Marijuana Revenue Competition — Look Out Below

by Pat Oglesby

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Federal law says you can’t sell or even possess marijuana, but states and localities are taxing it anyway. The immediate threat to revenues is not the federal government or voter backlash (voters love marijuana taxes), but the ever-present illegal market, so that’s been the focus of tax and drug scholarship. Meanwhile, a more subtle threat to revenue lurks and needs attention: Tax competitors (think: tax havens) threaten subnational jurisdictions that can’t or don’t control their borders. This is not a small problem.

Here’s a framework for looking at threats to marijuana revenue:

1. The illegal market can be marginalized by law enforcement or low taxes.
2. Only low taxes can defeat legal tax competitors.
3. Tax competition threatens local retail taxes more than state retail taxes.
4. Tax competition threatens local producer taxes much more than state producer taxes.
5. Federal legalization would ipso facto expose state taxes to daunting competition.

The Illegal Market Can Be Marginalized by Law Enforcement or Low Taxes

Buyers will prefer legal marijuana over illegal marijuana for a variety of reasons, like quality assurance, safety, and legal recourse against sellers. But they still might buy the illegal product if it’s noticeably cheaper. Two key factors can keep the legal price competitive: law enforcement, which keeps the illegal price high. But that takes time. It took years for the Roosevelt administration to eliminate big-time alcohol bootleggers after repeal of Prohibition.

Law enforcement can patiently root out tax-evading sellers to keep the illegal price high. But that takes time. It took years for the Roosevelt administration to eliminate big-time alcohol bootleggers after repeal of Prohibition. To be sure, enforcement of tax laws needs public support —

1. This article uses the term “marijuana” because the tax policy community has not taken much interest in policy around the drug, whose proponents tend to prefer the near-equivalent “cannabis.”
4. Even for national governments, low prices, whether or not caused by low taxes, in competing countries can be a problem. But a nation can control its borders much more effectively than a subnational government can.
5. Oglesby, supra note 3, at 267.
prosecutors to take cases to court and juries to convict. Can law enforcement marginalize the holdover illegal market? How soon? Those questions will have different answers in different jurisdictions. But law enforcement will have an interested ally — legal sellers who find it in their interest to support prosecutions of their tax-evading competitors.

Like law enforcement, low-enough taxes to keep legal after-tax prices competitive find that time is their friend. “Low-enough taxes” — that’s a moving target. After legalization, pretax marijuana prices fall, as the legal market gains efficiency and cuts costs. That’s happening already. As pretax prices fall, taxes can go up — with an offsetting effect on the after-tax price. Taxes can go up, but only if the political will is there.

So early on, to beat the illegal market, overall marijuana taxes should start low. To be sure, the illegal market will not be totally eliminated, but as the legal market takes over, overall taxes can go up. And some taxes can go up now. Even Washington, the state with the highest effective tax rate on marijuana, seems already to be “on the correct [undertaxing] side of the Laffer curve.”

But it’s the overall burden that can go up. Any particular jurisdiction can push taxes up if commerce can’t easily flee to a competing low-tax jurisdiction. That’s a big if.

**Only Low Taxes Can Defeat Legal Tax Competitors**

Taxes low enough to defeat the illegal marijuana market can be too high to get collected — because jurisdictions compete to offer low taxes. In a state with legal marijuana, consumers can buy anywhere in the state legally, and producers can sell anywhere in the state legally. Law enforcement, a key weapon in the battle against the illegal market, has no role to play in the fight against legal tax competitors. For instance, for a county in a state where marijuana is legal, a high tax rate likely will work only if nearby jurisdictions impose high taxes, too. If consumers can buy legally nearby, they will, if a lower price is worth their trouble. And production will tend to migrate to jurisdictions with low taxes.

The race to the bottom is tempting. To be sure, subnational governments have some unmeasurable amount of “pricing power” to impose taxes without sending too much commerce elsewhere. (“Too much” is a value judgment, unless revenue maximization is the sole criterion for judging a quantitative tax burden — although even revenue maximization involves guesswork that might include value judgments.) But unchecked, the race to the bottom among subnational jurisdictions taxing marijuana could mimic what happens with national income taxes, whereby offshore income tax havens are willing to yield revenue just to get a smidgen of commerce, and impose little tax — or none at all.

Local taxes on marijuana, spectacularly popular with voters, are especially vulnerable to competition, as we shall see.

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There is a fine point — a U-shaped curve for the tax burden over time is likely to reach an after-tax price that prevents leakage to the illegal market. “Based on the experiences of other states, more often the problem is not attracting consumers into the legal market when sales begin, but maintaining enough supply to meet the overwhelming initial demand. In other words, it seems that whenever legal markets for marijuana open, consumers are eager to buy from these legitimate businesses even if the tax rate may be considered high at the outset.”

Marijuana Policy Project, supra note 3.


So much to tax is a question with an answer that is certain to change as time passes. Meanwhile, the threshold question of what to tax, like price, weight, or THC potency, lacks a consensus answer. See authorities cited in note 3 supra. There are strong policy arguments for a price-based (ad valorem) tax as the first tax on marijuana, that is, as a placeholder for more sophisticated taxes, and as an ingredient in a multi-base cocktail of marijuana taxes. But many states and localities have not moved beyond that primitive first step. But in the long term, price-based taxes are likely to give way, in large part, to taxes based on weight or stated THC.


For example, in November 2016, stand-alone marijuana taxes were on ballots in 110 Oregon localities. All 110 won voter approval, none by less than 64 percent to 36 percent. See “Oregon Marijuana Measures,” Oregon Live (2016). In California that year, stand-alone marijuana taxes were on ballots in 44 localities. They prevailed in 43 of them, the only losing California local tax, in Colfax, got 63 percent approval but needed two-thirds. “Voters Guide to Drug Policy Reform Candidates and Measures,” Drug Policy Forum of California (Nov. 2016).
Tax Competition Threatens Local Retail Taxes More Than State Retail Taxes

Low retail marijuana taxes will lure some consumers away from their residence jurisdiction. Some won’t even need a special tax-beating trip to a competing low-tax jurisdiction: Some work there; some visit their mothers there every week. But some will go out of their way to buy across the border — spending more on transportation than they save on taxes — cutting off their noses to spite their faces, telling their government: “Your taxes here are too high. I’ll show you!”

Buying marijuana in a competing local jurisdiction within a legal state violates no law. Also, localities are typically smaller than states, and closer to competing jurisdictions. If consumers can buy legally nearby, they will, if a lower price is worth their trouble. Oregon solves this problem for its localities by capping local retail taxes at 3 percent of price. Other states, like California, have no limits on local marijuana taxes.

Already, competition has caused Berkeley, California, to cut its tax. That tax started at 10 percent of retail price, a rate that won approval from 83 percent of Berkeley voters. That tax took effect for the first time on January 1, when recreational marijuana became legal in California, but immediately it provoked complaints, because nearby jurisdictions had lower taxes. Aiming “to make Berkeley ‘more competitive in the regional market’ for recreational marijuana businesses,” the city council voted to reduce that tax to 5 percent — and “consultation with neighboring jurisdictions was agreed.” Berkeley council member Lori Droste said she “doesn’t want to create a mecca here,” but contemplates “a regional solution, to avoid a race to the bottom of competing low tax rates.” Luckily for localities, antitrust laws don’t prohibit that kind of intergovernmental cooperation.

Consumers living in Berkeley can buy legally anywhere in California and get tested, legal marijuana, presumably as good as they can get at home. If nearby jurisdictions kept taxes low, Berkeley’s eventual 10 percent retail tax may have driven a good bit of legal retail commerce elsewhere. Legally, whether 5 percent is the “right” tax rate for Berkeley, short or long term, is unknowable. But Berkeley’s 10 percent rate seems relatively high, and it’s reasonable to think it was high enough to drive significant commerce to neighboring jurisdictions. Setting tax rates to beat tax competition, like setting rates to beat the illegal market, is an art, not a science.

For states with high retail marijuana taxes, tax competition has been typically a minor threat. For instance, Washington state’s taxes (at least 43.5 percent of price) exceed those of neighboring Oregon (typically 20 percent in total). Cross-border leakage from Washington consumers buying Oregon-taxed marijuana at a small scale has not been a killer problem, in part because Washington’s population centers aren’t near the Oregon border. (Oregon’s illegal exports are primarily of untaxed pot, not surprisingly. That illegal market needs to be marginalized, but that’s not a tax competition problem.)

With consumer taxes, states have another advantage over localities. Interstate

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20 Washington’s excise tax is 37 percent at retail; its standard sales tax is 6.5 percent. Local sales taxes may increase the burden. “FAQs on Taxes,” Washington State Liquor and Cannabis Board.

21 Oregon collects a state excise tax of 17 percent at retail; most localities add a 3 percent excise. There are no sales taxes in Oregon. “Marijuana taxes,” Oregon Department of Revenue, Mar. 8, 2018.

22 “Washington State Economic and Revenue Forecast,” Economic and Revenue Forecast Council (Sept. 2016), at 82. Still, state prohibitions or taxes on interstate transportation of small amounts of alcohol or tobacco for personal use are honored in the breach. See, e.g., Peter DeMarco, “Border-Crossing With N.H. Booze Is Illegal, but Only on Paper,” Boston.com, Jan 31, 2010.

viewpoint

Transportation of marijuana has been a red flag for the federal government. And it’s a felony — which makes the marijuana community nervous. That federal law is largely unenforced, but “some legalized states are starting to carry penalties for transporting marijuana across state lines.” Look for more of that, as tax base protection, as the market evolves.

Tax Competition Threatens Local Producer Taxes Much More Than State Producer Taxes

On production, taxes on temptation goods, like alcohol and tobacco, are rare. There are two reasons.

First, the rationale for these taxes is that consumption is problematic — production (distilleries and factories) is OK. Or better than OK. Tax subsidies promote the production of temptation goods — sometimes singling them out. Consumption, not production, is what worries the public health community — and for some temptation goods, consumption worries enough of the public to impose tax. So consumption is the target for alcohol and tobacco taxes. Marijuana production is not the problem. If you were trying to find problems with production, you could point out that it generates odor from growing plants and may attract thieves; those are annoyances that hardly rise to the level of negative externalities that deserve taxing.

Second, production, more than retailing or consumption, is mobile. A manufacturing plant can shut down in the United States and in effect relocate to a low-tax country. Crops tend to be grown where government is most favorable (think: subsidies). But consumers won’t travel the world for an excise tax cut.

Look at alcohol and tobacco — the producing state simply doesn’t tax. Virginia doesn’t tax cigarettes manufactured there from tobacco grown there unless they are sold at retail in Virginia. (Otherwise, Kentucky’s untaxed producers could marginalize Virginia’s.) The United States doesn’t tax exported tobacco or alcohol either. It’s up to each jurisdiction, national or subnational, to deal with its own consumers — by taxing consumption.

But there’s a huge wrinkle for state taxes on marijuana production: So far, the competitive environment is totally different from the ordinary model, thanks to federal illegality. The interstate commerce clause doesn’t apply to federally illegal goods, so the states have a free hand. Each and every legalizing state has used that free hand to adopt total protectionism. For now, thanks to protectionism, all marijuana legally purchased at retail in any state is produced there, and vice versa; that is, all marijuana legally produced in any state can legally be offered for sale at retail only in that particular state. So no state accepts for sale at retail any marijuana grown elsewhere. For instance, marijuana produced in Colorado can’t be sold legally in Washington, which, like every legal state so far, forbids the sale of imports.

So for now, in legalizing states, taxing benign legal production is the economic equivalent of taxing legal consumption (the true target of a tax on a temptation good). State marijuana taxes on producers now make sense, because states can prevent imports. And taxing producers may be better than retailers — dealing with fewer taxpayers, and, if track and trace isn’t perfect, before leakage occurs, losing revenue and risking federal government scrutiny. So the states of Alaska, California, Colorado, and Nevada tax marijuana producers today.

What about localities? Many localities, especially in California, tax marijuana producers now by percentage of price or square footage of canopy under cultivation. Those taxes will not last indefinitely. This is get-it-while-you-can time. When the tax base can migrate easily, aggressive jurisdictions will cut taxes in a race to the bottom.

27 For instance, New York has a refundable alcoholic beverage production credit. And many standard credits and incentives benefit producers of anything, including temptation goods. See “Alcoholic Beverage Production Credit,” New York state, Dec. 13, 2017.
29 Localities in at least Colorado and California tax marijuana production. Center for New Revenue, supra note 15. Taxes on producers of medical marijuana were approved as early as 2010. Laws to Tax, supra note 3, at 257.
content to get even untaxed economic activity. Marijuana production will trend into jurisdictions with low or nonexistent production taxes.

And localities are already making noise about going to zero. Take Lompoc, California, where council member Jim Mosby argued to keep voters from considering marijuana taxes: “We have a lot of vacant buildings out there . . . and I really think that we need to do what we can to entice (business) into this community.”

According to the Lompoc Record, “Mosby also cited the city’s high unemployment rate while arguing his position. He suggested that the city would be better-served in the long run by having an edge over nearby communities — like Santa Barbara, for example — in attracting marijuana operators and could potentially go back and look at taxes after seeing how the market establishes itself in Lompoc.”

Mosby’s motion to keep marijuana businesses tax free prevailed. Lompoc is heading for the bottom. And it is likely to find company there.

But for now, localities are counting on revenue from producers — revenue that seems ephemeral. San Luis Obispo County, California, for instance, is proposing new marijuana taxes, with nearly all the tax revenue it officially projects31 coming from producers rather than retailers. If that revenue shows up, it may not last. Zero-tax Lompoc is in the next county over.

Federal Legalization Would Ipso Facto Expose State Marijuana Taxes to Daunting Competition

After federal legalization of marijuana, interstate tax competition is a sure thing — and a new danger that states are not ready for.

For producer taxes, we’ve seen that states don’t worry yet: As long as marijuana is federally illegal, states can legally prevent imports, so they can tax consumption by taxing producers.32 But federal legalization will mean the Constitution’s interstate commerce clause ipso facto applies to marijuana, so states can’t prevent imports — unless, as some did with alcohol, they continue all prohibition. Production will gravitate to states and localities without producer taxes — that’s where all alcohol and tobacco production happens today. That is, state producer taxes on marijuana will disappear.33 For local production taxes, get-it-while-you-can time is now. For state production taxes, get-it-while-you-can time will last a little longer.

If state taxes on consumers get too high relative to those of other states, they will provoke massive commercial smuggling,4 a la Virginia cigarettes to New York. With the threat of federal illegality gone, states will have to rely totally on their own devices to make sure that marijuana sold at retail has borne tax. The prospect of such interstate smuggling is an argument for the bulk of taxation to be federal.

Indeed, it’s likely that federal legalization of marijuana will involve a new federal excise tax as a political sweetener to attract support. That

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31. Cannabis Tax Revenue Projections. For official document, see http://agenda.slocounty.ca.gov/agenda/sanluisobispo/8254/U0/NJiGVzdC1tYXlicyBhAgQSAxNDegcGVybWllcyBwYWdlIDJhgb2YgMi5wZGVy-\/-12/n/88373.doc.
32. After federal legalization, states will still be able and well advised to tax by weight, as several do now. But they may not keep the collection point where it is today. States will move to tax all products that are eventually sold locally at retail equally, whether imported products or local products, as they do now with tobacco and alcohol — with taxes that are collected as early in the supply chain as is practical. Where production occurred won’t matter — so the producer won’t be taxed.
33. There is no reason for weight-based taxes to disappear. That’s true although state marijuana taxes are now typically collected from producers. State per-pack cigarette taxes, for instance, are in fact weight-based, and are typically collected from distributors who bring the product into the state. Since weight-based taxes are less vulnerable than ad valorem taxes to the inevitable decline in pretax prices and to transfer pricing manipulation, they should be expected to be the wave of the future in state cannabis taxes. Or maybe THC, the primary intoxicant, can somehow serve as a tax base.
new federal tax may constitute in itself a kind of tax competition for states, which may need to adjust to collect less tax to keep the illegal market at bay — by keeping the after-all-taxes price down. Still, federal legalization will remove any remaining prohibition premium (the amount sellers need to charge for taking the risk of illegality). That removal may allow pretax prices to decline further — perhaps leaving room for state taxes without shifting commerce to the illegal market.

And a new federal marijuana tax may help states with the mechanics of collecting their taxes. That new tax, like the federal taxes on tobacco and alcohol, may well be collected early, at or shortly after production — because raw marijuana, unlike the makings of alcohol (grapes, corn, hops), and unlike raw tobacco, is “extraordinarily valuable.” (Federal collection of a cannabis excise tax at retail would prove impractical.) If collection does not occur at the very beginning of the supply chain, the federal government will probably mimic the state systems that track and trace marijuana now from seed to sale. In any event, federal taxation cannot but help states in collecting whatever tax they can. Most state tobacco and alcohol taxes are based on weight and volume, and piggyback on taxes the federal government imposes earlier in the supply chain. State marijuana taxes can follow that model.

So federal excise taxation is a two-edged sword for state marijuana taxes: The downward pressure that high federal taxes will put on state taxes will hurt states, but federal involvement and oversight will help states. On balance, the hurt is likely to outweigh the help.

A possible response is revenue sharing, whereby some proceeds of the federal tax are allocated to states. But the creation of any allocation formula is likely to create a political uproar. For instance, after the repeal of Prohibition, President Roosevelt wanted to share federal alcohol revenue with states, but could not persuade Congress to go along, because producing and consuming states could not agree on an allocation formula. Kentucky, for instance, retained prohibition on consumption, but produced lots of liquor, while Massachusetts produced little but consumed much. But there are successful state-level precedents for revenue sharing, even already for cannabis. A compromise formula is already in place in Oregon, for instance, where half of cannabis revenue shared with cities is based on production, wholesaling, and processing, with the other half based on retailing. With state tax competition certain, revenue sharing of the proceeds of a uniform federal tax may be the long-term best hope for state revenue.

Conclusion

Marijuana markets are bound to evolve — and some of the ways they will evolve are foreseeable. It’s clear that many subnational taxes are, or will be, in trouble. While overall taxes can go up over time, local taxes already have to contend with strong tax competition, and state taxes will need to contend with enormous tax competition upon federal legalization. Change will be a constant, so nimbleness will be a necessity.