pesos, whatever). The answer is yes. Inflation has made the U.S. federal beer tax, $31 per 55 gallon barrel, lose over half its real value since it was last raised in the “Read My Lips: No New Taxes” tax increase of 1990.\(^{30}\) Indexing would solve that problem by increasing tax rates to take account of inflation. Any tax based on weight or potency will use currency, and needs indexing; unless a currency-denominated tax rate is indexed, the nominal tax burden is frozen, and the inflation-adjusted burden shrinks.\(^{31}\) (Indexing is irrelevant when the tax base is a percentage of price, because as prices go up, taxes do, too.) Indexing is common in the income tax; it is rare (too rare) in excise taxes.\(^{32}\) The City of Long Beach, California, indexes its square footage taxes on marijuana businesses.\(^{33}\) Good idea.

### Price Bases

**Price Bases In general**

Shouldn’t jurisdictions choose a price base? Let’s assume that potency is the ideal tax base; that it can’t be measured accurately enough for tax purposes; but that consumers ordinarily pay more for potent products. If so, price reflects potency. So a tax based on price would be a proxy for one based on potency.

So far, Colorado and Washington are trying to tax only by percentage of price. That seems easy, and quick. Setting up weigh stations and testing facilities would take time. And they mean more government -- which many in the marijuana community, driving legalization, feel justified in distrusting.

But calculating marijuana taxes as a percentage of price creates the danger that taxes will be both too high and too low.

Taxes may be too high at first, as start-up expenses push costs up with resulting upward pressure on pre-tax prices. Those high prices will be magnified by taxes that rise with the


\(^{32}\) For an exception, see, *e.g.*, [http://www.irs.gov/uac/IRS-Announces-2010-Air-Transportation-Tax-Rates](http://www.irs.gov/uac/IRS-Announces-2010-Air-Transportation-Tax-Rates), which increases the excise tax on the domestic segment of taxable air transportation for 2010 to $3.70, up from $3.60 in 2009.

\(^{33}\) See Table 1 in *Laws To Tax*, *supra* note 2.
price level. Taxes that are too high open the market to competition from bootleggers, with the pernicious results of (1) low actual collections and (2) continuing illegality.

Later, the prohibition premium – the extra amount illegal sellers charge to compensate for risk of getting caught – will disappear. Then, as efficiency, amortization of startup costs, and economies of scale drive pre-tax prices down, price-based taxes will shrink proportionately. A percentage base may turn out to haunt drug policy uniquely. Low prices create availability of intoxicant that drug policy disfavors, at least for youth and for problem users.

Retail price

Colorado and Washington both tax retail sales by percentage of price: Colorado at 10 percent, Washington at 25 percent. States and localities that impose retail sales taxes now generally collect them on sales of legal medical marijuana.

Gross receipts, as measured by sales, are the base of a tax on medical marijuana businesses in several California jurisdictions today. It applies in addition to the regular California sales tax.

But retail price may reflect other factors other than potency. These include branding and convenience of the retail location.

A retail price, unlike weight, can get slippery. For instance, what if the stated, manipulated price is . . . zero? What's the tax then? Hotel rooms featuring free marijuana are already popping up in Colorado. Don't be surprised to see "expensive" e-marijuana vaporizers sold in a package with "free," highly potent cartridges. Tax-free? No. How much is the tax? There'll be an argument.

And a retail price base creates opportunities for evasion, because retail tax may not be collected. Shoplifting and pilferage by employees evade the tax. So does hijacking of trucks en route to a retail location.

Wholesale price

34 Those automatic tax cuts resulting from a tax based on sales price provide one unique advantage. This article dwells on the necessity of letting government authorities adjust the tax burden nimbly, so as to respond quickly to competition from bootleggers. If bootleggers cut prices, prices should fall in the legal market to compete. With a price base, a price cut by legitimate operators will result in an immediate tax cut – which will provide a lower after-tax price that will help legal operators fight their price war with bootleggers. Still, this automatic adjustment is a poor substitute for the nimbleness that drug policy needs.


37 See Table 1, in Laws To Tax, supra note 2.
A wholesale price-based tax may be more collectable than a retail price-based tax, because it is collected earlier in the supply chain. But it requires finding an arm’s-length wholesale price.

The killer problem comes when a vertically integrated, that is, garden-to-customer, business owes a wholesale price-based tax. Colorado, whose Constitution allows a wholesale tax calculated at 15 percent of price, cannot make that percentage tax work. Colorado now requires vertical integration most of the time, and permits it in every case. With vertical integration, there is no wholesale sale, so Colorado uses an “average market” price\(^{38}\) to impose a de facto weight tax of 62 cents per gram ($281 per pound) of potent flowers and 10 cents per gram ($44 per pound) of less intoxicating and less valuable trim. Regulators will restate those rates every six months to reflect ongoing market prices.

**Producer price**

Washington imposes a 25-percent producer tax in addition to its 25-percent retail and wholesale taxes, but only if producer and wholesaler are separate. Sure enough, the market seems to be evolving toward integration of producer and wholesaler, so that tax will be rarely collected.

**A Combination of Approaches**

The European Union uses a “greater of” approach: “excise duties levied on cigarettes must account for at least 57% of price, and must be at least €64 per 1000 cigarettes.”\(^ {39}\) A marijuana tax scheme could follow the EU in combining approaches.

**Square Footage or Number of Plants**

A price base doesn’t work for nonprofits that are exempt from gross receipts tax – or for home-growers who don’t sell. And jurisdictions need lead time and resources to tax by weight or potency. So for marijuana operations, California cities are trying another tax base: square footage of growing area.

Most of the square footage marijuana taxes are $25 per square foot of indoor operations with grow lights. But Rancho Cordova is more aggressive: It counts grow areas, hydroponic or natural, with an alternate base of number of plants.\(^ {40}\) On indoor operations, the highest rate is the greater of $900 per square foot or $900 per plant. On outdoor operations, the highest rate is the greater of $900 per 12.5 square feet, that is, $72 per square foot, or $900 per plant. Measuring grow areas is more intrusive and less verifiable than measuring


\(^{40}\) Rancho Cordova Ordinance, Table 1 in Laws To Tax, supra note 2.
business space.

An analogy for these more targeted square footage taxes is not chickens before they hatch, but the size of the coop. A tax on grow areas could target intoxication somewhat better by counting not just square footage, but also the number of crops produced in a year.

This fallback approach seems crude because square footage of grow area does not seem tightly correlated with intoxication. But if you can’t tax exactly what needs taxing, you can tax a proxy. The United States would like to tax the net income of offshore insurance companies selling policies here, but we can’t measure it. So Code section 4371 puts a 4-percent excise tax on gross premiums that U.S. persons pay to them.

A square footage tax applies at the very beginning of the supply chain, so it minimizes the problem of post-tax leakage. And unlike an excise tax based on weight or potency, or a property tax requiring valuation, it requires little lead time to implement.

**Other tax issues**

Beyond the tax base, a host of tax issues can puzzle policymakers.

There might be special tax cuts for small businesses, or large ones; environmentally friendly operations might be rewarded, or unfriendly ones taxed more heavily; home growing operations might be tax-exempt within limits, as in Colorado, or banned, as in Washington. Marijuana sold to medical patients might escape tax. (In Colorado, two months into legalization, 70 percent of marijuana sales escaped all excise taxes on the ground that they went to medical patients.41 That’s a lot of sick people.) Income tax deductions for advertising and marketing might be denied.42 Penalties for possession of illegally obtained marijuana might be considered.

A collection point or points must be chosen, with an eye toward keeping tax evasion and costs of administration down. Rates, too, must be chosen, with the understanding that the market is not just fluid, it is unpredictable. Government must stand ready to react to the market.

**Options Other than Monopoly and Taxation**

**Auctioning Licenses**

In 2010, Oakland, California enacted an annual fee of $211,000 for each of four “marijuana factories.”43 Other schemes raise revenue through licensing at all levels of commerce.

Requiring licenses for everyone in the supply chain conforms with evolving international standards for tobacco. Making licenses expensive or otherwise restricting them narrows the supply chain at a possible choke point. Consumer licenses have been suggested, and correspond to fees that medical marijuana patients pay.

Auctioning licenses could let government share the proceeds of legalization. But issuing licenses can vest powerful businesses with control of intoxicants. Those businesses may increase their power over the life of the license. Entrenching incumbent sellers may be too powerful. An annual license auction might be optimal. Still, after the first year, the incumbent might be willing and able to outbid others because of intangibles it developed from the first year’s license. A nonrenewable license would address that problem.

As an alternative to banning renewal of licenses, laws could tilt against renewal, and in favor of new entrants. For instance, and incumbent could have to outbid competitors by a compounding excess -- say 10 percent. So the second year, the incumbent would have to pay 110 percent of the next bid; in the third year, 121 percent, and so on. After ten years, the incumbent would have to bid some 2.5 (that’s 1.1 to the 10th power) times the next bid to prevail. That rule could spread licenses and power around (if incumbents lose) -- or finance spending, allow tax cuts, or reduce debt (if incumbents prevail).

Models Forgoing the Revenue Card

Two remaining models would lack a meaningful revenue component. (1) Ownership of the means of marijuana production and distribution could be in the hands of a collective farm or co-operative, whose members own everything. To the extent that high prices are a goal of drug policy, inefficiency and small scale might help avoid price collapse. Or (2) ownership could be in the hands of an officially recognized nonprofit organization.

Conclusion

45 State and Federal, supra note 9 at 236.
47 Gleaning, supra note 2, at 1052.
48 If such a plan has not been tried in all the history of intoxicants, we might wonder why not, and view the plan with skepticism for that reason alone.
49 To prevent real parties in interest from disguising themselves or using dummy corporations or other related parties, rules like those of I.R.C. section 318 would be necessary.
Some policymakers might seek to legalize marijuana just for the revenue it could raise. But it is wiser to make new revenue at most a secondary goal, and to consider revenue as a tool, the most powerful tool, of drug policy. However the legalization game develops, it will surprise us in ways we can’t imagine, and policymakers should treat flexibility – the ability to change – as the primary desideratum for any legalization plan. For that reason alone, government monopoly trumps taxed private commerce.