

Laws to Tax Marijuana

by Pat Oglesby

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Introduction

Ten cities in California are already using four different schemes to tax marijuana: percentage of gross receipts, square footage of business space, square footage of grow space, and number of plants — all in addition to sales tax and an array of license fees. The battle of ideas is joined, and that's the American way. So far, these tax schemes are producing revenue from only doctor-recommended “medical” marijuana, which is legal in 14 other revenue-hungry states. Meanwhile, the tax schemes we use for tobacco — weight — and alcohol — potency — have not been tried for marijuana. But they show up in proposals in many states to legalize and tax all marijuana. Those proposals, despite federal threats, keep coming.

This article looks technically at existing and proposed laws to tax marijuana:

- who might tax it;
- how to define the target;
- what the tax base should be;
- how to set rates;
- how to correct early efforts that go wrong and to win the inevitable price war against bootleggers;
- what license fees to impose;
- how to deal with home production;

- whether to give tax breaks for medical marijuana;
- how to identify and track tax-paid product;
- where in the supply chain to collect tax;
- whether state monopoly makes sense as a supplement to taxation; and
- what the effective date should be.

The article examines existing medical marijuana taxes and unenacted proposals to tax legalized recreational marijuana, including introduced bills¹ in the legislatures of California,² Massachusetts,³ and Washington state,⁴ and California's failed Proposition 19,⁵ with its mirage-like revenue non-plan to legalize marijuana first and then maybe tax it later.

The article is just about revenue laws. It uses precedent and analogy rather than new economic analysis⁶ to study legal rules. It is assuredly not

¹An extensive list of proposals appears at Richard Evans, “Cannabis Taxation & Regulation,” available at <http://cantaxreg.com/>, under “Legalization Proposals” (last visited Dec. 7, 2010). This site is probably the most comprehensive compilation of information about laws to tax marijuana.

²Marijuana Control, Regulation, and Education Act, AB 2254, 2010 Leg., Reg. Sess. (Calif. 2010), available at http://www.leginfo.ca.gov/pub/09-10/bill/asm/ab_2251-2300/ab_2254_bill_20100218_introduced.html [hereinafter “AB 2254”]. AB 2254 is quite similar to AB 390, 2009 Leg., Reg. Sess. (Calif. 2009), available at http://www.leginfo.ca.gov/pub/09-10/bill/asm/ab_0351-0400/ab_390_bill_20090223_introduced.html. Assembly member Tom Ammiano (D) sponsored both. This article focuses on AB 2254 as the sponsor's latest word.

³An Act to Regulate and Tax the Cannabis Industry, SB 1801, 186th Gen. Court, Reg. Sess. (Mass. 2009) (and its identical House companion, HB 2929, 186th Gen. Court, Reg. Sess. (Mass. 2009)), available at http://cantaxreg.com/Legislation/CRTA_Massachusetts_2009.html [hereinafter “Massachusetts Bill”] (last visited Nov. 9, 2010).

⁴An Act Relating to Marijuana, HB 2401, 61st Leg., Reg. Sess. (Wash. 2010), available at <http://apps.leg.wa.gov/documents/billdocs/2009-10/Pdf/Bills/House%20Bills/2401.pdf> [hereinafter “Washington State Bill”].

⁵The Regulate, Control and Tax Cannabis Act of 2010, available at http://www.boe.ca.gov/news/pdf/Prop_19.pdf [hereinafter “Proposition 19 Text”] (last visited Oct. 20, 2010).

⁶Economists do not agree on the level of current consumption, current street prices, the elasticity of demand, the extent of bootlegging after legalization, and more. See Robert A. Mikos, “State Taxation of Marijuana Distribution and Other Federal Crimes,” *U. Chi. Legal F.* 222 (2010), available at

(Footnote continued on next page.)

about whether legalization is a good idea.⁷ It looks at regulation and enforcement only as ways to make a revenue scheme work, so it leaves aside impaired drivers, impaired workers, underage users, and the possibility of further corporatization of America. It barely touches on the tension between enforcement schemes and civil liberties. It doesn't estimate revenue.⁸

In 1933 hearings leading up to reimposition of taxes on alcohol after Prohibition, one witness said tax advocates who "know very little about this business" were "etherizing, futurizing, generalizing, and theorizing."⁹ I'm afraid you will find that kind of thing here, dear reader. But it's a start.

http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1549828 [hereinafter "State and Federal"]. For instance, legalization might cause some people to consume less as the lure of rebellion vanishes, but the notion that legalization will reduce overall use seems far-fetched. See Jim Leitzel, *Regulating Vice* 16-17 (New York: Cambridge University Press 2008) [hereinafter "*Regulating Vice*"]. Economists won't agree on a maximizing rate or on how much revenue a given tax rate might raise.

⁷Plenty has been written about whether to legalize marijuana. For a sample of the arguments, compare Bruce Bartlett, "Taxing Sin: A Win-Win for Everyone?" *Tax Notes*, Sept. 20, 2010, p. 1289, with U.S. Drug Enforcement Administration, "Speaking out against Drug Legalization," available at <http://www.justice.gov/dea/demand/speakout/index.html> (last visited Nov. 9, 2010). The availability (or absence) of meaningful revenue is just one factor in that discussion.

⁸Revenue estimating is beyond the ability of the author. A compendium of estimates appears at Paul L. Caron, "Projected Revenues from Marijuana Tax," *TaxProf Blog* (Nov. 30, 2009), available at http://taxprof.typepad.com/taxprof_blog/2009/11/projected-revenues-.html. In addition to raising revenue directly from a targeted tax, making marijuana legal would facilitate the collection of general taxes (on income, payroll, and the like) that underground enterprises evade. Jeffrey A. Miron, "The Budgetary Implications of Marijuana Prohibition" (June 2005) at 14, available at <http://www.prohibitioncosts.org/MironReport.pdf> [hereinafter "Miron"].

The latest word in revenue analysis appears in a recent study, Beau Kilmer et al., "Altered State?: Assessing How Marijuana Legalization in California Could Influence Marijuana Consumption and Public Budgets" (Rand Corp. 2010), available at http://www.rand.org/pubs/occasional_papers/2010/RAND_OP315.pdf [hereinafter "Altered State"]. This study seems thorough; admirably, it admits to uncertainty. To be sure, it analyzes only what has been on the table in California, that is, a weight-based tax, not a tax based on potency. Formal proposals in California don't include measures to defeat post-legalization bootlegging, such as identification and tracking of tax-paid products, so the study does not consider those measures, either. The Rand study did not undertake to suggest effective tax laws, just as this article does not undertake to estimate revenue.

⁹Tax on Intoxicating Liquor, Hearings Before the Committee on Ways and Means, House of Representatives and the Committee on Finance, United States Senate, 73d Congress, Interim, 1st and 2d Sessions 124 (Dec. 11-14, 1933) [hereinafter "1933 Hearings"] (statement of J.W. Murray, former and prospective liquor wholesaler).

To Tax or Not to Tax?

"What are we mad at today?" That's how many a tax drafting session on Capitol Hill used to begin during congressional recess, when staffs had time and a mandate to look for loopholes. Excise taxes, especially, target things that the public is mad at — more precisely, things that a political authority says are bad.¹⁰

Today, enough of the public is angry about recreational use of marijuana that it is prohibited. If that anger ever decreases to the point that recreational use is legalized, the public will still be mad enough to want to tax the heck out of it. Folks who don't consume marijuana could realize in small part the dream that the late Russell Long, former chair of the U.S. Senate Finance Committee, described: "Don't tax you, don't tax me, tax that fellow behind the tree."

Like golden eggs from an unwelcome goose, any revenue vanishes if the shunned source is eliminated.

To be sure, taxing anything that people are angry about is awkward. Like golden eggs from an unwelcome goose, any revenue vanishes if the shunned source is eliminated. Despite that awkwardness, and despite the argument against regressivity, sin taxes¹¹ on tobacco and alcohol bring revenue to every state and to the Union.

¹⁰See generally Sijbren Cnossen, *Excise Systems: A Global Study of the Selective Taxation of Goods and Services* (Baltimore: Johns Hopkins University Press, 1977); *Theory and Practice of Excise Taxation: Smoking, Drinking, Gambling, Pollution, and Driving* (Sijbren Cnossen ed., Oxford University Press, 2005) [hereinafter "*Theory and Practice*"]. Paternalistic taxes seek to protect individuals (who may lack belief in current or future damage) from themselves, that is, from negative externalities. Pigouvian taxes seek to compensate society for damage the user does to others, that is, for negative externalities. (Often those two categories overlap: cigarettes harm the user and, through secondhand smoke, at least, harm innocent bystanders.)

Pigouvian taxes are compatible with the view that a tax should be "neutral in its impact on resource allocation decisions" while allowing for non-neutrality where there are negative externalities or "spillover effect[s]." Richard K. Vedder and Lowell E. Gallaway, "Some Underlying Principles of Tax Policy," *Joint Economic Committee Study* (Sept. 1998), available at <http://www.house.gov/jec/fiscal/tx-grwth/taxpol/taxpol.htm>. (The authors identify but pointedly do not endorse "[t]he economically most neutral of all taxes[,] . . . tax, a levy of, say, \$200 on every person.") A variety of objections to excise taxes appears in William F. Shugart, II, ed., *Taxing Choice: The Predatory Politics of Fiscal Discrimination* (New Brunswick: Transaction Publishers 1997).

¹¹Jewish and Christian scriptures condemn abuse of alcohol but not alcohol per se. Islam, however, opposes alcohol.

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Today we try to tax income from intangibles, which we can hardly locate, much less measure. And we tax payroll, which is the last thing that we want the power of tax to destroy or even diminish. But we can measure marijuana, many citizens are angry about it, and it involves big, big money,¹² so this article looks at taxing it.

There is much skepticism today about the feasibility of a meaningful tax on marijuana. That's not unprecedented. "Prohibitionists had always argued that the liquor business was inherently unregulatable,"¹³ but they were proved wrong. It may still be that marijuana is uncontrollable and untaxable, that vis-à-vis human ingenuity, the weed is to tobacco as the zebra is to the horse.¹⁴

But there is reason to think American society will be as unsympathetic to evaders of marijuana tax as they are to moonshiners. All along, "making drinkers pay higher taxes for their liquor and punishing tax evaders were state powers most citizens recognized; denying drinkers the right to buy their liquor was state imposition of one group's morality upon another group."¹⁵ During Prohibi-

tion, the alcohol bootlegger had the powerful, macho image of a wealthy, feared, uncontrollable kingpin (like the Mexican cartel operators today). Now he's a toothless, clueless hillbilly, sneaking around the backwoods by the light of the moon.

Though we are divided in our views about marijuana prohibition, we come together in our lack of patience with tax cheaters. America's rebellious yearning for freedom is about self-determination, not about price.

Which Governments?

The article looks first at who might impose tax, and only later at what might be taxed, on what base, how much, how, and when.

The Question of Scale

Consensus ordinarily comes easier in a small group than in a large group.¹⁶ Opinions in a state tend to converge more than opinions in the nation.¹⁷ Similarly, as local option laws for alcohol show, opinions in localities converge more than those in a given state.

Moreover, the fewer the people in a jurisdiction, the less will be the upheaval when experiments with an evolving tax scheme produce unintended consequences. Any new tax scheme is an experiment, like it or not. Although schemes for taxation of beverage alcohol are stable today (including rates that seem to require raising or indexing), it took much trial and many errors to get here.¹⁸ And a process of trial and error can provide lessons for other jurisdictions.¹⁹

But smaller may not be better. The administration of a tax involves economies of scale. That is, the cost of creating new procedures and new forms from

Aisha Stacey, "Alcohol in Islam," *The Religion of Islam* (February 16, 2009), available at <http://www.islamreligion.com/articles/2229/> (last visited Nov. 13, 2010). Tobacco was not present where those religions' scriptures were written (and no believable source finds marijuana in them). Still, the term "sin" lives on, in expanded form. See generally Greg Mankiw, "Sin Taxes," Greg Mankiw's Blog (Apr. 11, 2006), available at <http://gregmankiw.blogspot.com/2006/04/sin-taxes.html> (last visited Nov. 13, 2010).

To the extent that a small daily amount of alcohol promotes health, a tax exemption, or even a subsidy, for the use of that amount might be ideal (but unadministrable). See Dale Gieringer, "Economics of Cannabis Legalization," *National Organization for the Reform of Marijuana Laws*, at 7 (June 1994), available at http://www.prohibitioncosts.org/NORML_Economics_Cannabis_Legalization.pdf (last visited Sept. 7, 2010) [hereinafter "Economics of Legalization"]. Tailoring a tax scheme for each individual would be theoretically even better, but even less imaginable. *Regulating Vice*, supra note 6, at 144.

¹²Dan Glaister, "All-time High for Homegrown as Pot Becomes Top Cash Crop in US," *The Guardian* (Dec. 19, 2006), available at <http://www.guardian.co.uk/world/2006/dec/19/usa.danlaister>. But no conceivable marijuana tax could satisfy revenue needs to the extent that alcohol taxes did in the 1930s.

¹³Harry G. Levine and Craig Reinerman, "From Prohibition to Regulation: Lessons from Alcohol Policy for Drug Policy" (Mar. 10, 1991) available at http://www.drugtext.org/index.php?option=com_content&view=article&id=603:from-prohibition-to-regulation&catid=192:policy&Itemid=44&q=reinerman&lang=en [hereinafter "Lessons"].

¹⁴See Jared Diamond, *Guns, Germs, and Steel* 157-175 (New York: W.W. Norton & Co., Ltd. 1999).

¹⁵Wilbur R. Miller, *Revenuers and Moonshiners* 8 (Chapel Hill: UNC Press 1991). In addition to ordinary citizens, in the late 1800s, for example, "Taxpaying distillers became important allies in the [revenue] bureau's crusade against evasion." *Id.* at 6.

¹⁶See, e.g., A. Paul Hare, "A Study of Interaction and Consensus in Different Sized Groups," *17 American Sociological Review* 261 (1952), available at <http://www.jstor.org/pss/2088071>.

¹⁷See, e.g., Robert S. Erickson et al., "State Political Culture and Public Opinion," *81 American Political Science Review* 797 (1987), available at <http://www.jstor.org/pss/1962677>.

¹⁸See generally Tun Yuan Hu, *The Liquor Tax in the United States, 1791-1947: A History of the Internal Revenue Taxes Imposed on Distilled Spirits by the Federal Government* (New York: Columbia University, Graduate School of Business 1950) [hereinafter "Hu"].

¹⁹Opportunities to experiment are a valuable feature of our federal system. For instance, within living memory, vehicles could not legally turn right at red lights in this country. But the states started experiments, the federal government followed in 1975, and experimentation continues. So "North America is [or was reportedly in 2002, at least] the only place in the world where the RTOR is allowed." Dominique Lord, "Synthesis on the Safety of Right Turn on Red in the United States and Canada" (November 2002), at 11 and 15, available at https://ceprofs.civil.tamu.edu/dlord/Papers/TRB_3410_Lord_RTOR_Nov_2002.pdf.

scratch can be spread among many people in a populous jurisdiction. Only populous jurisdictions can afford sophisticated approaches, like testing for potency and high-tech identification of tax-paid merchandise, that require high fixed costs.

A Federal Tax

A federal marijuana tax won't be coming soon.²⁰ Crypto-anarchists and well-meaning but naïve citizens oppose anything called a tax, even a useful tax. We would have to pull out of a multi-lateral drug treaty²¹ or override it,²² as we often do with tax treaties.²³ And the revenue a marijuana tax raised would be a less than a rounding error in a debt reported in tenths of trillions of dollars.

²⁰Any federal marijuana tax will come with less dispatch than the tax on newly legalized alcohol came after Prohibition was repealed on December 5, 1933. Then, the U.S. House Committee on Ways and Means reported a bill on January 3, 1934, that went through the House and Senate in time for President Roosevelt to sign on January 11, just eight days later. Hu, *supra* note 18, at 81. In that case, Congress had the benefit of studying the results of historic tax rates on alcohol in the United States and both historic and contemporary rates in other countries. See 1933 Hearings, *supra* note 9.

²¹International Narcotics Control Board, *Single Convention on Narcotic Drugs, 1961*, available at http://www.incb.org/incb/convention_1961.html (last visited Dec. 3, 2010) [hereinafter "Narcotic Convention"]. Article 4 allows only medical or scientific use of marijuana and other drugs.

²²Treaties are not a higher form of law than statutes in the United States (unlike in some countries). "Laws of the United States . . . and all Treaties . . . shall be the supreme Law of the Land." U.S. Const. art. VI, cl. 2. So "an Act of Congress . . . is on a full parity with a treaty, and . . . when a statute which is subsequent in time is inconsistent with a treaty, the statute to the extent of conflict renders the treaty null." *Reid v. Covert*, 354 U.S. 1, 18 (1956).

²³To the consternation of some. See N.Y. State Bar Ass'n Tax Section, "Comments on the Proposed Denial of Treaty Benefits for Certain Related-Party Deductible Payments" (May 22, 2010), available at <http://www.nysba.org/AM/Template.cfm?Section=Home&CONTENTID=38538&TEMPLATE=/CM/ContentDisplay.cfm>. But typically the overridden (and fossilized) tax treaty provision allowed treaty shopping (third country beneficiaries) or some not bargained for, unanticipated loophole. Drug prohibition, by contrast, was at the heart of the 1961 deal.

Overriding treaties, in the tax area at least, stirs up declarations of concern that America's treaty partners will act or even be offended. Those declarations, added to ordinary legislative inertia, make loopholes discovered in outworn tax treaties hard to close and a gold mine for the crafty. The proper method to close loopholes, according to the Tax Section, is bargaining with partners. But partners will tend to want a quid pro quo. If the U.S.-Venezuela income tax treaty, for instance, develops loopholes, fixing them gratuitously will not be at the top of President Hugo Chavez's agenda. Renegotiation of the multilateral Narcotic Convention seems even less feasible than trying to fix a bilateral tax treaty. Whether each and every element of that 1961 treaty still makes sense now is open for debate, though. Other countries might even welcome our leadership in enacting a limited, targeted override.

But that pesky debt keeps piling up, so the country may get desperate. Maybe we'll have a Constitutional Convention. Or maybe a financial collapse will lead to strong-arm rule. In either event, everything will be on the table.

State Taxes and Federalism

Any state tax on marijuana would probably need the approval, stated or tacit, of the federal government.²⁴ States and localities collecting taxes "cannot necessarily block federal authorities from seizing the information they glean from drug distributors."²⁵ But the city of Oakland, Calif., has been singling out medical marijuana by collecting a modest gross receipts tax on it since January 1, 2010,²⁶ without reports of any federal interference. So far.

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Oakland's tax collection is benefiting from the benign neglect the Obama administration has taken toward medical marijuana.²⁷ Recently, the administration took a hard line against Proposition 19 in

²⁴But "the federal government lacks the resources needed to enforce its own ban vigorously . . . [it] is only a two-bit player when it comes to marijuana enforcement." Robert A. Mikos, "On the Limits of Supremacy: Medical Marijuana and the States' Overlooked Power to Legalize Federal Crime," 62 *Vand. L. Rev.* 1421 (2009) (hereinafter "Overlooked Power"), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1356093 (p. 104).

²⁵State and Federal, *supra* note 6, at 225.

²⁶"Oakland Marijuana Tax, Measure F, July 2009," *Ballotpedia*, available at http://www.ballotpedia.org/wiki/index.php/Oakland_Marijuana_Tax_Measure_F_July_2009 (last visited Nov. 13, 2010). Oakland voters recently raised the rate from 1.8 percent to 5 percent of gross receipts. See Table 1, *infra*.

²⁷Attorney General Eric Holder has said, "it will not be a priority to use federal resources to prosecute patients with serious illnesses or their caregivers who are complying with state laws on medical marijuana." Carrie Johnson, "U.S. Eases Stance on Medical Marijuana," *The Washington Post* (Oct. 20, 2009), available at <http://www.washingtonpost.com/wpdyn/content/article/2009/10/19/AR2009101903638.html>.

This benign neglect is a manifestation of standard prosecutorial discretion. If it extended to recreational marijuana, under the Narcotic Convention, *supra* note 21, foreign countries could complain about the inaction. Then they would have to try to settle the dispute "by negotiation, investigation, mediation, conciliation, arbitration, recourse to regional bodies, judicial process or other peaceful means of [both countries'] own choice." *Id.* Article 48. After all that, complainants could go to the International Court of Justice, perhaps for some international equivalent of a writ of mandamus. That is far-fetched. The federal government is doing little to enforce drug laws internally now, anyway. See *Overlooked Power*, *supra* note 24.

California.²⁸ Maybe that hard line would yield to a sensible scheme that was well thought through in advance rather than punted, Proposition 19-style, to localities, free to race to the bottom. Indeed, “drug hawks would probably prefer that California impose some sanction on marijuana [that is, a tax] than no sanction at all.”²⁹

By analogy, the federal government tolerates state schemes that get revenue from the suspect activity of gambling. But the public is probably angrier about marijuana than about gambling.³⁰ At the same time, a lot of citizens are mad at Washington and want Washington to leave them alone.³¹ Fiscal conservatives, social liberals, and libertarians may not be a majority of the country, but they have enough influence not to be sneezed at. And the federal government may choose to tread cautiously on revenue sources in states it may need to bail out.

Revenue for Localities

States could allow autonomy or provide revenue to localities in various ways.

Local Option for Legalization

Many states let localities decide whether to make something legal. In North Carolina, for example, “dry” counties and towns allow no alcohol sales, while other localities allow sales of beer and wine only; for liquor, some allow only package sales for off-premises consumption, while others allow both those and liquor by the drink.³²

A state could let localities opt into or out of a scheme to legalize marijuana. Legalizers³³ of marijuana might not prevail in a state without deferring to people in areas that oppose legalization. A state could also allow localities a menu of options, such as on-premises smoking, incorporation of the substance into edibles, and so on.

Even without taxes, a locality could benefit from the economic activity of legal retail marijuana sales.

By analogy, an advocate of liquor by the drink makes this argument: “It allows good quality restaurants to come in and offer good paying jobs to stimulate the local economy.”³⁴

The theory behind medical marijuana is hard to reconcile with local option, at least for possession. It’s hard for a state to say sick people in only some of its localities can use medicine. But allowing medical marijuana in areas where folks object to it may be part of the reason *Time* magazine asked, “Can a backlash be far behind?”³⁵

AB 2254, the most recent serious California bill, would apply statewide. California Proposition 19, though, would have delegated to local governments the power to authorize commerce in marijuana.³⁶

Local Taxes in Lieu of State Taxes

If Proposition 19 had passed, localities would have been free to impose — or not — their own taxes on marijuana. The state could then have decided to tax marijuana in co-existence with local schemes — or not to tax it.³⁷ (The measure’s vagueness drew opposition from all sides.³⁸) By choosing to impose no or low taxes, localities might have sought economic activity from their own residents, from nearby residents, or from tourists. That’s a race to the bottom. But there was evidence of a race to the middle, at least in Albany, Calif.: Proponents of a successful ballot measure there argued that a “proposed new tax would be comparable with nearby

³⁴“Stokesdale Liquor by the Drink Referendum (2009),” *Ballotpedia*, available at http://ballotpedia.org/wiki/index.php/Stokesdale_Liquor_By_the_Drink_Referendum_%282009%29 (last visited Oct. 19, 2010).

³⁵Andrew Ferguson, “How Marijuana Got Mainstreamed,” *Time* 30, 32 (Nov. 11, 2010), [hereinafter “Mainstreamed”].

³⁶Proposition 19 Text, *supra* note 5, section 2.B.7. But “if a city decides not to tax and regulate the sale of cannabis, . . . buying and selling cannabis within that city’s limits remain illegal, but . . . the city’s citizens still have the right to possess and consume small amounts [up to one ounce].”

³⁷The state’s authority to tax is expressed subtly in the text of the legislative proposal: *See, e.g., id.*, proposed section 11302(b) of Article 5 of Chapter 5 of Division 10 of the Health and Safety Code: “Any licensed premises shall be responsible for paying all federal, state and local taxes.” Proponents of the Proposition made the authority clear in their official message to voters: “Proposition 19 enables *state* and local governments to tax marijuana” (emphasis added). California Secretary of State’s Voter Guide to Proposition 19, available at <http://www.voterguide.sos.ca.gov/pdf/english/19-arg-rebuttals.pdf> (last visited Dec. 2, 2010).

³⁸Prohibitionists alleged: “Proponents of Prop 19 tried to mislead voters into voting for a title and summary, . . . Prop 19 provided no means of collecting revenue.” No on Prop 19, “Californians Reject Flawed Marijuana Measure” (Nov 3, 2010), available at <http://www.noonproposition19.com/>. But at a site in favor of marijuana use, among reasons to oppose the initiative was “Excessive Taxes.” Stop 19, “Why Cannabis Users Should Vote No,” available at <http://stop19.com/expertanalysis/> (last visited Nov. 8, 2010).

²⁸Evan Perez, “U.S. Casts Vote Against Pot,” *The Wall Street Journal* A4 (Oct. 16-17, 2010).

²⁹State and Federal, *supra* note 6, at 249.

³⁰Another analogy cuts the other way: Utah gained admission into the Union only after agreeing to ban polygamy. The whole wasn’t going to tolerate blatant divergence from a popular norm by one of its parts. *See* Utah History to Go, “Statehood and the Progressive Era,” available at <http://historytogo.utah.gov/lessons/statehoodandtheprogressiveera.html> (last visited Nov. 1, 2010). But people were really, really angry about polygamy.

³¹Owing to a variety of factors, citizens on average deem state and local governments far more trustworthy than the national government.” Overlooked Power, *supra* note 24, at 152.

³²*See* North Carolina Alcoholic Beverage Control Commission, “Legal Sales Areas,” available at <http://www.ncabc.com/xo/> (click on “View by category”) (last visited Nov. 5, 2010).

³³This article calls advocates of legalization “Legalizers,” and advocates of current law “Prohibitionists.”

cities that are enacting similar ballot measures for a cannabis dispensary or business.”³⁹

Voters in Albany and nine other localities in California faced initiatives on November 2, 2010, to impose local taxes: some on recreational marijuana in light of the possible passage of Proposition 19, and some on the medical kind. They all passed. Table 1 describes them.⁴⁰

³⁹League of Women Voters of California Education Fund, “Measure Q: Business License Tax for Cannabis Business,” City of Albany, available at <http://www.smartvoter.org/2010/11/02/ca/alm/meas/Q/> (last visited Nov. 28, 2010) [hereinafter “Albany Ordinance”].

⁴⁰Parallel sources could supply the information on Table 1. The sources cited were chosen because they furnish enough detail. This footnote lists first the source for the details of the proposal; then, after a semicolon, for voting results:

Albany: Albany Ordinance, *supra* note 39 (this site expands on the cursory official ballot language); Alameda County Registrar of Voters, “General Election, November 2, 2010,” available at http://www.acgov.org/rov/current_election/index.htm (Click on Local, Albany, Measure Q) (last visited Nov. 11, 2010) [hereinafter “Alameda Results”].

Berkeley: City of Berkeley, “Ordinance No. #,### -N.S., Amending Chapter 9.04 Of The Berkeley Municipal Code To Increase The Tax Rate On Cannabis Businesses” section 3, available at <http://www.ci.berkeley.ca.us/uploadedFiles/Clerk/Elections/Cannabis%20Tax%20Text%207-16-10%20FINAL.pdf> (last visited Oct. 17, 2010) [hereinafter “Berkeley Ordinance”]; Alameda Results, *supra* (Click on Local, Berkeley, Measure S).

La Puente: “Local Cannabis Taxation Ordinances,” *Yes on 19*, available at <http://yeson19.com/node/198> (last visited Nov. 10, 2010) [hereinafter “Yes on 19”]; “La Puente Marijuana Business License Tax, Measure M” (November 2010), *Ballotpedia*, available at http://ballotpedia.org/wiki/index.php/La_Puente_Marijuana_Business_License_Tax,_Measure_M_%28November_2010%29 (last visited Nov. 12, 2010).

Long Beach: City of Long Beach, “Resolution Number 10-0079” (Aug. 6, 2010), available at <http://www.longbeach.gov/civica/filebank/blobload.asp?BlobID=28274>; “Long Beach Tax on Recreational Marijuana, Measure B (November 2010);” *Ballotpedia* [hereinafter “Long Beach Resolution”], available at http://www.ballotpedia.org/wiki/index.php/Long_Beach_Tax_on_Recreational_Marijuana,_Measure_B_%28November_2010%29 (last visited Nov. 12, 2010).

Oakland: Alameda County Registrar of Voters, “City of Oakland Measure V; General Election, November 2, 2010,” available at http://www.acgov.org/rov/documents/local_measures_2010-11-02.pdf (last visited Nov. 11, 2010); Alameda Results, *supra* (Click on Local, Oakland, Measure V).

Rancho Cordova H: Sacramento County, “City of Rancho Cordova Measure H,” available at http://www.elections.saccounty.net/coswcm/groups/public/@wcm/@pub/@vre/documents/webcontent/sac_025023.pdf; League of Women Voters of California Education Fund, “Measure H: Cannabis Business Tax, City of Rancho Cordova” (Results as of Nov. 12, 2010, 1:57 a.m.), available at <http://www.smartvoter.org/2010/11/02/ca/sac/meas/H/>.

Rancho Cordova O: Sacramento County, “Ordinance No. 19-2010, An Ordinance Of The City Of Rancho Cordova Adding Chapter 3.85 To The Rancho Cordova Municipal Code

Local Taxes Piggybacking on State Taxes

The tiering of federal, state, and local governments allows lower-tier governments to piggyback on an established higher-tier revenue scheme. Today, localities often impose excise taxes on top of state excises. For example, New York City imposes a local tax of \$1.50 per cigarette pack in addition to the state’s \$4.35.⁴¹ Several localities in Alaska impose local cigarette taxes of \$1 or more per pack in addition to the state’s tax of \$2 per pack.⁴² Those local excises, like piggybacked local sales taxes, involve little administrative complication. A marijuana scheme could follow that pattern.

Targeted Revenue Sharing

A state could transfer a portion of statewide excise receipts to the localities that choose to legalize the substance and produce the revenue, as, for instance, North Carolina does with alcohol. About 70 percent of North Carolina’s quarter billion dollars of annual alcohol revenue goes to the state’s general

With Respect To A Personal Cannabis Cultivation Tax,” available at http://www.elections.saccounty.net/coswcm/groups/public/@wcm/@pub/@vre/documents/webcontent/sac_025029.pdf (last visited Nov. 12, 2010) [hereinafter “Rancho Cordova Ordinance”]; League of Women Voters of California Education Fund, “Measure O: Tax on Personal Cannabis Cultivation, City of Rancho Cordova” (results as of Nov. 12, 2010, 10:57 a.m.), available at <http://www.smartvoter.org/2010/11/02/ca/sac/meas/O/>.

Richmond: “City of Richmond Marijuana Tax, Measure V (November 2010),” *Ballotpedia*, available at http://ballotpedia.org/wiki/index.php/City_of_Richmond_Marijuana_Tax,_Measure_V_%28November_2010%29 (both description and results) (last visited Nov. 12, 2010).

Sacramento: League of Women Voters of California Education Fund, “Measure C: Marijuana Business Tax, City of Sacramento,” available at <http://www.smartvoter.org/2010/11/02/ca/sac/meas/C/> (description and results as of Nov. 12, 2010, 1:57 a.m.).

City of San Jose, “Measure U - November 2, 2010 Election: City Attorney’s Impartial Analysis,” available at <http://www.sanjoseca.gov/clerk/elections/2010Election/novembermeasures/caoameasureu.pdf> (last visited Dec. 2, 2010); League of Women Voters of California Education Fund, “Measure U: Marijuana Business Tax, City of San Jose” (results as of Nov. 10, 2010, 4:38 p.m.), available at <http://www.smartvoter.org/2010/11/02/ca/sj/meas/U/>.

Stockton: City of Stockton, “November 2, 2010 Election” Measure I, available at <http://www.stocktongov.com/election/ballot.cfm> (last visited Dec. 2, 2010); League of Women Voters of California Education Fund, “Business Tax on Permitted Marijuana Sales, City of Stockton” (results as of Nov. 12, 2010, 10:57 a.m.), available at <http://www.smartvoter.org/2010/11/02/ca/sj/meas/I/>.

⁴¹Ann Boonn, “Top Combined State-Local Cigarette Tax Rates” (June 23, 2010), available at <http://www.tobaccofreekids.org/research/factsheets/pdf/0267.pdf> [hereinafter “Cigarette Taxes”]. This site lists local tobacco taxes imposed in addition to state (and federal) taxes.

⁴²*Id.*

(Footnote continued in next column.)

**Table 1.
Local Ordinances Adopted or Amended November 2, 2010, in California**

City	Medical marijuana gross receipts tax	Recreational gross receipts tax (if Prop. 19 passed) on for-profits	Square footage taxpayer	Square footage base	Square footage tax rate	Adopted	Voters in favor
Albany	2.5% on for-profits	2.5%				Yes	84.2%
			Nonprofits	All indoor space	\$25/ft ²		
Berkeley	2.5% on for-profits	10%				Yes	82.4%
			Nonprofit medical marijuana operations	All indoor space up to 3,000 ft ²	\$25/ft ²		
			Nonprofit medical marijuana operations	All indoor space 3,000 ft ² and over	\$10/ft ²		
La Puente	10%	10%				Yes	68%
Long Beach		15%				Yes	73.1%
			All for-profits	All indoor space	\$25/ft ² indexed		
			All nonprofits	All indoor space	\$10/ft ² indexed		
Oakland	5%, up from current 1.8%	10%				Yes	70.8%
Rancho Cordova H	On for-profits: 12% on first million, 15% thereafter	12% on first million, 15% thereafter				Yes	68.5%
			Nonprofit entities	All indoor space	\$100/ft ²		
Rancho Cordova O			Individuals	Indoor cultivated areas up to 25 ft ²	\$600/ft ²	Yes	56.4%
			Individuals	Indoor cultivated areas 25 ft ² and over	\$900/ft ²		
			Individuals	Outdoor cultivated areas up to 25 ft ²	\$48/ft ²		
			Individuals	Outdoor cultivated areas 25 ft ² and over	\$72/ft ²		
Richmond	5%	5%				Yes	78.2%
Sacramento	4%	10%				Yes	71.8%
San Jose	Council can tax up to 10%	Council can tax up to 10%				Yes	77.7%
Stockton	2.5%	10%				Yes	66.7%

fund, but nearly 20 percent goes back to those localities that choose to allow alcohol sales.⁴³ None of that revenue goes directly to localities that ban alcohol.

What Substances?

To impose tax, a jurisdiction needs a subject (or target), a measuring base, and a rate. This article now focuses on the target of the tax.

A Light and Compact, but Pungent, Weed

Defining taxable marijuana in words⁴⁴ is easy. Pinning it down in the world is not.

In thinking about an intoxicant, schemes to tax alcohol are useful. In thinking about a plant that people smoke or consume by mouth, schemes to tax tobacco are useful. Neither provides a perfect model for the battle against marijuana bootlegging.

Some factors make marijuana easier or more lucrative to hide or otherwise more of a challenge to tax than alcohol. First, marijuana is lighter and more compact by value than alcohol. Weight and bulk far outweigh the relative difficulty of transporting a liquid rather than a solid.

Second, during the processing phase, illegal distillation of spirits (which requires observable heat), fermentation of wine, and brewing of beer require hiding the time-consuming transformation of other liquids into alcohol. Marijuana processing is simpler.

Third, consumers understand that store-bought liquor is not poisonous but that moonshine liquor can kill them on the spot; bootlegged marijuana may contain more mold and pesticides than the regulated

kind, but it shouldn't bring on instant death. That makes bootlegged marijuana more marketable than bootlegged liquor.

Some factors make marijuana easier to find and tax than alcohol. First, some marijuana is very pungent.⁴⁵ Second, corn, grapes, and other raw materials for alcoholic beverages are legal as they grow in the field, so any illegal activity is detectable only after the agricultural harvest. Contraband marijuana needs to be hidden while it grows, and aerial surveillance is a threat.

Compared with tobacco, marijuana is hard to tax. Its light weight and low bulk make it easier to hide.

Compared with tobacco, marijuana is hard to tax,⁴⁶ though is more pungent and it needs to be hidden while it grows. First, marijuana's light weight and low bulk make it easier to hide. Second, tobacco is notoriously hard to grow.⁴⁷ Marijuana grows easily: Primitive strains, at least, have the nickname weed. That factor makes marijuana harder to control and tax. Third, the process of converting sticky fresh tobacco into consumable form is observable, requiring either air-drying, which takes a long time, or artificial heating, which is tricky. Post-harvest processing of agricultural marijuana is simpler, so there is less time and there are fewer clues to find contraband during that phase.

On balance, it's not hard to conclude that marijuana will be easier to bootleg and therefore harder to tax than both alcohol and tobacco.⁴⁸

Hemp

Federal law bars the cultivation of the hemp plant, legal in many developed countries, which

⁴³N.C. Alcohol Beverage Control Comm'n, "Revenue Distribution Chart," available at <http://www.ncabc.com/pricing/revenuechart.aspx> (last visited Sept. 17, 2010) (describing fiscal 2009 distributions).

⁴⁴The U.S. Code says:

The term "marihuana" means all parts of the plant *Cannabis sativa* L., whether growing or not; the seeds thereof; the resin extracted from any part of such plant; and every compound, manufacture, salt, derivative, mixture, or preparation of such plant, its seeds or resin. Such term does not include the mature stalks of such plant, fiber produced from such stalks, oil or cake made from the seeds of such plant, any other compound, manufacture, salt, derivative, mixture, or preparation of such mature stalks (except the resin extracted therefrom), fiber, oil, or cake, or the sterilized seed of such plant which is incapable of germination. 21 U.S.C. 802 (16).

Legalization proposals track that language, but change the h in "marihuana" to a j. See, e.g., section 3 of A.B. 2254, *supra* note 2. For the purposes of this article, as in Proposition 19's proposed section 11304(d)(1) of Article 5 of Chapter 5 of Division 10 of the Health and Safety Code, *supra* note 5, "Marijuana" and "Cannabis" are interchangeable terms.

⁴⁵See Maureen O'Connor, "Do Not Pet a Drug-Sniffing Dog When You Are Carrying Marijuana at an Airport," *Gawker*, available at <http://gawker.com/5655244/do-not-pet-a-drug-sniffing-dog-when-you-are-carrying-marijuana-at-an-airport> (last visited Oct. 14, 2010); Mendocino County (California) Code section 9.31.020 (Supplement 27, July 2010), available at <http://www.co.mendocino.ca.us/bos/pdf/cerent/Mendocino%20County%20code/Mendocino%20County%20Code%20Supplement-27.pdf>. ("Marijuana plants, whether grown indoors or outdoors, especially as they mature prior to harvest, may produce a distinctive odor that may be detectable far beyond property boundaries.")

⁴⁶But that's not saying much: Illicit production of tobacco to beat tax in the developed world is negligible. It happens in uncontrolled areas of the Third World, though. See text accompanying note 118, *infra*. But tax-arbitrage smuggling of low-tax paid tobacco across borders is a big problem. *Id.*

⁴⁷See State and Federal, *supra* note 6, at 236 note 58.

⁴⁸For the relative difficulty of taxing marijuana on the basis of potency, see text accompanying note 71, *infra*.

provides fiber and other products. Current proposals in the states to tax psychoactive marijuana seek to exempt hemp. California AB 2254 aims to exempt it in this way: “marijuana containing less than one-half of 1 percent tetrahydrocannabinol⁴⁹ by weight is not subject to . . . [the \$50 per ounce tax],”⁵⁰ but it would not exempt hemp dealers from licensing fees. Meanwhile, the Massachusetts bill would set the threshold at 1 percent THC.⁵¹

A more defensible threshold might be the one that Canada and the European Union use to ban marijuana and legalize hemp: less than 0.3 percent THC.⁵² In addition to a percentage threshold, Canadian regulations provide that “A person who holds a license to cultivate industrial hemp only for fibre shall harvest the crop before the achenes of 50 percent of the plants are resistant to compression.”⁵³ Presumably that head-scratcher for the layperson means the grower must harvest the plant before it matures into psychoactivity. In any event, Canada has figured out how to make the distinction, so states should be able to do so, also, if they decide to, bearing in mind the risk that bootleggers will hide marijuana plants in a hemp field as long as they can.

Harder Drugs

This article ignores harder drugs. Balancing the benefits of banning a substance against the fiscal and other benefits of regulating and taxing it is a case-by-case analysis. This article does not make that analysis even for marijuana, much less for substances such as heroin and cocaine,⁵⁴ whose perceived negative externalities exceed those of

marijuana. Beyond the perceived differences in externalities, the bulk, weight, and pungency of marijuana exceed those of many other banned substances, so it is easier to detect, regulate, and tax. Even for absolutists who want to legalize everything, it would be instructive to see how various plans for regulating and taxing marijuana might play out.

What Base?

After defining a subject for the tax, determining a tax base is necessary. It could be weight, potency, percentage of sale price, some combination of those factors, or the number of plants. A square footage or property tax on production or business areas is another option.

Weight

Weight is an obvious option for the base of a tax on marijuana. “Twenty-one states have laws on the books that tax the sale of marijuana (and other illicit drugs)”⁵⁵ on the basis of weight, though these dead-letter gotcha taxes are really fines. Weight is used to tax cigarette tobacco⁵⁶ regardless of tar and nicotine. Weight is the base used in AB 2254, the most recent serious California bill, at a rate of \$50 per ounce. Once moisture content is accounted for, a weight-based tax is easy to impose and to analyze. A weight-based tax, though, would tend to drive less potent, cheaper intoxicants out of the market.⁵⁷

Potency

Potency is a rough proxy for the tax base of the whole federal alcohol scheme. The federal tax on liquor is directly proportional to alcohol content.⁵⁸ The tax on wine jumps from \$1.07 per gallon for alcohol content of 14 percent or less to \$1.57 per

⁴⁹Delta-9 tetrahydrocannabinol or THC is the main psychoactive ingredient of marijuana. Other psychoactive cannabinoids exist. See E.M. Williamson and F.J. Evans, “Cannabinoids in Clinical Practice” (Dec. 2000), available at <http://www.cannabis-marijuana.com/cannabinoids/clinical.html> (last visited Nov. 15, 2010). All pending proposals treat them as too negligible to consider.

⁵⁰AB 2254, *supra* note 2, proposed section 34004 of Division 2 of the Revenue and Taxation Code.

⁵¹Massachusetts Bill, *supra* note 3, section 4.d.

⁵²Ray Hansen, “Industrial Hemp Profile” (Nov. 2009), available at http://www.agmrc.org/commodities_products_fiber/industrial_hemp_profile.cfm.

⁵³[Canadian] Department of Justice, “Industrial Hemp Regulations (SOR/98-156)” section 15(1), available at <http://laws.justice.gc.ca/eng/SOR-98-156/page-3.html> (last visited Dec. 2, 2010). Meanwhile, the University of Minnesota reports more scientific progress in differentiation. See “New DNA ‘Fingerprinting’ Technique Separates Hemp from Marijuana,” *UM News* (Mar. 22, 2006), available at http://www1.umn.edu/news/news-releases/2006/UR_RELEASE_MIG_2820.html.

⁵⁴See generally John J. Donohue III, et al., “Rethinking America’s Illegal Drug Policy,” preliminary draft (Oct. 2, 2009) (cited with permission of John J. Donohue III), available at http://mfi.uchicago.edu/publications/papers/donohue_drugpolicy.pdf (describing how the analysis for cocaine might differ from that for marijuana).

⁵⁵State and Federal, *supra* note 6, at 258. Those so-called taxes are supplements to enforcement schemes. Some have been found unconstitutional as self-incriminatory.

⁵⁶Weight-based taxes generally apply to large and small cigarettes, large and small cigars, pipe tobacco, smokeless tobacco (snuff and chewing tobacco), and roll-your-own tobacco. IRC section 5701. To be precise, “On cigarettes, weighing not more than 3 pounds per thousand, [the tax rate is] \$19.50 per thousand.” *Id.* at section 5701(b)(1). The tax (with a higher rate for heavier cigarettes) is thus technically per unit with a cap on unit weight. Taxes on cigarette papers and tubes are imposed by count. *Id.* at section 5710(c) and (d).

⁵⁷Adam Gifford Jr., “The Unintended Consequences of Regulating Addictive Substances,” *Cato Journal* 306-07 (Vol. 19, No. 2, Fall 1999), available at <http://www.cato.org/pubs/journal/cj19n2/cj19n2-7.pdf>.

⁵⁸Alcohol 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/atftaxes.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.

gallon for potency of 14 percent and over.⁵⁹ It jumps again, to \$3.15, for potency of 21 percent and over.⁶⁰ Only the tax on beer, \$18 per barrel of 31 gallons, does not turn on potency.⁶¹

The federal scheme extends the potency concept to tax alcohol in hard liquor at a higher rate per ounce than in its less powerful competition,⁶² but generally does not tax alcohol in wine more heavily than in less potent beer. “The federal excise tax rates . . . are approximately 10 cents, 7 cents, and 21 cents per ounce of pure alcohol for beer, wine, and distilled spirits, respectively.”⁶³ Maybe these rates reflect the clout of interest groups. Maybe, though, they reflect perceptions of tendency to overindulge with each kind of beverage.⁶⁴

For marijuana, “Ideally, the tax rate per ounce should be proportional to THC potency.”⁶⁵ Whatever the theoretical merits of taxing on the basis of potency, it involves a new function — testing — whose integrity has to be monitored.⁶⁶ And lines

⁵⁹*Id.*

⁶⁰*Id.*

⁶¹*Id.*

⁶²Alcohol taxes that came back to life after Prohibition ended were “designed to discourage the consumption of distilled spirits as contrasted with light wines and beer.” “Report to the Secretary of the Treasury of Recommendations of Informal Interdepartmental Committee Relative to Taxation and Control of Alcoholic Beverages,” *supra* note 9, at 331 [hereinafter “Interdepartmental Recommendations”].

⁶³Center for Science in the Public Interest, “The Case for Alcohol Excise Tax Increases” 2 (2007), available at <http://www.cspinet.org/booze/taxguide/AlcoholTaxIncreases.pdf> (last visited Oct. 9, 2010). All states tax liquor more heavily than other alcoholic beverages, and most of them tax wine more heavily than beer. See Tax Foundation, “State Sales, Gasoline, Cigarette, and Alcohol Tax Rates by State, 2010” (Apr. 1, 2010), available at <http://www.taxfoundation.org/taxdata/show/245.html>.

⁶⁴Cheap fortified wines may be associated with low-income heavy drinkers rather than moderate drinkers.

⁶⁵See Economics of Legalization, *supra* note 11, at 8.

⁶⁶The California State Board of Equalization staff was investigating a potency base before the defeat of Proposition 19: “Staff has discussed the possibility of using potency as a component of an excise tax scheme. Right now it is an option to consider . . . when and if marijuana is legalized, and the legislature moves to impose an excise tax.

“With properly crafted legislation and sufficient resources staff believes it is doable.

“Staff agrees there are issues around testing and certification . . . to be addressed to support a potency based tax. The question that goes with that is compliance. Legalization itself will move distribution from an underground economy to a regulated industry. Will the industry buy into that level of regulation? No one knows.” E-mail from BOE spokeswoman Anita Gore to the author (Oct. 12, 2010, 8:24:16 p.m.), quoted in “Potency as a Base for a Tax on Marijuana — BOE,” available at <http://newrevenue.org/2010/12/08/potency-as-a-base-for-a-tax-on-marijuana-boe/> [hereinafter “BOE Potency”].

have to be drawn. Alcoholic beverages, being liquid, are more fungible and thus easier to test than a solid vegetable product.

Whether THC potency makes sense as a tax base depends in part on the cost of the testing, split into fixed and variable elements. One would need to decide how many samples need testing, and that decision turns on adequacy of homogenization.⁶⁷

Some information on cost is available. At a Colorado lab, “Prices currently range from \$60-\$75 per test, with steep discounts for volume.”⁶⁸ Another source says, “The whole process [involving gas chromatography, flame ionization, and mass spectrometry tests] costs \$100 per sample.”⁶⁹

Another business provides more detail. Steep Hill Lab in Oakland tests potency by using a two-gram sample to represent up to two pounds of medical cannabis. The lab selects material from some 5 to 15 sites in the bulk material.⁷⁰ The lab’s published price to test flowers and concentrates is \$120.⁷¹

Even if the cost of testing is acceptable, it’s unlikely that a visual selection process would be rigorous enough for a government to use for tax purposes. That is, the subjectivity involved in choosing material to test from 5, 15, or some other number of sites may make potency too unreliable to be the tax base. Pushing a blender to liquefy could yield a product adequately homogenized, but so powdery that consumers might prefer what the bootlegger is selling.

A proxy for homogenization has been used in nontax testing of cigarettes for tar and nicotine.⁷² Independent buyers visit stores in 50 unannounced locations and buy packages of cigarettes. The buyers mail them in for testing to a lab, whose results, brand by brand, are the average of the results of the

⁶⁷Tobacco buyers in the days of the chanting auctioneer of the Lucky Strike ads would bid in seconds, hardly breaking stride as they walked by a pile, by lifting leaves up to see what they were buying. The fungibility of tobacco in a particular pile was enough for an immediate evaluation.

⁶⁸Rob Reuteman, “New Lab Firms Cater To Medical Marijuana Business,” CNBC (Dec. 7, 2010), available at <http://www.cnbc.com/id/40491295/>.

⁶⁹David Downs, “Is Cutting-Edge Marijuana Lab the Future of Legitimate Pot?” *East Bay Express* (Mar. 5, 2009) available at http://www.alternet.org/drugs/130163/is_cutting-edge_marijuana_lab_the_future_of_legitimate_pot?page=en_tire (last visited Oct. 12, 2010).

⁷⁰E-mail from Wilson Linker, Steep Hill Lab, to the author (Dec. 5, 2010, 9:43 p.m.), excerpt available at <http://newrevenue.org/2010/12/06/potency-testing-mechanics/>.

⁷¹Steep Hill Cannabis Analysis Laboratory, “Potency Analysis,” available at <http://steephilllab.com/services/potency-analysis/> (last visited Dec. 6, 2010).

⁷²Harold C. Pillsbury Jr., “Review of the Federal Trade Commission Method for Determining Cigarette Tar and Nicotine Yield,” National Cancer Institute, available at http://cancercontrol.cancer.gov/tcrb/monographs/7/m7_2.pdf (last visited Oct. 13, 2010).

purchased packs. But that testing is the work of a private industry group, whose work the Federal Trade Commission merely oversees as part of its duty to prevent deceptive claims in advertising. That system does not seem rigorous enough to impose tax, and does not seem suited for the proliferation of brands that might accompany legalization.

Potency testing might happen even without a potency-based tax. Regulations might require that packages of marijuana disclose THC content as a kind of warning or as ordinary consumer information. If so, the cost of testing could be attributable to the regulatory system. Even absent any tax or regulatory requirement, sellers might publicize content so consumers could comparison-shop; if so, consumer protection agencies might monitor sellers' claims. Either of these independent reasons to test would weaken the argument that a potency-based system is too expensive. But nontax testing may not be rigorous enough, especially on homogenization and sampling, for a tax scheme.

The Massachusetts bill, alone among current proposals, uses potency as a base.⁷³ In a potency scheme, consumers will tend to favor tax-paid products displaying official government numbers over iffy competition from bootleggers, whom they can hardly sue for misrepresentation or worse.

Retail Price

An excise tax could be imposed on retail sales, in addition to any standard sales tax. (The sales tax base could include or exclude excise taxes; most include them.) Or marijuana could be exempt from sales tax, but taxed at retail at a percentage greater than that imposed on standard items. That kind of higher, separately stated tax applies to services such as lodging and car rentals in many localities. Several California jurisdictions have also adopted gross receipts, as measured by sales, as the base of a tax on medical marijuana businesses.⁷⁴ It applies in addition to the regular California sales tax.⁷⁵

⁷³The text accompanying note 126, *infra*, describes the proposal to use potency.

⁷⁴See Table 1, *supra*.

⁷⁵States with sales taxes apply them to sales of marijuana. See State Board of Equalization, "Special Notice: Information on Sales Tax and Registration for Medical Marijuana Sellers" (June 2007), available at <http://www.boe.ca.gov/news/pdf/173.pdf>. Some argue that the BOE's position applies to a null set, with the following reasoning: (1) California's medical marijuana law does not allow sales of marijuana to patients. (2) Transfers are instead distributions from a cooperative. In a simple example, if two people finance, plant, tend, and harvest from a garden, the division of its fruits between them is not a sale. So (3) no sales tax is due. Operations paying sales taxes encounter this argument: "Almost all the dispensaries in California are illegal," said William Panzer, an Oakland lawyer who helped draft Proposition 215. "They're

(Footnote continued in next column.)

To the extent that retail price reflects potency, a tax based on retail price is a proxy for one based on potency. But retail price may reflect other factors, such as branding and convenience of the retail location. Taxing fancy products more highly than basic products tends to reduce regressivity. But to the extent that "the harm caused by a unit . . . is unrelated to its price,"⁷⁶ a tax based on retail price misses taxing what citizens are angry about. That is, if products of identical potency sell for different pretax prices, a tax based on price looks like a luxury tax or a revenue raiser, while a tax based on weight looks like a measure to discourage consumption.⁷⁷

A tax based on price looks like a luxury tax or a revenue raiser, while a tax based on weight looks like a measure to discourage consumption.

A retail price base creates opportunities for evasion because it allows much untaxed marijuana into the community before a retail sale takes place. That is, it creates uncertainty about whether tax will be paid.⁷⁸

A Combination of Approaches

The European Union uses a "greater of" approach: "excise duties levied on cigarettes must

sole proprietorships, not collectives." Jesse McKinley, "Don't Call It 'Pot' in This Circle; It's a Profession," *The New York Times* (Apr. 23, 2010), available at <http://www.nytimes.com/2010/04/24/us/24pot.html>. One non-lawyer, meanwhile, takes this view: "The organization should get a state seller[]s permit [and] pay sales tax on the net value of the member investment after costs, even though it is not a sale." Richard Johnson, "Richard's Legal Guide For Growers" (June 11, 2010), available at <http://www.mendocinocountry.com/independent/1cannabis/richardsguidetogrowers.html> (last visited Nov. 26, 2010). Despite its internal inconsistency and blow to the bottom line, that view avoids a fight and could gain an official ally.

⁷⁶See Gerald Prante, "What Is Proper Tax Policy for Smokeless Tobacco Products?" *Tax Foundation Fiscal Fact No. 120* (Mar. 26, 2008), available at <http://www.taxfoundation.org/research/show/1858.html>.

⁷⁷Recently, though, the American Lung Association has opposed efforts of some producers of smokeless tobacco to shift its federal tax base from wholesale price to weight. American Lung Association, "Factsheet: Taxation of Smokeless Tobacco: Percentage of Price vs. Net Weight," available at <http://www.tobaccofreekids.org/research/factsheets/pdf/0175.pdf> (last visited Oct. 12, 2010). That opposition arises because the weight-based tax is not indexed, so it will decrease in real terms over time. For a more thorough comparison of ad valorem taxes (such as sales taxes) and specific taxes (such as those based on weight), see Sijbren Cnossen and Michael Smart, "Taxation of Tobacco," in *Theory and Practice*, *supra* note 10, at 38-41.

⁷⁸See text accompanying note 234, *infra*.

account for at least 57 percent of price, and must be at least €64 per 1000 cigarettes.⁷⁹ The federal tax on large cigars uses a “lesser of” approach: it is 52.75 percent of the sales price but not more than \$402.60 per 1,000 units.⁸⁰

A marijuana tax scheme could follow the European Union in combining approaches. It is possible to use all three of the factors weight, potency, and percentage of sale price. But to the extent that potency and price are correlated, weight and one other factor would be plenty.

Square Footage or Number of Plants

Voters in several California cities adopted initiatives in November 2010 that would use the square footage of certain property as the base for some taxpaying entities. The entities using this base are primarily nonprofits that are exempt from gross receipts tax, which is the standard tax for other entities.

This fallback approach seems crude because square footage does not seem tightly correlated with the intoxication that the public is angry about. 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.

An analogy for these square footage taxes is not chickens before they hatch, but the size of the coop. In conformity with preexisting local models, the taxes typically count not only all interior space such as hallways but also “garages, carports, [and] porches.”⁸¹

Most of the taxes apply to all business space, owned or rented; most rates are \$25 per square foot or less. Including office space, for example, creates an incentive to source back office and other work elsewhere (at home, at a coffee shop, to a third-party provider of services, and so on).

Rancho Cordova imposes a more targeted tax that counts just grow areas, hydroponic or natural, with an alternate base of number of plants. On indoor operations,⁸² the highest rates is the greater of \$900 per square foot or \$900 per plant. On outdoor operations the rate is \$900 per 12.5 square feet, that is \$72 per square foot, or \$900 per plant. But external measurements are less intrusive than measurements of grow areas. 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.

California localities use square footage taxes in large part because they are limited by an old voter initiative, Proposition 13, to 1 percent in ad valorem property taxes. A square footage tax avoids valuation disputes, but that makes it cruder. The 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.

Indexing

Indexing happens automatically when the tax base is a percentage of price, because as prices go up, taxes do, too. An unindexed tax based on weight or potency, though, freezes the nominal tax burden in dollar terms and reduces the inflation-adjusted tax burden. But none of the pending statewide proposals provides indexing for inflation. Indexing is common in the income tax; it is rare (too rare) in excise taxes.⁸³ The flat square footage taxes on marijuana businesses in the city of Long Beach, Calif., are indexed.⁸⁴ Good idea.

What Rate?

With a subject and tax base identified, the discussion moves to setting rates. Economics provides no clear answers, so history and analogy may help. The discussion that follows mostly uses weight as the tax base, but the same kind of analysis would apply to potency, price, or any other base.

When the taxes on alcohol were reimposed after the repeal of Prohibition, the legislation was “inevitably a work of hopeful ignorance. No one had a solid foundation to analyze what the tax should be, or what revenues might be reasonably expected.”⁸⁵

Similarly, today, with marijuana, uncertainty prevails about elasticity of demand, street price, responses of bootleggers, and much more. Proposition

⁷⁹“Tobacco Taxation: Commission Proposes Increasing Excise Duties,” *Europa* (July 16, 2008), available at <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/08/114>. Sales of cigarettes in the European Union also incur VATs.

⁸⁰IRC section 5701(a)(2).

⁸¹Long Beach Resolution, *supra* note 40.

⁸²See Table 1, *supra*.

⁸³But see “IRS Announces 2010 Air Transportation Tax Rates,” IR-2009-120 (Dec. 23, 2009), available at <http://www.irs.gov/irs/article/0,,id=217533,00.html>, which increases the excise tax on the domestic segment of taxable air transportation for 2010 to \$3.70, up from \$3.60 in 2009. Indexing of dollar amounts in a tax scheme is of paramount importance these days. See Kenneth J. Kies in *Forty Years of Change, One Constant: Tax Analysts*, Dec. 27, 2010, p. 15 [hereinafter “Forty Years”]; see also James Wetzler in *id.* p. 24, available at <http://taxanalysts.com/www/website.nsf/Web/40thAnniversary>.

⁸⁴See Table 1, *supra*.

⁸⁵Thomas Pinney, *A History of Wine in America: From Prohibition to the Present, Volume 2* (Berkeley: University of California Press, 2005) [hereinafter “Pinney”] at 41.

19, criticized here for punting to localities, at least acknowledged the difficulty of setting a rate by setting no rate at all.

Starting With Street Price

One criterion in arriving at a tax rate for marijuana is that of maintaining its street price at least at the current level.⁸⁶ Legalizers are not asking for a price cut.⁸⁷ People who are angry about marijuana don't want one, either.

Data on street prices is available. A federal site lists prices between \$75 and \$400 per ounce in one-ounce quantities.⁸⁸ The Rand Corp. estimates a street price in California for sinsemilla-grade marijuana of \$250-\$400 per ounce.⁸⁹ Other sites purport to list street prices, as well.⁹⁰ The reliability of data

is in question to the extent that incentives for law enforcers lead them to overstate the value of their seizures.⁹¹ In states where medical marijuana is legal, the picture is further clouded, because leakage to non-medical users should create more supply and drive prices down.

A tax rate that maintains the current street price would let a state attempt to soak up the prohibition premium, the above-normal return from commerce in marijuana that arises from the risk of getting caught. But a Rand study suggests that tax rates maintaining the current price would be so high as to be counterproductive.⁹² That is, bootleggers would triumphantly undercut the tax-paid price, and consumers would largely prefer the cheaper, riskier product.

Balancing Revenue and Compliance

Matching street price may be a weak proxy for the two principal goals⁹³ of policymakers setting a tax rate for marijuana. One goal is to set a rate high enough to maximize net revenue.⁹⁴ The other is keeping the rate low enough to make compliance high and bootlegging rare.⁹⁵ President Roosevelt's group designing reimposition of taxes on alcohol in 1933 put it this way:

Recommendations have been designed to eliminate the organized illegal liquor industry. . . . [R]ates of excise tax were calculated to yield maximum revenue without necessitating a price to the ultimate consumer of legal basic alcoholic beverages . . . high enough to enable the illegal product to compete.⁹⁶

Deciding whether bootlegging is rare enough is a matter of opinion, except in extreme cases, such as when a tax is so high that few choose to pay it, or so low as to produce negligible revenue.⁹⁷ A jurisdiction

⁸⁶One analysis indicated that the pretax retail price of legalized cannabis could be as low as \$2 per ounce in 1994 dollars. See *Economics of Legalization*, *supra* note 11. Street prices then were in the \$100 to \$600 range. The analysis suggested a tax rate of about \$500 to \$1,000 per ounce of THC content, or some 50 cents to a dollar per joint, in 1994 dollars. That rate was said to make the market pay what it would bear, and would have produced a post-tax price of roughly \$75 to \$150 per ounce.

Prices of medical marijuana reportedly remain high despite elimination of the prohibition premium at the retail level. Prices per ounce in Los Angeles reportedly ranged from \$200 to \$720 when sold in eighth-ounce quantities. Tamara Audi, "L.A. Reins in Its Pot Shops," *The Wall St. J.* (May 11, 2010), available at <http://online.wsj.com/article/SB10001424052748704879704575236533613537808.html?KEYWORDS=tamara+audi>.

⁸⁷Singer John Prine put it this way: "You may see me tonight with an illegal smile./It don't cost very much, and it lasts a long while." "Illegal Smile," from the album *John Prine* (1971). Some legalizers seek taxation as part of a deal involving legalization. "We want to pay our fair share," said one. Marcus Wohlsen, "Pro-Marijuana Ad Pushes Pot as Budget Fix," available at <http://abcnews.go.com/Business/story?id=8033734&page=1> (last visited Oct. 31, 2010). Legalizers could find that taxation leads to "political influence, legal security, and social legitimacy." Kimberly D. Krawiec, "A Woman's Worth," 88 *N. C. L. Rev.* 1739, 1744 (2010), available at <http://ssrn.com/abstract=1548929>. But given a tradition of distrust of government, not all will agree. The coalition of "bootleggers and Baptists" who supported Prohibition has its current counterparts.

⁸⁸Arthur Fries *et al.*, *Technical Report for the Price and Purity of Illicit Drugs: 1981-2007* Table 0.5, Institute for Defense Analyses Paper P-4370 (2008), available at http://www.whitehousedrugpolicy.gov/publications/price_purity_tech_rpt/price_purity_tech_rpt07.pdf.

⁸⁹Altered State, *supra* note 8, at 17, quoting an earlier figure of \$300 to \$450. That type "would likely predominate in the legalization scenarios [the authors] believe most likely." The slightly lower \$250-\$400 range comes from an e-mail from Beau Kilmer, Co-Director, RAND Drug Policy Research Center, to the author (Dec. 1, 2010, 6:30:25 p.m.) (on file with author).

⁹⁰See, e.g., "Marijuana Prices, Marijuana Statistics and Weed Prices," DopeStats, available at <http://www.dopestats.com/dopestats/template.jsp?drug=230> (last visited Oct. 13, 2010).

⁹¹See Scott Morgan, "Philadelphia Police Say Marijuana Costs \$100 Per Joint," *High Times* (Jan. 15, 2008), available at http://hightimes.com/news/ht_admin/3896.

⁹²Altered State, *supra* note 8, at 47-48.

⁹³This leaves aside the goal of discouraging consumption.

⁹⁴AB 2254's approach of seeking only enough revenue for drug treatment does not seek to maximize revenue.

⁹⁵For an argument that bootlegging will persist so strongly after legalization as to require a low tax rate, see Rosalie Liccardo Pacula, "Legalizing Marijuana: Issues to Consider Before Reforming California State Law" (Oct. 28, 2009), available at http://www.rand.org/pubs/testimonies/2009/RAND_CT334.pdf.

⁹⁶Interdepartmental Recommendations, *supra* note 62.

⁹⁷Bootlegging of alcohol in North Carolina, for instance, does not seem prevalent enough to create an argument for cutting the tax on alcohol: "Statewide, ALE [Alcohol Law Enforcement] agents find only a half dozen or so working stills a year." Michael Biesecker, "Agents Bust a Nash County Still," *News & Observer* (Raleigh, N.C.) (Nov. 11, 2009), available at http://www.newsobserver.com/news/crime_safe_tly/story/185464.html.

may choose to sacrifice revenue, even in the long term, to keep bootlegging at a subjectively acceptable level.

The tax rate is a critical element of a potential bootlegger's analysis in deciding whether to compete illegally against a tax-paid product.

If marijuana is legal and taxed, current bootleggers and new businesses may choose to operate legally, illegally, or not at all. The tax rate is a critical element of a potential bootlegger's analysis in deciding whether to compete illegally against a tax-paid product. The framers of post-Prohibition alcohol taxes were so nervous about a price war against bootleggers that they urged the legal alcohol industry voluntarily to "forgo excessive profits."⁹⁸ The potential bootlegger of any substance would consider factors beyond price, like the likelihood and consequences of getting caught,⁹⁹ consumer preference for legal products, and the burden of compliance.¹⁰⁰ In a game-like or circular way, taxwriters would consider the bootlegger's analysis in setting rates.¹⁰¹

Lessons From Alcohol

Taxwriters in years gone by looked at excise tax rates as a percentage of cost of manufacture, which did not include distribution and selling costs. When a \$2-per-gallon tax amounted to eight to 12 times the "average cost of manufacture" of whiskey in the Civil War, bootlegging ran rampant.¹⁰² A reduction in that tax by 75 percent in 1868 to two or three times the cost of manufacture, "practically stopped illicit distillation" and more than doubled revenue from the tax.¹⁰³ Two times the cost of manufacture was a rough standard used in the reimposition of tax

after passage of the 21st Amendment, too. Whiskey then thought to cost \$1 or a little more per proof gallon to produce¹⁰⁴ bore a federal tax of \$2,¹⁰⁵ with the understanding that state taxes would add to the final price to the consumer.

Analyzing alcohol taxes as a percentage of retail price would help, but good data are hard to come by. The liquor lobby estimates federal and state taxes at 39 percent of the retail price of spirits nationally,¹⁰⁶ but Rand says federal and state excises amount to just 11 percent of the price in California.¹⁰⁷ An alcohol watchdog group says excise taxes make up 11 percent of the retail price for beer.¹⁰⁸ Those rates seem low compared with those in other countries. "Across [22] countries in [a] sample, the unweighted mean tax burden ["as a percentage of retail price"] on beer was 35 percent[;] . . . for wine . . . 30 percent[;] . . . and for spirits 61 percent."¹⁰⁹

¹⁰⁴That was the statement of Lovell H. Parker, chief of staff of the Joint Committee on Internal Revenue Taxation, about the price of good quality, 100 proof whiskey. 1933 Hearings, *supra* note 9, at 11. Various witnesses had different estimates of the average cost of production; \$1.20 was the figure supplied by Harry Lourie of the Tariff Commission. *Id.* at 83.

¹⁰⁵Thomas B. Ripy, "Federal Excise Taxes on Alcoholic Beverages: A Summary of Present Law and a Brief History" Congressional Research Service Report RL30238 14 Appendix B (June 15, 1999), available at <http://stuff.mit.edu/afs/sipb/contrib/wkileaks-crs/wikileaks-crs-reports/RL30238.pdf> [hereinafter "Ripy"].

¹⁰⁶Federal taxes were said to take up 18 percent of a consumer's price; state and local taxes take up 21 percent, but that presumably includes sales taxes; and "indirect" taxes, including "personal income, corporate income, payroll and property taxes," take up 20 percent. Distilled Spirits Council of the United States, "Excessive Tax Burden, Distilled Spirits, 2005, United States," available at <http://www.discus.org/pdf/2005bottle.pdf#xml=http://search.americaneagle.com/discus/index.asp?cmd=pdfhits&DocId=997&Index=f%3a\dtSearch\discus&HitCount=1&hits=b+&hc=23&req=property> (last visited Nov. 10, 2010). Those indirect taxes are of the kind borne by businesses and consumers generally, and they are not part of the standard analysis.

¹⁰⁷Smuggling, *supra* note 101, Table 1, at 4.

¹⁰⁸Three percent goes to state and 8 percent to federal excise taxes. "Increasing Alcohol Taxes — Myth v. Reality," *Marin Institute* (September 2009), available at http://www.marininstitute.org/site/images/stories/pdfs/taxes_myth_vs_reality.pdf (last visited Nov. 10, 2010). A different assumption about retail price yields an estimate for California of 7 percent. Smuggling, *supra* note 101, Table 1 at 4.

¹⁰⁹James Fogarty, "The Demand for Beer, Wine and Spirits: Insights from a Meta Analysis Approach" (American Association of Wine Economists Working Paper No. 31) 10 (Nov. 2008), available at http://www.wine-economics.org/workingpapers/AWE_WP31.pdf. "The countries in the sample were: Austria, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, UK, and US." Many of those countries' totals include VATs.

⁹⁸Report to the Secretary of the Treasury of Findings of Fact and Law of the Informal Interdepartmental Committee Relative to Taxation and Control of Alcoholic Beverages," Supplement to Hearings, *supra* note 9, 304, 308 [hereinafter "Interdepartmental Findings"].

⁹⁹See State and Federal, *supra* note 6, at 232.

¹⁰⁰See BOE Potency, *supra* note 66.

¹⁰¹"One would expect the extent of tax evasion to be affected to some degree by mechanics of the tax's design, collection, and enforcement, as well as its size. Hence, it would seem prudent for jurisdictions contemplating imposing marijuana taxes of this magnitude to invest substantial energy in crafting wisely the particulars of those mechanics." Jonathan P. Caulkins *et al.*, "Smuggling and Excise Tax Evasion for Legalized Marijuana" 7 (2010), available at http://www.rand.org/pubs/working_papers/2010/RAND_WR766.pdf [hereinafter "Smuggling"].

¹⁰²Hu, *supra* note 18, at 42.

¹⁰³*Id.* States in that era imposed license fees rather than gallonage taxes.

Lessons From Tobacco

Tobacco taxes often make up a significant part of what consumers pay for the product.¹¹⁰ In California, state cigarette excise taxes are 87 cents and federal taxes are \$1.01 per pack (a proxy for weight). One study, excluding sales tax, estimates that excises alone there amount to 47 percent of the after-tax price and 89 percent of the pretax price.¹¹¹ That tax burden does not include the some \$246 billion that tobacco companies pay states over a 27-year period under the Master Tobacco Settlement Agreement.¹¹²

California's tobacco tax is lenient by some standards. Other states have much higher taxes,¹¹³ and Europe taxes cigarettes ferociously. Total European taxes, including value added taxes, reportedly make up at least 70 percent (in Lithuania) and as much as 88.7 percent (in Belgium) of the after-tax retail price.¹¹⁴ In other words, in Lithuania, the tax is 233 percent of pretax retail price; in Belgium, it's 885 percent.¹¹⁵ So in Belgium, growers, distributors, and retailers get less than 12 cents of every euro spent on cigarettes; more than 88 cents go to taxes.

Most domestic evasion of tobacco taxes involves products purchased legally in one jurisdiction and resold in another.¹¹⁶ That is, smugglers sell packages that look and feel official because they comply

¹¹⁰World Health Organization, "WHO Technical Manual on Tobacco Tax Administration" (2010), http://whqlib.doc.who.int/publications/2010/9789241563994_eng.pdf (a useful compendium of information about foreign tobacco taxes).

¹¹¹Smuggling, *supra* note 101, Table 1 at 4. Meanwhile, "the average price for a pack of cigarettes nationwide is roughly \$5.51 (including statewide sales taxes but not local cigarette or sales taxes, other than NYC's \$1.50 per pack cigarette tax)" as of 2010. Eric Lindblom, "State Cigarette Excise Tax Rates & Rankings" (Aug. 3, 2010), *available at* <http://www.tobaccofreekids.org/research/factsheets/pdf/0097.pdf>.

¹¹²See Illinois Department of Public Health, "Master Settlement Agreement," <http://www.idph.state.il.us/TobaccoWebSite/msa.htm> (last visited Nov. 1, 2010).

¹¹³Cigarette Taxes, *supra* note 41.

¹¹⁴European Commission, Directorate General, Taxation And Customs Union, Indirect Taxation and Tax Administration, Environment and Other Indirect Taxes, "Excise Duty Tables: Part III — Manufactured Tobacco (Ref 1031 rev. 1)" 7 (July 2010), *available at* http://ec.europa.eu/taxation_customs/resources/documents/taxation/excise_duties/tobacco_products/rates/excise_duties-part_iii_tobacco_en.pdf.

¹¹⁵1/0.113 = 8.8496.

¹¹⁶Matthew C. Farrelly *et al.*, "State Cigarette Excise Taxes: Implications for Revenue and Tax Evasion" 2 (May 2003), *available at* http://www.rti.org/pubs/8742_excise_tax_es_fr_5-03.pdf. And here is an example, from afar:

Paraguay, a low-tax country, manufactures more cigarettes per year than its population could hope to smoke in a lifetime. The majority of its exports are reportedly sold illegally in Brazil. Of course, part of this could be attributed to corruption — Paraguay ranks near the

(Footnote continued in next column.)

with the packaging rules in the low-tax jurisdiction where they were originally sold. So, rate-setting must involve consideration of taxes in other jurisdictions.¹¹⁷

In addition to cross-border smuggling, weak governments may face clandestine local operators. "In Pakistan's tribal areas," some of them Al Qaeda-infested, "the problem of illicit sales stems largely from small-scale manufacturers . . . that are not paying taxes on the cigarettes they sell, or at least are not paying the full level of taxes due."¹¹⁸

An Initial Rate for Marijuana

Illegal production of marijuana varies by state, though it may reach nowhere the level of alcohol bootlegging at the time of the repeal of Prohibition, when "the illegal industry [was] entrenched, organized, and efficient."¹¹⁹

AB 2254 would tax sales of marijuana at \$50 an ounce. But that bill aims only to fund drug education and rehab programs, so a board would reduce the rate to match the needs of those programs. As a percentage of the current street price of contraband, that \$50 per ounce is in the low double digits.¹²⁰

If legalization drives pretax prices down, though, \$50 per ounce takes up a bigger portion of total price to the consumer. A Rand study estimates that 58.6 percent of the final price would go to pay taxes.¹²¹ Taxes would amount to 207 percent of the producer's costs — that's in the range of the percentage found sustainable for liquor by 1868,¹²² and near the percentage Congress imposed on liquor in 1934.¹²³

But marijuana is harder to tax than liquor, so the 58.6 percent of final price the Rand study foresees

bottom on Transparency International's notorious Corruption Perceptions Index, and some politicians have indeed been implicated in the illegal cigarette trade. But the root of the problem clearly lies elsewhere: Without Brazil's 80 percent cigarette tax rate, there would be little incentive to break the law.

Taco Tuinstra, "An Inconvenient Truth," *Tobacco Reporter Magazine* (April 2008), *available at* http://www.tobaccoreporter.com/home.php?id=119&cid=4&article_id=10847.

¹¹⁷Patrick Fleenor, "High Cigarette Taxes Stoke Bootlegging, Violence" (Apr. 6, 2010), *available at* <http://www.taxfoundation.org/news/show/26132.html>.

¹¹⁸George Gay, "Taxing Game," *Tobacco Reporter Magazine* (Aug. 2005), *available at* http://www.tobaccoreporter.com/home.php?id=119&cid=4&article_id=889.

¹¹⁹Interdepartmental Findings, *supra* note 98, at 307.

¹²⁰See text accompanying note 89, *supra*.

¹²¹That figure includes sales taxes. Altered State, *supra* note 8, at 20-21. A typical producer would receive only some 28.3 percent (including profit) of the final price that the consumer pays. Retailers and distributors make the total add up to 100 percent.

¹²²See text accompanying note 103, *supra*.

¹²³See text accompanying note 105, *supra*. That 1934 percentage was in the range of 167 percent (\$2.00/\$1.20) or 200 percent (\$2/\$1).

may be too high.¹²⁴ An oft-cited study suggests an upper limit of 50 percent of final price, and uses a more modest 25 percent of final price as a basis for analysis.¹²⁵

To complete the discussion of rates by turning to a potency base, the Massachusetts bill¹²⁶ sets the following:

- \$250 per ounce of marijuana if THC content is 10 percent or more;
- \$200 per ounce if THC content is as much as 5 percent but less than 10 percent; and
- \$150 per ounce if THC content is more than 1 percent and less than 5 percent.

A board could adjust those rates up or down, to maximize revenue and to prevent bootlegging. In an apparent bow to street price, the Massachusetts bill's sliding scale reverses the pattern of the federal tax on beverage alcohol, which taxes hard liquor more per ounce of pure alcohol, for example, than it taxes beer: The Massachusetts bill tends to reduce the tax per unit of intoxicant as the potency goes up.

Adjusting the Marijuana Tax Rate

Any new tax scheme is likely to need fine-tuning, or even wholesale rewriting. Decades ago, the story goes, congressional staff discovered a loophole that one industry was using and drafted a proposal to close it. Estimators assigned a billion-dollar revenue gain to the proposal; Congress adopted it; the industry got around it. Then staff would come up with a new plan to close the loophole and raise that same billion dollars, and the cycle would repeat.

Maybe that story is apocryphal, but starting to tax a product whose market has sought the shadows is likely to produce lots of new and fresh ideas and some especially spectacular blunders. In the price war with bootleggers that would inevitably follow legalization, taxwriters will probably start by setting a rate that is too high and encourages bootlegging, or too low, leaving revenue on the table.

Even if taxwriters set the best possible rate, bootleggers will react to and take advantage of it if it is static. Bootleggers will know the market better than taxwriters, at least at first, and they tend to be more entrepreneurial, more flexible, and less risk-

averse than government. A tax mechanism providing nimble tweaking from the outset will facilitate trial and shorten the pain of error.

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As legal competition weakens bootlegging, jurisdictions should be able to raise rates over time.¹²⁷ Although the Rand study "Altered State?"¹²⁸ views the rate of tax evasion as an unknown, it does not focus on the possibility that the rate of evasion would be dynamic rather than static. But taxing authorities could drive the rate of evasion down over time by fighting and winning a price war against bootleggers.

That's what happened with the reimposition of federal taxes on beverage alcohol in 1934, after repeal of Prohibition in 1933. When policymakers discussed "post-repeal liquor taxation, . . . [i]t was generally agreed that the immediate objective should be directed to the elimination of the bootlegger."¹²⁹ Maximizing revenue could wait. "For framers of the new tax measure . . . , the central task was to arrive at a tax rate low enough to enable the legal industry to undersell the illegal industry and yet high enough to give a satisfactory return to the government."¹³⁰

President Roosevelt's team put it this way:

The illegal industry must make a substantially higher gross and net profit on its sales than the legal industry. If it does not, it will not be profitable to run the risks involved. . . . As between legal and illegal products of substantially similar price the buying public will have greater confidence in and will prefer to buy the legal product.

It seems reasonable to suppose that a more drastic price competition by the legal industry will be necessary in the early post-prohibition

¹²⁴A Rand study argues that the proposed rate is too high: As compared with other familiar excise taxes, a \$50 per ounce excise tax on marijuana is either very high or truly unprecedented depending on the metric employed. . . . California should not rule out the possibility that tax evasion would wipe out essentially all of the potential revenues from a \$50 per ounce excise tax. Smuggling, *supra* note 101, at 7.

¹²⁵Miron, *supra* note 8, at 14-15. A recent refinement suggests taxes of 33 percent of the final price. Jeffrey A. Miron and Katherine Waldo, "The Budgetary Impacts of Ending Drug Prohibition," *Cato Institute* 9-10 (2010), available at <http://www.cato.org/pubs/wtpapers/DrugProhibitionWP.pdf>.

¹²⁶*Supra* note 3.

¹²⁷One idea in 1933 to deal with the foreseeable and gradual elimination of the bootlegger was to codify a tax rate that rose over time. 1933 Hearings, *supra* note 9 (statement of Harry L. Lourie of the Tariff Commission staff, suggesting a tax of \$1.10 per proof gallon in the first year and \$2.20 in the second year). But a deferred higher rate would have incentivized the bootlegger to hold inventory to compete against higher tax-paid prices. *Id.* at 33 (statement of Joseph H. Choate, Jr., of the Federal Alcohol Control Administration).

¹²⁸*Supra* note 8.

¹²⁹Hu, *supra* note 18, at 73.

¹³⁰*Id.* at 75.

period while the illegal industry is still organized and well financed. It would probably require a considerably higher price to revive a defeated illegal industry than it would to keep a well entrenched one in business. This price could be facilitated by keeping the tax burden on legal alcoholic beverages comparatively low in the earlier post prohibition period in order to permit the legal industry to offer more severe competition to its illegal competitor. When that competitor has been driven from business the tax burden could be gradually increased. Investigators . . . estimate that it will require three years of such competition to break the organization of the illegal industry.¹³¹

As the reimposers of alcohol taxes hoped, bootlegging faded fast: “The syndicated type of illicit operation was virtually destroyed by the end of 1937, and since that time the control of production and distribution of illegal distilled spirits became largely a problem of coping with relatively small violators.”¹³²

Quickly, legitimate business moved in to take the bootlegger’s place.

Once it ceased to be outlawed, the alcohol industry was no longer dominated by unregulated, illicit entrepreneurs. . . . The leaders of the major alcohol industries are members of the economic establishment with an investment in maintaining order and obedience to law. . . . Now [in 1991], over a half-century since prohibition, it is easy to forget that all this was the outcome of self-conscious public policy and not the “natural” result of market forces or national zeitgeist.¹³³

The tax increases that the framers of the 1934 tax envisioned were indeed gradual at first. Congress increased the 1934 rate on liquor, \$2 per proof gallon, to \$2.25 per proof gallon in 1936 and to \$3 in 1940. Then World War II changed everything. In 1942 the rate rose to \$6; in 1944, to \$9.¹³⁴ That increase was 450 percent (414 percent in real terms) within 12 years.¹³⁵

An even earlier example shows the need for flexibility when first taxing a drug. James I of

England took years to make needed adjustments (with 12 pence (d.) per shilling (s.):

James I’s abhorrence of tobacco is well known, and it is not surprising to find that he should select tobacco to bear a very heavy duty. In 1602 he charged a special impost of 6s. 6d. [78d.] per pound on all imported tobacco. Prior to this date it had been charged at 2d. per pound as “other merchandise not specially mentioned”. The effect of this high duty was a vast increase in smuggling. . . . In 1620 the duty was reduced to 1s. [12d.] per pound, and it was decreed that all tobacco should bear a government stamp.¹³⁶

James’s failed rate was 39 times higher than the original rate, and 6.5 times higher than the ultimate rate. The tax then was a customs duty, not an excise tax, but the lesson applies: The first try can be really wrong.

The Massachusetts bill would create a board that could adjust statutory rates up or down.¹³⁷ California AB 2254 allows for only reductions of the statutory rate — and only annually.¹³⁸ A one-way ratchet seems less than ideal. Allowing only one tweak per year, meanwhile, makes for predictability, but not for nimbleness.

An individual can react more nimbly than a board, so an official could be charged to regulate commerce in and to collect revenue from legalized marijuana. Elected insurance commissioners in some states are responsible for protecting the public and, by capping rates, establishing the price the consumer pays.¹³⁹ An appointed or elected official could influence the after-tax price of marijuana by changing the tax rate from time to time.¹⁴⁰

Although delegating power to set liquor prices in state-owned stores or lottery prices is routine, delegating power to set tax rates seems unlegislative or extraordinary. But legislatures could sunset the delegation and regain the power to set rates after a

¹³⁶Graham Smith, *Something to Declare: 1000 Years of Customs and Excise* 10 (London: Harrap 1980).

¹³⁷*Supra* note 3, section 10.

¹³⁸*Supra* note 2, section 33 (proposed statutory section 34032). The 2010 voter initiative in the city of Berkeley, California, to impose taxes on marijuana allows the city council to eliminate or reduce them at any time. Berkeley Ordinance, *supra* note 40, section 3. Hu, *supra* note 17, is vehement about providing transition rules when rates change (in his discussions of floor stocks taxes, *passim*).

¹³⁹*See, e.g.*, Ga. Code Ann. Section 33-31-12 (2010).

¹⁴⁰Beyond the scope of this article is the question for legislatures whether to empower a more nimble governmental authority to speedily ban, or even to regulate and tax, designer drugs like “K2, or ‘fake marijuana,’ which is essentially a legal, smokable form of psychoactive potpourri.” The quotation is from Mary Carmichael, “Fake-Pot Panic,” *Newsweek* (Mar. 4, 2010), available at <http://www.newsweek.com/2010/03/03/fake-pot-panic.html>.

¹³¹Interdepartmental Findings, *supra* note 98, at 308-309.

¹³²*Supra* note 18 at 95. Hu goes on: “Mash seizures provides [sic] a fairly reliable index of illegal production. It is significant that this series showed a drop of 65 percent between 1935 and 1938.” *Id.* at 96.

¹³³Lessons, *supra* note 13.

¹³⁴All the rates come from Ripy, *supra* note 105, at 14, Appendix B.

¹³⁵Cumulative inflation between the imposition of the \$2 tax in January 1933 and the imposition of the \$9 tax in April 1944 was 35.66 percent. “Inflation Calculator,” available at http://inflationdata.com/inflation/Inflation_Calculators/Inflation_Calculator.asp#calresults (enter the appropriate months) (last visited Dec. 2, 2010).

designated period for experimentation and for flushing out bootleggers. Compared with ceding power to choose or change the tax base, ceding rate-setting power is more circumscribed and should be more acceptable.

Cliffs

Discontinuities or cliffs occur when some incremental changes in the amount that the tax base measures result in a tax change that is disproportionate (and when other changes in the amount measured result in no change in tax).

We still use a cliff to tax wine. At 14 percent alcohol (the threshold for fortified wine), the federal tax per bottle jumps from 21 cents to 31 cents, rounded. Maybe that's why a lot of wine has 13.9 percent alcohol.

Sometimes, the rationale for cliffs is clear. Before reform to a continuous ad valorem percentage method, the federal cigar tax was based on seven price ranges. Each range had its own specific tax stamp. Those brackets were needed to "keep to a reasonable level the number and denomination of stamps that had to be printed."¹⁴¹

The problem of cliffs is not restricted to excises. Comic book character Scrooge McDuck once became exasperated when an incremental penny of income pushed him into a higher tax bracket. Even today, with rounding, an incremental penny of income can produce as much as \$14 of extra federal tax.¹⁴²

In the Massachusetts bill, an ounce of marijuana with 10 percent THC content would bear a tax of \$250; an ounce with 9.9 percent THC content would bear a tax of only \$200. An ounce with 5.1 percent THC content would bear that same tax of \$200. That's arbitrary. A smooth, percentage-based rate solves that problem.

What License Fees?

Growers and Sellers

Oakland has enacted an annual fee of \$211,000 for each of four "marijuana factories."¹⁴³ Proposals that predate that ordinance lack its ambition. The

¹⁴¹Staffs of the Treasury Department and the Joint Committee on Internal Revenue Taxation, "The Structure of the Federal Excise Tax on Cigars" 4 (JCS 2-66, Oct. 21, 1966).

¹⁴²We still make folks use tax tables. See IRS, "2009 Tax Table," available at <http://www.irs.gov/pub/irs-pdf/i1040tt.pdf>. (In many cases, "you must use the Tax Table." See IRS, "1040 Instructions," 37, column 3, available at <http://www.irs.gov/pub/irs-pdf/i1040.pdf> (last visited Dec. 13, 2010)). If we require the Tax Tables because taxpayers can't do percentages, maybe innumeracy explains some of our budget woes.

¹⁴³Ray Sanchez, "Oakland Approves Four Marijuana Factories," *ABC News* (July 21, 2010), available at <http://abcnews.go.com/Business/US/oakland-approves-marijuana-factories/story?id=11209664>.

Massachusetts bill would charge \$500 for a cultivator's license; \$1,000 for a processing license; \$3,000 for a trade license for transporters, warehousemen, wholesalers, and distributors; and \$2,000 for retailers. AB 2254 would charge up to \$5,000 each for a cultivator's, manufacturer's, and wholesaler's license the first year and \$2,500 each later year. There would be no fee for retailers.

A thorough approach is to impose fees for licenses on everyone in the supply chain, including, in conformity with evolving international standards for tobacco,¹⁴⁴ retailers. The amounts could be substantial. Licensing not only would create a revenue source but also help keep track of tax paid marijuana. Making licenses expensive or otherwise restricting them narrows the supply chain at a possible choke point.¹⁴⁵ Lower fees for small businesses are a complication but are common.¹⁴⁶

Consumers

Mark A.R. Kleiman, who wrote a book on drug policy, says:

Personal drug licensure, particularly with quantity limitations, seems to represent a wild, even Orwellian, extension of government meddling in private life if we apply it to alcohol or tobacco. By contrast, as applied to currently illicit drugs such a system looks like a virtually complete legalization.¹⁴⁷

In many cases, individuals have to pay for a license before they can buy something.¹⁴⁸ A young-looking person needs to pay for a driver's license or

¹⁴⁴Department of the Treasury, "Report to Congress on Federal Tobacco Receipts Lost Due To Illicit Trade and Recommendations for Increased Enforcement" 13 n.26 (Feb. 4, 2010) available at <http://www.ttb.gov/pdf/tobacco-receipts.pdf> [hereinafter "Treasury Tobacco Report"].

¹⁴⁵State and Federal, *supra* note 6 at 236.

¹⁴⁶Lower fees are a dime a dozen. See, e.g., City of Seattle Department of Executive Administration, "Licensing Information," available at <http://www.cityofseattle.net/rca/licenses/Blicform.htm> (last visited Dec. 9, 2010). See also City of Santa Monica, "Business License Tax and Fee Summary," available at <http://www01.smgov.net/finance/licenses/pdf/feesum2page.pdf> (last visited Dec. 9, 2010). Graduated license fees are not a new and fresh idea. See Hu, *supra* note 18, at 119 *et seq.*

¹⁴⁷Mark A.R. Kleiman, *Against Excess* Chapter 4 (Laws), available at <http://www.spsr.ucla.edu/faculty/kleiman/book/> (last visited Dec. 1, 2010). Part of this chapter goes deeply into possible mechanisms for consumer licenses. A discussion of the economics of consumer licenses appears in *Regulating Vice*, *supra* note 6, at 163-165.

¹⁴⁸Sweden tried individual drinking licenses in the early 20th century before abandoning the idea. Daniel Okrent, *Last Call: The Rise and Fall of Prohibition* 75 (New York: Scribner 2010). This book goes into the politics of the repeal of Prohibition. It says that a statement that without the need for revenue "we would not have had Repeal for at least ten years" "may have been right." *Id.* at 361.

other official photo ID card before buying alcohol. Those cards don't cost extra for the purchasing privilege, but they aren't free. More to the point, many states charge patients fees to be able to buy medical marijuana. Colorado charges a \$90 fee; Michigan charges \$100; California charges \$66, and counties there may charge extra.¹⁴⁹ Some of those states reduce fees, but usually not to zero, for patients receiving means-based government health-care assistance.

Requiring licenses to purchase will not seal the system. Even if purchasers need a license, an intoxicated could find its way to folks without licenses through straw-person buyers, in the way that teenagers without fake IDs lurk near convenience stores in hopes of finding someone who will buy them beer. Too high a price for a license will lead to straw transactions.

Licenses to *possess* marijuana make no sense. States now realize some revenue by selling licenses for fishing and hunting, which are inherently observable. Possession of marijuana is not.

Special rates for nonresidents of the taxing jurisdiction could be set low to encourage marijuana tourism or high to discourage it. Or nonresidents could be ineligible for licenses, like out-of-state patients who cannot buy medical marijuana.

To be theoretically complete, a sliding-scale fee for individual licenses to purchase marijuana could achieve some progressivity. That scale could have a minimum fee, like those imposed on applicants for medical marijuana. And it could have a maximum, so the superwealthy couldn't beat the system by sending agents to do the purchasing.¹⁵⁰ Sweden, Finland, and other countries fine traffic violators on the basis of income, so high earners pay higher fines than others.¹⁵¹ Those countries, though, are relaxed

about income tax information; America is not ready to disclose people's incomes to agencies outside revenue services.¹⁵²

What Special Breaks?

An excise tax aims mainly at collecting revenue or at discouraging something we're angry about. But special rules may find their way into the tax law to benefit or burden activities or classes of taxpayers or to make the law more administrable.

Small or Large Businesses

Today, special tax rates favor small alcohol producers.¹⁵³ For example, the general federal rate for beer is \$18 per 31-gallon barrel, but brewers who produce less than 2 million barrels annually pay only \$7 per barrel on the first 60,000 barrels.¹⁵⁴ More help may be on the way: S. 3339, sponsored by 17 U.S. senators, would set excise taxes at \$3.50 per barrel for the first 60,000 barrels and \$16 for the next 1.94 million barrels for any brewer producing not more than 6 million barrels in a year.¹⁵⁵

Ease of tax administration is an argument for a concentrated industry with few taxpayers.

A similar rule benefits wine businesses that produce no more than a quarter million gallons a year: They get a drastically reduced tax rate on the first 100,000 gallons.¹⁵⁶ For wine, at least, there is no cliff: The benefits phase out gradually.¹⁵⁷

Some view with alarm the prospect of big corporations taking over the marijuana trade. One counter-argument is that big corporations are more reliable taxpayers because they want to protect their reputations and won't fly by night. That argument may be generally accurate, though a watchdog group

¹⁴⁹“How to Get a Medical Marijuana Card,” available at <http://www.mahalo.com/how-to-get-a-medical-marijuana-card> (last visited Dec. 11, 2010) [hereinafter “Medical Card”]. States are changing their access fees frequently, so this is a moving target.

¹⁵⁰The high Scandinavian traffic ticket fines are involuntary and provide no model for an optional consumer's license. Deciding the ratio of the minimum to the maximum would be necessary. For example, sliding scales for mental healthcare in Brooklyn show ratios below 1:7. They are, at various providers, \$19-\$95, \$25-\$90, \$25-\$35, \$30-\$185, \$0-\$30 (ratio meaningless), \$35-\$95, and \$50-\$100. Personal Counseling [Department], Brooklyn College, “Mental Health Hotlines and Resources” (April 2005), available at <http://pc.brooklyn.cuny.edu/Hotlines.htm>.

¹⁵¹See, e.g., Robert Adams, “Finnish Millionaire Gets 111,888-Euro Speeding Ticket” (Mar. 9, 2009), available at <http://www.globalmotors.net/finnish-millionaire-gets-111888-euro-speeding-ticket/>.

¹⁵²To exhaust the options for progressivity, a scheme to base the cost of a purchaser's license on the official valuation of the applicant's dwelling or total property in the state makes no sense. Renters, trusts, joint owners, and out-of-state second homeowners doom it.

¹⁵³The federal government has also resisted vertical integration of the beverage alcohol business by generally forbidding common ownership of producers, middlemen, and retailers. See the “Tied House” rules of 27 C.F.R. Part 6, 27 C.F.R. section 6.1 *et seq.*

¹⁵⁴I.R.C. section 5051.

¹⁵⁵S. 3339, 111th Cong. (2010), available at <http://thomas.loc.gov/cgi-bin/query/z?c111:S.3339> (last visited Nov. 11, 2010).

¹⁵⁶IRC section 5041(c).

¹⁵⁷See *id.* section 5041(c)(2), which provides for a gradually diminishing credit and thus an increasing tax rate as production passes the quarter-million gallon mark.

alleges many “examples of cigarette company complicity in cigarette smuggling.”¹⁵⁸

Still, ease of tax administration is an argument for a concentrated industry with few taxpayers, and appears to be the rationale behind Berkeley’s lower square footage tax rate for nonprofit operations with over 3,000 square feet of space.¹⁵⁹ But Berkeley limits facilities to 30,000 square feet, much smaller than the industrial scale operations allowed in nearby Oakland. Berkeley’s overall scheme aims to serve the additional purpose of encouraging existing dispensaries and cultivators, who have generally not caused problems locally, to open licensed cultivation facilities.

Environmentally Friendly Operations

Some indoor grow houses have reportedly taken 180 gallons of diesel fuel to produce one pound of marijuana.¹⁶⁰ “At indoor grow sites, Humboldt County environmental officials report finding tubs of used antifreeze, leaking fuel lines, pesticide containers, and nutrient-laden potting soil that runs off into streams during rains, feeding algae blooms that suffocate fish.”¹⁶¹

A tax scheme could favor marijuana grown outdoors, using the natural light of the sun over that grown indoors, in energy- and water-intensive grow houses.

A tax scheme could favor marijuana grown outdoors, using the natural light of the sun over that grown indoors, in energy- and water-intensive grow houses. Rancho Cordova voters set a precedent for differential rates in 2010. A rate as high as \$900 now applies to each square foot of *indoor* cultivated area or each indoor plant; outdoors, the top rate is \$72 (\$900 per 12.5 square feet).¹⁶² The rationale for that difference is not concern for the environment,

¹⁵⁸National Center for Tobacco-Free Kids, “The Big Cigarette Companies and Cigarette Smuggling (May 18, 2003), available at <http://www.tobaccofreekids.org/research/factsheets/pdf/0044.pdf>.

¹⁵⁹Berkeley Ordinance, *supra* note 40.

¹⁶⁰Sam Quinones, “Pot Growers Are a New Crop,” *Los Angeles Times* (Oct. 15, 2010), available at <http://www.latimes.com/news/local/la-me-indoor-pot-20101015,0,4660032,full.story>. “That’s “enough to take a big rig from Los Angeles to Oklahoma City.” *Id.*

¹⁶¹*Id.*

¹⁶²Rancho Cordova Ordinance, *supra* note 40.

though: It reflects a judgment that growers can produce 12.5 times more plants in a given space indoors than outdoors.¹⁶³

In deciding whether to grow outdoors, producers would consider not just differential tax rates, but also factors such as different costs for farmland compared with buildings and different costs for security needed to prevent theft.¹⁶⁴

Home Growers

Economists tend to downplay the amount of revenue at stake with consumers who will grow their own marijuana instead of buying the taxed, commercial kind. A recent Rand study suggests that home growing, at least if limited, would largely succumb to competition from legal mass producers benefiting from economies of scale.¹⁶⁵ Years ago a legalizer wrote: “The inducements to home cultivation should not be exaggerated: in Alaska, where it was the one legal way to get marijuana before 1991, pot continued to be sold illicitly at prices around \$250 an ounce, proof that many pot smokers are quite disinclined to grow on their own.”¹⁶⁶

If the cost of taxed marijuana is relatively low, consumers will tend to avoid the hassle of home horticulture. In addition to after-tax price, the decision will be informed by other factors, such as the perceived quality, reliability, and branding of taxed alternatives; the availability of a secure location for plant growth; the consumer’s interest and experience in cultivation; and the regulatory environment.

However small the interest in home growing may be, a tax scheme will have to have some rule, yea or nay. To govern the production of taxed substances for personal use, federal law provides three possible models:

¹⁶³The tax base outdoors is the greater of the actual area used or 12.5 square feet per plant; indoors, it’s the greater of the actual area used or one square foot per plant. *Id.*

¹⁶⁴An application for a Rhode Island medical marijuana business permit illustrates the commercial value of untaxed marijuana: the applicant’s “building is already equipped with bullet-proof glass and three time-lock vaults which makes it ideal for establishing a Compassion Center.” Alternative Therapeutics, “Application for Operation of a Medical Marijuana Compassion Center” (May 12, 2010), available at <http://www.health.ri.gov/news/temp/mmp/AlternativeTherapeutics.pdf>. Taxing products based on where they are grown in an excise or ad valorem scheme would involve more complication.

¹⁶⁵Jonathan P. Caulkins, “Estimated Cost of Production for Legalized Cannabis” (Rand Corp. July 2010), available at http://www.litagon.org/pubs/working_papers/2010/RAND_W_R764.pdf (last visited Nov. 16, 2010).

¹⁶⁶Economics of Legalization, *supra* note 11, at 4.

- absolutely no production, for liquor;¹⁶⁷
- limited production (100 gallons per individual, 200 gallons per household), for beer and wine; and
- unlimited production, for tobacco.

The personal use permitted under the last two schemes allows gratuitous transfers, but no sales, of legally produced substances.

The following discussion examines those models for marijuana.

Prohibition

If home growing is prohibited, the decision to grow one's own is the decision to buy from a bootlegger writ small. Small, noncommercial growing would be hard to detect, though a federal agency lists 14 ways of noticing that a neighbor may be growing substantial amounts of marijuana.¹⁶⁸ A tax stamp or other marker is particularly useful if any marijuana anyone possesses has to be tax paid.¹⁶⁹

AB 2254 effectively prohibits home growing: "The fees and the regulations on growing . . . preclude the growth of marijuana for personal consumption."¹⁷⁰

Limitations

A leading commentator says "California could not feasibly license or tax home-grown marijuana, any more than it could license or tax home-grown tomatoes."¹⁷¹ That's like saying a government can't *out-law* home-grown recreational marijuana, but they all try to, effectively or not.

Weight would not be a good de minimis standard for home growing, because field measurement is not feasible and plants could grow beyond plan. Even if weight or potency is the tax base, any threshold of possession should be based on something measurable in the field, like area under cultivation or number of plants.

Proposition 19 would have allowed individuals to cultivate marijuana in an area up to 25 square feet. That would have made tax enforcement difficult: "Suppose there is four pounds of marijuana at my house. Why, officer, that's the results from my last legal 5-foot-by-5-foot personal garden harvest. What, you don't see any 5-by-5 growing space? Well,

¹⁶⁷Alcohol and Tobacco Tax and Trade Bureau, "General Alcohol FAQs" (revised Apr. 2006), available at <http://www.ttb.gov/faqs/genalcohol.shtml> (describes the rules for all alcoholic beverages).

¹⁶⁸Drug Enforcement Agency, Seattle Field Division, "Signs Your Neighbor Is Running a Marijuana Grow Operation," available at www.usdoj.gov/dea/pubs/states/seattle.htm (last visited Nov. 14, 2010).

¹⁶⁹See the discussion at "Identification," *infra*.

¹⁷⁰"Analysis of Ammiano Bill," *Legalization Wiki* (Mar. 30, 2010), available at http://legalizationwiki.org/Ammiano_Bill_AB_390. That analysis also applies to the successor bill, AB 2254, *supra* note 2.

¹⁷¹State and Federal, *supra* note 6, at 237.

I used to grow, but I took down my garden and sold my equipment after my last harvest."¹⁷² Maybe enforcement efforts would be slack. By analogy, a friend who brews lots of his own beer reports no enforcement of the 200 gallon limit on his operations. He expects no governmental interest unless he starts selling his home brew.

Any limit would have to be high by current standards. One source reports "an average domestic plant yield of 448 grams or approximately 1 pound per plant."¹⁷³ Even that average would yield an amount that is over 10 times the felony threshold in North Carolina.¹⁷⁴ A Rand report estimates average consumption per user of about 100 grams per year, or less than four ounces.¹⁷⁵

Tax Exemption

An unlimited tax exemption for homegrown marijuana would, of all the options, forgo the most revenue and most tempt growers to engage in illicit commerce.¹⁷⁶ But although tobacco is harder to grow than marijuana, unlimited, tax-free home cultivation of tobacco remains an uncommon hobby.¹⁷⁷

In the Massachusetts bill, "Like making one's own beer or wine today, personal cultivation and possession is outside the statute."¹⁷⁸

Medical Users

Current Law

Medicinal Alcohol

A medicinal exemption from the federal alcohol tax is based on the character of the product, not the condition of the user.¹⁷⁹ No federal alcohol tax is

¹⁷²"Radical" Russ Belville, "California's Prop 19: A Word-for-Word Analysis" (July 17, 2010), available at <http://stash.norml.org/californias-prop-19-a-word-for-word-analysis>.

¹⁷³Drug Policy Alliance, "Cannabis Yields 1992," available at <http://www.drugpolicy.org/marijuana/medical/challenges/litigators/legal/plantyeilds/deaplantyeilds.cfm>. Yields of over five pounds per plant were reported at the upper end of the range.

¹⁷⁴That threshold is 1.5 ounces. N.C. Gen. Stat. section 90-95(d)(4).

¹⁷⁵Altered State, *supra* note 8, at 18. See Beau Kilmer et al., "Reducing Drug Trafficking Revenues and Violence in Mexico" 11 note 1 (Rand Corp. 2010), available at http://www.rand.org/pubs/occasional_papers/2010/RAND_OP325.pdf [hereinafter "Mexico"] (listing other sources for an estimate in this range), and *id.* at 11-12 (discussion of the uncertainty involved in this estimate).

¹⁷⁶For completeness, another scheme would allow a home grown exemption only for consumption on the premises, indoors or outdoors, of the grower.

¹⁷⁷See "How to Grow and Process Tobacco at Home," available at <http://www.howtogrowtobacco.com/> (last visited Nov. 11, 2010).

¹⁷⁸Massachusetts bill, *supra* note 3, Introductory Material.

¹⁷⁹That said, Wisconsin has a rule that exempts from excise tax "liquor sold to hospitals for medicinal purposes."

(Footnote continued on next page.)

imposed on “medicines, medicinal preparations, food products, flavors, flavoring extracts, or perfume containing distilled spirits, which are unfit for beverage purposes.”¹⁸⁰ But a doctor friend who recommends spirits for elders losing weight from lack of appetite reports that pharmacies he works with had never heard of filling a prescription for medicinal alcohol. Medicare and other insurers don’t pay for spirits, just as they don’t pay for gluten-free products.

“Sale or use for beverage purposes is indicative of fitness for beverage use”¹⁸¹ in the federal scheme. A product may also be found fit for beverage use on the basis of either “the content and description of the ingredients” on a required form or “on organoleptic examination”¹⁸² by a panel of tasters.¹⁸³ The alcohol tax is so low, though, that the after-tax price is lower than the prices of many patented pharmaceuticals.

Even before the process of the repeal of Prohibition finished playing out, Congress removed all restrictions on the medical use of alcohol.¹⁸⁴ Legalization of medical marijuana may someday be seen as a precursor to full legalization.

Marijuana

Medical marijuana is legal on the basis of a physician’s recommendation in 15 states and the District of Columbia.¹⁸⁵ Its legality turns on the observed or reported condition of the user, not the more objective character of the product. Although marijuana differs from the typical prescribed pharmaceutical because it lacks standard dosing regimens,¹⁸⁶ its efficacy has been reported in some

controlled clinical tests.¹⁸⁷ Substantial numbers of scientists, doctors, patients, and voters — and some legislatures — say marijuana has medicinal uses. This article wholeheartedly stipulates that it does.

Since January 1, 2010, Oakland has imposed a tax on medical marijuana,¹⁸⁸ the only kind legal under California law. Now nine other California cities do.¹⁸⁹

A specific tax on medical marijuana doesn’t necessarily mean that a city is angry about it. The city may instead be singling out a highly profitable business that can afford to pay a blunt-instrument gross receipts tax. In Berkeley, for example, taxes per \$1,000 of gross receipts are 60 cents for grocery stores (a low-margin business), \$3.60 for doctors’ and other professional offices (with higher margins than grocery stores), \$100 for professional sports events (presumably a cash cow), and \$150 for gun shops.¹⁹⁰

The California cities that voted to tax medical marijuana in November 2010 all would have taxed recreational marijuana, too, if Proposition 19 had passed.¹⁹¹ Some cities would have taxed both kinds at the same rate, presumably for one or more of three reasons: similar profitability, administrative convenience, and concern about imposters. Other cities, like Berkeley, would have sacrificed administrative convenience and taxed sellers of recreational marijuana (at \$100 per \$1,000 of gross receipts) more heavily than sellers of medical marijuana (\$25 per \$1,000).

Legalization Proposals

Unenacted proposals to legalize marijuana for all adult users run the gamut of analogies, from penicillin to Pabst Blue Ribbon, about whether to tax medical marijuana. At one extreme, AB 2254 provides: “no fee shall be imposed under this part on marijuana used medicinally with a doctor’s recommendation.”¹⁹² At the other extreme, the Massachusetts bill¹⁹³ simply taxes all marijuana, medical or not.

State of Wisconsin, Department of Revenue, Publication AB-103, *Alcohol Beverage Tax Information*, section III.C.1.d (August 2009), available at <http://www.revenue.wi.gov/pubs/ab-103.pdf>. Such sales would still be subject to federal tax rules.

¹⁸⁰See, e.g., IRC section 5131; *id.* section 7652(g).

¹⁸¹27 C.F.R. section 17.134

¹⁸²*Id.*

¹⁸³Rachel Sanderoff, “Organoleptic Evaluation: Fit vs. Unfit,” available at <http://www.ttb.gov/ssd/pdf/organoleptic-evaluation.pdf> (last visited Oct. 4, 2010).

¹⁸⁴Pinney, *supra* note 85, at 8.

¹⁸⁵Marijuana Policy Project, “State-by-State Medical Marijuana Laws” (2008), available at http://www.mpp.org/assets/pdfs/download-materials/SBSR_NOV2008_1.pdf. That source is dated but thorough. These recommendations are not prescriptions, technically, because marijuana can’t legally be prescribed. Overlooked Power, *supra* note 24, at 146-147.

¹⁸⁶CNBC’s documentary *Marijuana Inc.* shows a reporter in a marijuana pharmacy or “dispensary” asking, “what’s different about” varieties of medical marijuana for sale, and being told by owner Richard Lee, sponsor of Proposition 19, that it’s like “red and white wine, you know, different flavors of wine.” CNBC, *Marijuana Inc.: Inside America’s Pot Industry* 24-minute mark (first broadcast July 17, 2009), available at <http://www.cnbc.com/id/15840232?video=1185791780&play=1> [hereinafter “*Marijuana Inc.*”]. Any information about potency and other factors that would seem important to dosing regimens did not survive editing.

¹⁸⁷Anna Wilde Mathews, “Is Marijuana a Medicine?” *Wall St. J.* (Jan. 18, 2010), available at <http://online.wsj.com/article/SB10001424052748703626604575011223512854284.html>.

¹⁸⁸That tax is a modest 1.8 percent of gross receipts. City of Oakland, “A Resolution Submitting, on the Council’s Own Motion [various matters to voters]” (July 23, 2010), available at <http://clerkwebsvr1.oaklandnet.com/attachments/25613.pdf>.

¹⁸⁹See Table 1, *supra*.

¹⁹⁰Section 9.04.240 of the Berkeley Municipal Code (current through Oct. 19, 2010), available at <http://codepublishing.com/ca/berkeley>.

¹⁹¹See Table 1, *supra*.

¹⁹²AB 2254, *supra* note 2, proposed section 34004 of Division 2 of the Revenue and Taxation Code.

¹⁹³Massachusetts bill, *supra* note 3.

Healthy Imposters

One anti-marijuana source alleges, “The vast majority of those using crude Marijuana as medicine are young and are using the substance to be under the influence of THC and have no critical medical condition.”¹⁹⁴ A superficially more objective source, a documentary produced by CNBC, shows a reporter saying, more subtly, that medical marijuana cards are “remarkably easy to come by.”¹⁹⁵

Even sympathizers show irritation with posing. “We all support [medical marijuana],’ [Los Angeles City Council member Dennis Zine] says. ‘It’s been abused, and it’s simply a mask for the recreational use of marijuana, with the doctors who write prescriptions at will for a different dollar value, whether it[’s] \$65 or \$100 or \$200. . . . People are abusing it, and they are simply using it to get high.”¹⁹⁶ This article takes as given that a nonnegligible number of people get recommendations for medical marijuana that they use for recreational purposes.

Arguments for Special Rules

Users and suppliers of medical marijuana make several arguments against its taxation. Compassion should preclude taxation. Medicine is not something that people are or should be angry about; on the contrary, we tend to subsidize it. Prescribed medicine bears no sales taxes or European-style value added taxes. Taxes on medicine tend to be more regressive than taxes on ordinary necessities, because sick people are not so able to earn a wage as healthy ones. Any recreational impostors should not be allowed to burden sick people.

Arguments Against Special Rules

Affordability

Four factors may offset the financial burden of a tax on medical marijuana, at least in a jurisdiction that moves from prohibition directly to legalization:

- Total cost to the patient after legalization will probably go down, at least in the short run, as government keeps taxes down to compete with bootleggers. A Rand study raises the possibility

of a price decrease of around 75 percent from current street prices, even after taxes are paid.¹⁹⁷

- If there were no distinction between users on the basis of medical need, new patients wouldn’t have to scrape up a doctor’s fee because they wouldn’t need a recommendation.
- States typically charge nontrivial application or other fees for medical marijuana patients,¹⁹⁸ though California cuts its fee from \$66 to \$33 for less well-off Medical patients.¹⁹⁹ Those fees would disappear.
- Patients may be able to use standard help available for pharmaceuticals generally. Private insurance companies, disparage them as we may, decide routinely who is sick and what medicine sick people need. (Tax authorities don’t.) Private charities may help.²⁰⁰ The uninsured with means can bear the tax. The sympathetic case is the uninsured who are both poor and sick. Medicaid or other benefit programs may someday be available, and the enactment of health insurance reform may provide more help. But maybe not enough.

Administrability

In tax policy, simplicity is the enemy of fairness.²⁰¹ Any special tax rule for medical marijuana hands government the task of making or monitoring decisions about people that categorize later events when the tax break is claimed. That is a challenge.

Tax rules routinely draw bright lines between substances, as the federal government does when taxing wines with alcohol content of 13.9 percent and of 14 percent at different per gallon rates. But categorizing human beings can be more difficult.

To be sure, there are easy categorizations, like the extra federal tax exemption for individuals 65 and over (though the circumstances of one’s birth may draw suspicion, as President Obama has learned).

¹⁹⁴California Police Chiefs’ Association Position Paper on the Decriminalization of Marijuana” (September 2009), *available at* http://www.californiapolicechiefs.org/nav_files/marijuana_files/files/CPCA_Position_Paper_Decriminalization_Marijuana.pdf. The Police Chiefs’ Association’s website goes on: “It has become clear, despite the claims of use by critically ill people that only about 2 percent of those using crude Marijuana for medicine are critically ill.” Many individuals who have never been critically ill have taken plenty of medicine, though.

¹⁹⁵Marijuana Inc., *supra* note 186, at the 23-minute mark.

¹⁹⁶Richard Gonzales, “Medical Marijuana Plan Draws Mixed Reviews in Calif.,” *NPR* (Oct. 29, 2009), *available at* <http://www.npr.org/templates/story/story.php?storyId=113977020>.

¹⁹⁷“Altered State,” *supra* note 8, comparing a recently estimated current street price per ounce of \$300 to \$450 per ounce (at page 17) with a possible post-legalization total price to the consumer of \$88, consisting of retail price of \$38 plus tax of \$50 (at 19-20). A taxed “dose” of medical marijuana would be cheaper than a dose of many prescription drugs whose prices include extraordinary profits derived by intangible-intensive industries and attributable to high costs of often unsuccessful research and development.

¹⁹⁸Medical Card, *supra* note 149.

¹⁹⁹California Department of Public Health, “Medical Marijuana Program: Application/Renewal,” *CDPH 9042 (May 2008)*, *available at* <http://www.cdph.ca.gov/pubsforms/forms/CtrlForms/cdph9042.pdf> (last visited Dec. 2, 2010).

²⁰⁰*But see* Marijuana Policy Project, “Medical Marijuana Financial Assistance Program,” <http://www.mpp.org/about/medical-marijuana.html> (last visited Dec. 2, 2010) (indicating that a “scholarship” program to pay state registry fees has been suspended).

²⁰¹Fairness is in the eye of the beholder. Simplicity is the enemy of special tax breaks, too.

The extra tax exemption for blindness on the Form 1040 draws bright numerical lines²⁰² that are objective on their face, though they depend on a doctor who submits a report to the IRS.

Some standards (the presence of AIDS, ALS, cancer, and much more) for medical marijuana recommendations are objective. Others are not. Thirteen of the 15 states that allow medical marijuana do so for pain that is variously described as chronic, severe, severe chronic, debilitating, or intractable.²⁰³ Ninety-four percent of Colorado marijuana patients say they suffer “severe pain.”²⁰⁴ Drawing bright lines between people whose chronic pain is enough to warrant medication and everyone else is difficult. No one is perfectly whole. A friend puts it this way: “We all have chronic pain in the soul.”

In tax policy, simplicity is the enemy of fairness.

Drawing medical lines can expand into an industry. Determination of Social Security disability has led to so many disputes that lawyers make it a specialty.²⁰⁵ The stakes in those disputes are high enough to pay lawyers on both sides. But for medical marijuana determinations, the case-by-case game is not worth the government’s candle.

Once government has identified patients eligible for tax relief, it needs to provide that relief to patients but not to others at transaction time. Some California cities may have considered parallel distribution channels, with patients buying only at tax-favored dispensaries, and recreational users paying full tax at stores. But current schemes that exempt charitable purchasers from sales tax seem more workable: sellers sell to all comers, and provide relief at the point of sale, ordinarily on the basis of an official document. Such a document would work like a commercial coupon or food stamps, but could be lent or counterfeited.

²⁰²Reg. sec. 1.151-1(d). A person is blind with no better than 20/200 vision in the better eye with correcting lenses, or if the widest diameter of her or his visual field subtends an angle no greater than 20 degrees.

²⁰³Marijuana Policy Project, “A Comparison of Key Aspects of State Medical Marijuana Laws,” available at <http://www.mpp.org/assets/pdfs/library/StateMMJLawsKeyFeatures.pdf> (last visited Nov. 20, 2010).

²⁰⁴Mainstreamed, *supra* note 35, at 36.

²⁰⁵“A Board Certified Social Security Disability Lawyer engages in the comprehensive legal practice of counseling and representing persons with disabilities and their representatives about their rights to receive benefits from the social security administration.” National Board of Legal Specialty Certification, “Board Certified Social Security Disability Lawyer,” available at <http://www.nblsc.us/> (last visited Sept. 16, 2010).

What if a patient buys medical marijuana for recreational use? There, we may have only the honor system.

Lying

Any special rule based on reports of unprovable symptoms creates an incentive for individuals seeking recreational use to lie. Unpoliced, that kind of rule leads to disrespect for the law. It may even lead to disrespect for the medical profession, because some doctors might get the reputation of believing all or nearly all claims that lead to a recommendation for marijuana.

Self-Perception

An incentive to see one’s self as a victim leads to the opposite of positive thinking. If healthy people want something and have to say they are sick to get it, they may come to think they are sick or even become sick, like the child who hates school and develops a stomachache in the morning. But that incentive, like that for lying, is also present in any disability insurance plan, public or private. Seeing one’s self as a victim finds noble expression in fighting for one’s rights or well-being. Seeing others as victims calls well-meaning people to action. But the incentive to save a little money through a tax break for medical marijuana seems less powerful than the incentive to be able to consume it legally at all, which is the incentive that folks in medical marijuana states face today.

Revenue

Any special break diminishes the tax base. The fiscal drain may extend beyond patients: If the tax differential is significant, patients may sell illicitly to recreational users or bring medicine to share with healthy people at a potluck.

A Nontax Solution: Tighter Rules on Doctors

One way to protect the tax base from recreational users who pose as patients is to tighten standards for honoring doctors’ recommendations. States that have allowed doctors to specialize in marijuana recommendations are already facing a backlash.²⁰⁶ Bright-line rules could address the problem. For instance, during Prohibition, the federal government limited the number of prescriptions that doctors could write for medicinal alcohol.²⁰⁷ More recently, Colorado allowed doctors to write marijuana recommendations for no more than five patients.²⁰⁸

²⁰⁶See Jennifer Steinhauer, “Los Angeles Marijuana Sellers Limited,” *The New York Times* (Jan. 26, 2010), available at <http://www.nytimes.com/2010/01/27/us/27pot.html> (Los Angeles limits the number of dispensaries).

²⁰⁷See 1933 Hearings, *supra* note 8, at 18.

²⁰⁸Don Quick, “Medical Marijuana System Must Be Fixed,” *Denver Post* (Jan. 17, 2010), available at http://www.denverpost.com/recommended/ci_14196615.

What Tax Enforcement?

Identification

Sophisticated markers, like high-technology stamps,²⁰⁹ can identify tax-paid cigarettes: “Currently, 47 states require proof — via marking the cigarette packages with stamps — that state cigarette taxes have been paid.”²¹⁰ My tobacco-friendly state of North Carolina requires no stamps, though, because smugglers (even some with terrorist ties²¹¹) increase the state’s revenue. In Canada, monitoring of tear tape, “the pressure-sensitive plastic ribbon that is wrapped around a package of cigarettes to facilitate the opening of the cellophane wrapping that encloses the package,” also aims to prevent evasion.²¹² The U.S. Treasury has proposed a “track and trace” system, using bar codes or the like, for cigarettes.²¹³

Knowing of technology used to enforce the California cigarette tax, staff of the State Board of Equalization investigated stamps for identification of tax-paid marijuana in case Proposition 19 passed.²¹⁴ Colorado officials are “considering mandating that medical pot include radio-frequency identification devices, somewhat like coded tags on library books, to keep track of who’s getting what.”²¹⁵

²⁰⁹See Eric Lindblom, “The Case for High-Tech Cigarette Tax Stamps” (Apr. 15, 2010), available at <http://www.tobacofreekids.org/research/factsheets/pdf/0310.pdf>. The sophistication of this technology and of anti-bootlegging measures that Lindblom describes overwhelms the non-expert.

²¹⁰John Eckart, commissioner, Indiana Department of Revenue, “Changing the Cigarette Tax Stamp: Feasibility Study Report” 3 (Nov. 1, 2009), available at <http://www.in.gov/legislative/igareports/agency/reports/IDOR09.pdf>.

²¹¹In 2002, a federal jury in Charlotte convicted two Lebanese citizens of diverting millions of dollars in cigarette smuggling proceeds to the radical Islamic group Hezbollah by shipping North Carolina cigarettes to Michigan for resale.” *SNUS News & Other Tobacco Products*, “North Carolina May Restore Tax Stamp to Reduce Smuggling” (Feb. 10, 2010), available at <http://snus-news.blogspot.com/2010/02/north-carolina-may-restore-tax-stamp-to.html>.

²¹²Ontario Ministry of Revenue, Bulletin TT 1-2004 “Requirements for Tear Tape Manufacturers and Markers of Cigarettes under the Tobacco Tax Act” (October 2009), available at http://www.rev.gov.on.ca/en/bulletins/tt/tob1_2004.html.

²¹³Treasury Tobacco Report, *supra* note 144, at 9-10 and at note 22 at 9.

²¹⁴[California] State Board of Equalization (BOE) Legislative and Research Division, “Proposition 19,” available at <http://www.boe.ca.gov/news/pdf/Proposition%2019%20draft%20analysis.pdf> [hereinafter “BOE Analysis”] (last visited Dec. 2, 2010). The staff said that at least two years would be needed to implement a stamp scheme. *Id.* at 11.

²¹⁵Associated Press, “Marijuana Tracking on the Way in Colorado” (Sept. 29, 2010), available at <http://www.cbsnews.com/stories/2010/09/29/national/main6912057.shtml>. Already, Mendocino County identifies growing plants with “zip-ties,” plastic ties with individual numbers stamped on

(Footnote continued in next column.)

Seals or stamps could mark not only a pack of cigarettes, but also a pouch like those in which pipe tobacco is sold. A seal or stamp could also mark packages of infused brownies, sodas, olive oil, chewing gum, or whatever policymakers allow sold.

An open container, even empty, could give a rebuttable presumption of legality for the quantity it can contain.

An open container, even empty, could give a rebuttable presumption of legality for the quantity it can contain. To be sure, that presumption would allow evaders to refill an open container with contraband, in the style of my friend who pours cheap Scotch into single malt bottles to impress his guests. As a corollary, there could be a rebuttable presumption of evasion for any unpackaged amount that would not fit into the largest legally sold package. In that scenario, users would need to finish one package before opening the next one.

Consumable markers are conceivable. We dye tax-exempt home heating oil, for example, to distinguish it from otherwise identical taxable diesel fuel.²¹⁶ In distinguishing tax-paid marijuana from non-tax-paid marijuana, any consumable marker would have to be nontoxic, hard to counterfeit, inexpensive to apply, and easy to detect in the field.

Individual paper cylinders (once out of a sealed package) could bear a nontoxic mark, using technology like that used to fight counterfeiting of currency. Users who didn’t want to smoke would take the marijuana out of its paper tube before, say, incorporating it into food.

Genetic markers of the kind that seed companies use to identify plants whose material and offspring they claim to own²¹⁷ might someday allow identification of tax-paid marijuana.²¹⁸ That kind of genetic engineering sounds far-fetched, but scientists are working on an analogous task: “A desirable step

them, and purchased for a fee. Mendocino County (California) Code section 9.31.060 (Supplement 27, July 2010), available at <http://www.co.mendocino.ca.us/bos/pdf/current/Mendocino%20County%20code/Mendocino%20County%20Code%20Supplement-27.pdf>.

²¹⁶See Minnesota Petroleum Marketers Association, “ULSD Rules and Decals, Diesel Labeling And Delivery Ticket Requirements,” available at http://www.mmpaonline.com/diesel_labels.htm (last modified Apr. 13, 2010).

²¹⁷See Brian D. Wright, *Plant Genetic Engineering and Intellectual Property Protection* (2006), available at <http://ucanr.org/freepubs/docs/8186.pdf>.

²¹⁸“Hemp And Marijuana: Genes Producing THC, Active Ingredient In Cannabis Plant, Identified,” *ScienceDaily* (Sept. 15, 2009), available at <http://www.sciencedaily.com/releases/2009/09/090915113538.htm>.

[toward eliminating confusion between hemp and psychoactive Cannabis] is to make drug-free plants visually recognizable. Since the hairs can be seen with a magnifying glass, this could be accomplished by engineering a hairless Cannabis plant.²¹⁹ But even allowing government enough power to require such markers might not preclude cloning or other bootlegging techniques.

Tracking

From the outset, governments can track taxable substances by monitoring the raw materials that go into them. Beer makers are advised, “Since you must report the usage of malt and hops and beer loss, agents can spot reports that may be fraudulent. Also, when the TTB comes in for an audit they will look at brewing records, raw material invoices and whatever else they wish to examine to determine if your operation is legit.”²²⁰ Similarly, “monitoring of raw leaf tobacco [to] . . . control the supply of raw leaf tobacco from grower to manufacturer” is part of Canada’s comprehensive excise system.²²¹

During the production phase, until the federal liquor tax scheme was dramatically relaxed in 1979, there was a “system of joint control under which IRS agents were kept on the premises and their presence required when certain actions were performed to insure collection of the taxes. Spirits were kept under government lock and seal until denatured, the tax had been determined, or the spirits removed for a legitimate tax exempt or tax free purpose. Generally, taxes were determined when the spirits were removed from the bonded premises.”²²²

There’s more. Since shortly after the repeal of Prohibition, the federal government has banned

post-production transportation of liquor in containers holding more than one gallon.²²³ Keeping track of liquor bottles, a distinct form of packaging, still helps the federal government collect taxes on spirits.²²⁴

Technology offers new forms of tracking. In Colorado, “Owners will soon be required to place video cameras throughout their cultivation sites and dispensaries.”²²⁵ The cameras will “trace the movement of every marijuana bud from the moment its seeds are planted to the point of sale”²²⁶ and will capture the face and photo identification card of every patient.²²⁷ “The video will be transmitted to a website accessible to regulator round the clock.”²²⁸ Weighing is to be caught on camera.²²⁹ This kind of technology could allow citizens to watch via video as officials assess tax at the moment of the placement of goods under seal.

The better a tracking scheme works, the more likely it is to cost too much and to intrude on privacy. Workable schemes lie between the honor system and the diamond mine.

²²³Hu, *supra* note 18, at 97.

²²⁴The rules that track bottles include:

27 C.F.R. section 19.634. Receipt and storage of liquor bottles. No proprietor shall accept shipment or delivery of liquor bottles except from the manufacturer thereof, a supplier abroad, or another proprietor. . . . Liguor bottles, including those of less than 200 ml capacity, shall be stored in a safe and secure place, either on the proprietor’s qualified premises or at another location.

Id. at section 19.638 Disposition of stocks of liquor bottles.

When a proprietor discontinues operations, or permanently discontinues the use of a particular size or type of liquor bottle, the stocks of such bottles on hand shall either be disposed of to another person authorized to receive liquor bottles, or destroyed, including disposition for purposes that will render them unusable as bottles.

²²⁵This discussion was stricken from an early draft as too far-fetched before the quoted material appeared in a cover story in *Time* magazine. Mainstreamed, *supra* note 35, at 36.

²²⁶*Id.*

²²⁷State of Colorado Department of Revenue, Medical Marijuana Enforcement Group, “Notice Of Rulemaking Hearing” 59-60 (Dec. 15, 2010), available at <http://www.colorado.gov/cs/Satellite?blobcol=urldata&blobheader=application%2Fpdf&blobkey=id&blobtable=MungoBlobs&blobwhere=1251678551504&ssbinary=true>.

²²⁸Mainstreamed, *supra* note 35, at 36.

²²⁹Stephanie Simon, “Colorado’s Medical-Pot Rules: ID, Video and a Vast Paper Trail,” *The Wall Street Journal* (Nov. 23, 2010), available at <http://online.wsj.com/article/SB10001424052748703559504575630760766227660.html>.

²¹⁹University of Minnesota News Release, “Weeding Out Marijuana: Researchers Close in on Engineering Recognizable, Drug-Free Cannabis Plant” (Sept. 14, 2009), available at http://www1.umn.edu/news/news-releases/2009/UR_CONTE_NT_130681.html.

²²⁰Ashton Lewis, “Sales Setup,” *Brew Your Own: The How-to Homebrew Beer Magazine* (May/June 2009), available at <http://byo.com/stories/wizard/article/section/121-mr-wizard/2010-going-pro-mr-wizard>. Although tracking marijuana production offers no ready analogue to tracking bulky malt and hops, authorities seeking the location of illegal indoor growing facilities look for abnormally high consumption of water and electric power.

²²¹Brandy Brinson, “Regulating Security,” *Tobacco Reporter Magazine* (June 2006), available at http://www.tobaccoreporter.com/home.php?id=119&cid=4&article_id=798 (in Canada, tobacco taxes are high).

²²²Ripy, *supra* note 105, at 9-10.

Collection Point

Principles

A principle of excise administration is to assess²³⁰ tax at a choke point where the supply chain constricts to involve a small number of people and locations.²³¹ Then fewer people have to learn the rules (and there should be fewer mistakes), fewer entities need auditing, and both taxpayers in the aggregate and government spend less time and incur less cost in making the system work.

Another principle is to assess tax near the beginning of the supply chain, so that the substance does not leak out of that chain untaxed. Taxes imposed at the end of the chain, like sales taxes, make leakage more likely.

Finding an appropriate assessment point for a newly legalized substance depends on how the industry will be organized. Although governments could take a passive role, let the industry evolve, and impose taxes at the best choke point in the structure that turns up, they could instead mandate an organization for the industry that will help meet fiscal needs.

Analogies

For alcohol in the United States, the federal choke point is near the beginning of the chain, as raw materials become alcohol. This process takes place in secure locations. Tax is imposed as or before beverage alcohol is removed from the choke point.²³²

For tobacco, the choke point is found in the middle of the supply chain, after the time when and distance from the place where the curing or drying process makes harvested tobacco smokable. Smokable tobacco from tens of thousands of domestic farms travels untaxed to manufacturing plants where tax will eventually be assessed.

Options

Putting the choke point at the beginning of the chain for marijuana could involve limiting by license the number of farms or grow areas and placing them under scrutiny. That scheme, involving consolidation of the industry, would conflict with the independent traditions of marijuana growers. But although taxation and regulation may have helped to

consolidate the liquor and cigarette industries, they can coexist with a more fragmented industry, like wine. And capital intensity is a separate cause of consolidation in all those industries.

For marijuana, on balance, the middle of the supply chain may be the best assessment point.

For marijuana, on balance, the middle of the supply chain may be the best assessment point. Staff of the California Board of Equalization, which “typically recommends that excise taxes or fees be imposed as high in the distribution chain as possible,” advised against collecting taxes on marijuana from “the highest point in the distribution chain[,] . . . growers[,] . . . [because], growers normally sell in bulk volume, which would not be conducive to a unit-based tax.”²³³ The staff instead recommends collecting at the level of the distributor or processor, where repackaging would allow for the use of tax stamps.

The staff concluded that assessment that close to middle of the chain would be adequate:

Generally speaking, growers would be licensed and inspected regularly. By knowing the size of a grower’s crop, we know the approximate amount of product produced. Just like alcohol, some product may go out the back door that the taxing agency is not aware of. This can never be completely controlled. There is no fool proof system to stop all evasion schemes. But by using indicia, licensing all the levels including retailers, and doing regular inspections, the state of California can reduce the evasion level.²³⁴

The end of the supply chain, the point of retail sale, is an ineffective collection point. Shoplifting, pilferage by employees, casual sales, and theft during transit are examples of tax evasion enabled by failing to collect tax early in the process.²³⁵

To combine the benefits of a retail price base with those of an early and narrow choke point, the *Basic*

²³⁰This article inartfully uses the words assess and collect as if they were synonyms: They are close enough for this analysis.

²³¹See David R. Burton and Dan R. Mastromarco, “Emanicipating America from the Income Tax: How a National Sales Tax Would Work,” Cato [Institute] Policy Analysis No. 272 (Apr. 15, 1997), available at <http://www.cato.org/pubs/pas/pa-272.html>. Not only are large corporations easy to police, but also they are “likely to be concerned with keeping the image of the industry clean and respectable.” Lessons, *supra* note 13.

²³²See, e.g., IRC section 5401 et seq. (beer).

²³³BOE Analysis, *supra* note 214, at 8.

²³⁴E-mail from BOE spokeswoman Anita Gore to the author, quoted in “Collection Point for Marijuana Tax” (Nov. 4, 2010), available at <http://newrevenue.org/2010/11/04/collect-ion-point-for-marijuana-tax/>.

²³⁵But collecting tax early in the process creates a cost that later operators in the supply chain routinely mark up to include a profit. Anecdotally, in the wine business, “every increment of pricing is doubled by the time the wine reaches the consumer.” Sara Schorske, “Refresher Course on Wine Taxes,” *Vineyard & Winery Management* (Sep./Oct. 1998), available at <http://www.csa-compliance.com/html/Articles/RefresherCourseWine.html>.

World Tax Code and Commentary, by Ward Hussey and Don Lubick, suggests imposing excise tax at the time of production as a percentage of “the retail price current at the time of production to achieve a uniform and large base without competitive advantage to vertically organized enterprises.”²³⁶ The advantage the world code seeks to avoid is this: If one company or an affiliated group owns all of a supply chain, there is no third-party time-of-production transfer price to base tax on — the taxpayer has an incentive to understate it. In response, the government has only the wishfully named arm’s-length method of guessing at tax pricing, a tool grown so feeble that it has turned the international tax schemes of the mightiest nations into laughing-stocks.²³⁷ The world code avoids that trap.

But the world code’s approach is not the one to start with. There is no “current retail price” of a product just entering a legal market. Moreover, as the market develops, brands and enterprises may come and go quickly; and deposit of estimated tax up front is only a partial solution. The world code’s approach will be useful for marijuana taxes only if and when companies are few and brands are stable.

A Public Option?

The line between revenue from excise taxes and those from state monopolies may be hard to draw. “Arguably, profits of government-owned tobacco, alcohol, and gambling monopolies should also be considered part of the excise tax system.”²³⁸

A public marijuana monopoly offers advantages over an entrepreneurial model. First, a public seller can tweak prices more quickly than a legislature can adjust tax rates, so it can offer stiff and nimble competition to bootleggers in the inevitable price war.

²³⁶Ward M. Hussey and Donald C. Lubick, *Basic World Tax Code and Commentary*, Harvard University International Tax Program (1996), at 21, available at [http://www.taxanalysts.com/www/bwtc.nsf/PDFs/basica.pdf/\\$file/basica.pdf](http://www.taxanalysts.com/www/bwtc.nsf/PDFs/basica.pdf/$file/basica.pdf). Whether regulation will allow or prohibit vertical integration in the marijuana business remains to be seen. The federal government opposes vertical integration in the alcohol business. See *supra* note 153

²³⁷*Cf.* Charles I. Kingson, “The Great American Jobs Act Caper,” 58 *Tax L. Rev.* 327, 387 (2005) (“Deciding how much one’s left hand contributes to one’s right may constitute a career, but not much of a life.”). The arm’s-length method was more workable when it arose because commerce then involved few intangibles. Now, “the foolish continuation of separate company accounting for the affiliates of large multinationals” is losing so much steam that “transfer pricing may well be gone in a decade, replaced by formula apportionment.” Lee A. Sheppard, in *Forty Years*, *supra* note 83, at 21. Whether the marijuana industry will be as intangible-intensive as the alcohol and tobacco industries remains to be seen.

²³⁸*Theory and Practice*, *supra* note 10, at 2.

Second, a state monopoly should and apparently does tend to maximize net revenue generally. Virginia’s retail monopoly on sales of liquor, for example, raises gross revenue that is reportedly an order of magnitude greater than taxes produced in neighboring Maryland and the district.²³⁹ That monopoly, combined with taxes, yields this result: “In the District and most of Maryland, just a dollar or two from a fifth of Jack Daniel’s goes to government. But in Virginia, where whiskey and every other kind of liquor is sold in state-run stores, more than \$13 of the retail price goes to the state.”²⁴⁰ However, gross and net are completely different. The district and Maryland incur no costs for facilities or people to conduct a retail business.

A public marijuana monopoly offers advantages over an entrepreneurial model.

Third, monopoly offers more stable long-term revenue. A report from the Marin Institute says:

It is rare for states to raise excise tax rates on alcoholic beverages because the alcohol industry powerfully lobbies against any such increases. As effective tax rates on alcohol erode over time, states that privatize alcohol sales will find it difficult to match the revenue they previously realized from state-run stores by raising state alcohol tax rates.²⁴¹

A similar argument would apply to legalized marijuana taxed on the basis of weight or potency without indexing.

Fourth, public monopoly offers more regulatory controls. The 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.”²⁴²

A monopoly has disadvantages. First, private industry is ordinarily more efficient than a state

²³⁹Rosalind S. Helderman, “Virginia’s Inner Struggle To Get Off The Scotch Tax,” *The Washington Post* (Aug. 5, 2010), available at <http://www.washingtonpost.com/wp-dyn/content/article/2010/08/04/AR2010080407323.html?hpid=topnews>.

²⁴⁰*Id.*

²⁴¹Marin Institute, “Privatization of State-Run Alcohol Sales: An Expensive Solution” (May 2010), available at http://www.marininstitute.org/site/images/stories/pdfs/privatization_talking_points.pdf (last visited Nov. 3, 2010).

²⁴²Mary Anastasia O’Grady, “Can Mexico Be Saved?” *The Wall Street Journal* A11 (Nov. 13-14, 2010). See generally Evan Cohen and Jehan deFonseka, “Tax Policies for Legalized Marijuana in California” 16-18, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1626985 (last visited Dec. 16, 2010).

monopoly, though efficiency may not help sell a plan to a public that is to some extent angry about marijuana use.

Second, state monopoly can lead not only to inefficiency but also to waste, conflicts of interest, sweetheart deals, and corruption. In North Carolina, for instance, liquor for off-premises consumption, a state monopoly, has proved susceptible to embarrassing scandal.²⁴³

Third, the argument that a state taxing undesirable goods tends to become compromised in its opposition to them applies a fortiori to a state that sells those goods.

Fourth, and most seriously, in the short run at least, a monopoly would move the state into the marijuana business. That move would put the state itself in violation of federal law, and would need from the federal government benign neglect of a new and high order,²⁴⁴ involving a special kind of comity.

On balance, state monopoly combined with excise taxation and license fees should provide the richest revenue source. Monopoly is also likely to provide the most bulletproof regulatory scheme. In states now without medical marijuana, it would face no entrenched opposition from legally operating entrepreneurs. A final and perhaps overriding factor is that states have only one chance to set up a monopoly; a state can always switch from monopoly to a private model, but it can't ordinarily switch the other way. Faced with the unknown and the choice of use it or lose it, "use it" is often the shrewd and prudent answer.

The Washington bill²⁴⁵ imposes no tax. But it would allow each city, town, and unincorporated area to decide, by petition and referendum, to allow marijuana sales through state-owned stores. The state would take revenue by marking the price up, as it does now for liquor: A state board would "from time to time" set the price of marijuana as it does now for liquor, with a cap of 35 percent (presumably of gross revenue from sales).²⁴⁶

When?

Effective Date

AB 2254 would be effective 30 days after adoption of regulations.²⁴⁷ Under Proposition 19, marijuana would have become legal immediately under opera-

tion of California law. The BOE staff anticipated that after enactment of any statewide weight-based tax scheme, eight months would be needed to implement it.²⁴⁸

To avoid confrontation with the federal government, state legislation could delegate authority to the executive branch to bring the scheme into force. For instance, an official could stand ready to promulgate final regulations (which would trigger effectiveness) if the federal government said OK or if the official decided it had winked or blinked.

Sunsetting

With a sunset, legalization and taxation could expire after some number of years unless voters or the Legislature approved extension. Sunsetting an untried scheme puts inertia, inherent in the legislative process, on the side of caution.²⁴⁹

At the federal level, Congress's repeated sunset of tax benefits has been criticized as sacrificing tax policy to political expediency — to the point of giving sunset a bad name.²⁵⁰ Sunsetted or expiring tax benefits tend to give lobbyists sinecures and to keep campaign contributions flowing. They understate cost because they lose revenue for only a part of the relevant fiscal window. Tax burdens require a different analysis. Sunsetting them understates revenue gain.

But sunsets have a legitimate purpose: to reverse the burden of going forward when rules are experimental. Legalization of marijuana and everything associated with it would be a series of experiments. For a new marijuana tax, a sunset date could terminate legislative delegation (to a nimble official) of the power to set rates. After a set period of time thought adequate to fight a tumultuous price war, rate-setting power would automatically return to the deliberative legislature. The legislature could always extend the time of delegation, but only by an affirmative vote.

Conclusion

As it scratches the surface of a new area of tax law, this article reaches several conclusions. Marijuana is hard to tax, so any schemes to tax it have to be flexible. Tax rates on marijuana need to be low at first to gain advantage in the inevitable price war against bootleggers. As taxing authorities win that

²⁴³Editorial, "ABC Reforms," *Winston-Salem (N.C.) Journal* (July 16, 2010), available at http://www2.journalnow.com/content/2010/jul/16/abc-reforms/c_1.

²⁴⁴State and Federal, *supra* note 8, at 247-248.

²⁴⁵*Supra* note 4.

²⁴⁶*Id.* at section 31.

²⁴⁷AB 2254, *supra* note 2, proposed section 26070 of the Division 9 of the California Business and Professions Code. Meanwhile, section 37 of the bill makes other provisions effective on the adoption of other regulations, "which is to

(Footnote continued in next column.)

occur no later than July 1, 2005." The reader is left to wonder about that inappropriate effective date.

²⁴⁸BOE Analysis, *supra* note 214, at 11.

²⁴⁹Legislative inertia is an even bigger problem with tax treaties, which cry out for indexing. *See supra* note 23.

²⁵⁰*See generally* Rebecca M. Kysar, "The Sun Also Rises: The Political Economy of Sunset Provisions in the Tax Code," *Ga. L. Rev.*, Vol. 40(2) March 2006, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=887388.

war, they can raise rates and generate more revenue. Indexing of dollar amounts is essential. The tax can omit special rules for medical marijuana. State monopoly is a viable option. But this article reaches no conclusion on other issues, such as whether the ideal potency base is feasible, what to do about home-grown marijuana, and whether any scheme would bring in enough revenue to be politically palatable.

History tells us that, “it took a full-time, multi-year effort for . . . researchers and planners . . . to come up with a workable beginning blueprint for

post-prohibition alcohol control [and many other players participated eventually]. Furthermore, this system has been constantly adjusted ever since.”²⁵¹ Any new revenue scheme starting from zero is bound to leak, overreach, or otherwise need fixing as time brings unanticipated consequences to light. It will require the work of many minds. ☆

²⁵¹Lessons, *supra* note 13.