

The Golden State’s ‘High’ Expectations: Will California Realize the Fiscal Benefits of Cannabis Legalization?

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“Reforming America’s marijuana laws can be likened to assembling a jigsaw puzzle: finding the first few pieces to join is difficult and time consuming, but the more the pieces come together the clearer the puzzle’s pattern becomes and the easier the job gets.”¹

I. INTRODUCTION

In the 1930s, anti-marijuana propaganda, combined with what some call legislative carelessness, led to the demonization of cannabis, marking it as the antithesis to mainstream American culture.² Indeed, in 1969, only 12% of Americans supported legalization of marijuana.³ But recently, the federal government has taken a relaxed approach to enforcing marijuana laws, allowing states that have legalized to realize the potential tax benefits from marijuana.⁴ Now, with national support at 60% and successful results in states legalizing recreational use, the discussion around legalizing marijuana is heating up.⁵ On November 8, 2016, California voters legalized recreational marijuana with the

1. Jeffrey Miron, Ph.D., *A Cost-Benefit Analysis of Legalizing Marijuana*, in THE POT BOOK: A COMPLETE GUIDE TO CANNABIS 447, 461 (JULIE HOLLAND ED., 2010).

2. See generally, Richard J. Bonnie & Charles H. Whitebread II, *The Forbidden Fruit and the Tree of Knowledge: An Inquiry Into the Legal History of Marijuana Prohibition*, 56 VA. L. REV. 971, 1054 (1970) (reviewing the historic origin of marijuana prohibition and public discourse in the United States).

3. Art Swift, *Support for Legal Marijuana Use Up to 60% in U.S.*, GALLUP (Oct. 19, 2016), <http://www.gallup.com/poll/196550/support-legal-marijuana.aspx> (on file with *The University of the Pacific Law Review*).

4. Alex Halperin, *Trump Probably Won’t Crush the Legal Weed Industry, But He Could Do Something Worse*, SLATE (Mar. 16, 2017), http://www.slate.com/articles/business/moneybox/2017/03/trump_probably_crush_legal_weed.html (on file with *The University of the Pacific Law Review*).

5. See Swift, *supra* note 3 (highlighting increases in support for legalization across socio-political backgrounds).

passage of Proposition 64 (Prop. 64), also known as the Adult Use of Marijuana Act (AUMA).⁶ That same day, voters in Nevada, Massachusetts, and Maine passed similar propositions.⁷ Undeniably, passing these laws have swung the door to legalization wide open.⁸ Now, the United States is bracing itself for an industry expected to grow “faster than ganja under grow lights.”⁹

Indeed, the promise of generating new tax revenue is one of the main reasons supporting legalization.¹⁰ Consequently, generating revenue from marijuana sales requires a sound tax policy.¹¹ Typically, this requires selecting a tax base, level, and collection point.¹² Usually, the revenue goes to covering the costs of the law and various state programs.¹³ The successes in Colorado and Washington demonstrate the recreational market’s potential for raising tax revenue.¹⁴ Now, all

6. *California Proposition 64, Marijuana Legalization (2016)*, BALLOTPEDIA, [https://ballotpedia.org/California_Proposition_64_Marijuana_Legalization_\(2016\)](https://ballotpedia.org/California_Proposition_64_Marijuana_Legalization_(2016)) (last visited Mar. 15, 2017) (on file with *The University of the Pacific Law Review*); Press Release, *Marijuana Wins Big On Election Night*, Drug Policy Alliance, (Nov. 8, 2017) <http://www.drugpolicy.org/news/2016/11/marijuana-wins-big-election-night>.

7. See *Legalization*, NORML, <http://norml.org/legal/legalization> (last visited Mar. 15, 2017) (on file with *The University of the Pacific Law Review*) (summarizing information on the states that have fully legalized medical and recreational marijuana).

8. See Madison Margolin, *The Pot Law That Could Be ‘Deal Breaker for the Drug War,’* ROLLING STONE (July 5, 2016), <http://www.rollingstone.com/politics/news/the-pot-law-that-could-be-deal-breaker-for-the-drug-war-20160705> (on file with *The University of the Pacific Law Review*) (discussing the inevitable industrialization of the marijuana industry and California’s potential to further validate it).

9. Carol Tice, *Why Legal Cannabis Is 2015’s Best Startup Opportunity*, FORBES (Feb. 5, 2017, 7:34 PM), <https://www.forbes.com/sites/caroltice/2015/02/05/why-legal-cannabis-is-2015s-best-startup-opportunity/#682a95613f2c> (on file with *The University of the Pacific Law Review*).

10. E.g., JOHNATHAN P. CAULKINS, BEAU KILMER & MARK A. R. KLEIMAN, *MARIJUANA LEGALIZATION: WHAT EVERYONE NEEDS TO KNOW* 146–47 (2d ed. 2016) (highlighting how the promise of increased tax revenue is one of the main reasons supporting legalization); STEERING COMM., BLUE RIBBON COMM’N ON MARIJUANA POL’Y, *PATHWAYS REPORT: POLICY OPTIONS FOR REGULATING MARIJUANA IN CALIFORNIA*, 48 (2015), available at <https://www.safeandsmartpolicy.org/wp-content/uploads/2015/07/BRCPathwaysReport.pdf> [hereinafter BRC Report] (on file with *The University of the Pacific Law Review*) (pointing out how increased revenue is one of the reasons supporting legalization in California).

11. See, BEAU KILMER ET AL., RAND DRUG POL’Y RES. CTR., *CONSIDERING MARIJUANA LEGALIZATION: INSIGHTS FROM VERMONT AND OTHER JURISDICTIONS* 76–77 (2015) (reviewing the complexities and nuances of taxing marijuana).

12. See *id.* at 76 (pointing out that in addition to the tax level, legislatures must also determine when and how to tax marijuana).

13. See BRC Report, *supra* note 10, at 48 (highlighting that a successful marijuana tax system will generate revenue for “increased education, public health, and enforcement costs associated with marijuana cultivation and use”).

14. See CAULKINS ET AL., *supra* note 10, at 216. (highlighting that the “general absence of disaster” in Colorado and Washington is good in and of itself); see also Katelyn Newman, *Milestoned: Colorado Pot Tax Revenue Surpasses \$500M*, U.S. NEWS (July 20, 2017), <https://www.usnews.com/news/best-states/colorado/articles/2017-07-20/colorado-pot-tax-revenue-surpasses-500-million> (on file with *The University of the Pacific Law Review*) (highlighting the revenue that Colorado and Washington have generated from the marijuana market).

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eyes are on the Golden State as it seeks to become the “golden standard of legalization.”¹⁵ Certainly, with the country’s top population and the sixth biggest economy in the world, California’s impact on marijuana will be massive.¹⁶ Some projections estimate that California could generate around \$1 billion in tax revenue alone.¹⁷ Now, state officials in California are ready to start spending the money that recreational marijuana may bring.¹⁸ Nonetheless, successfully generating revenue off the recreational market largely depends on unknowable, and unpredictable, variables.¹⁹

Although Colorado and Washington have generated plenty of revenue from their markets, the differences between each state make revenue projections unpredictable.²⁰ Further, any marijuana tax regime “will not fit for long” because the “industry will evolve in unpredictable ways.”²¹ For instance, high prices when legal sales begin could polarize consumers toward the illicit market and stall industry growth.²² At the same time, low prices could undercut a state’s revenue goals.²³ Moreover, marijuana’s illegal status under federal law contributes to the recreational market’s volatility.²⁴ Along these lines, criminal enforcement, banking, and IRS tax rules have the potential to slow down market growth and decrease revenue.²⁵ Additionally, with the oldest medical marijuana industry in the country, California presents a unique challenge for regulators.²⁶

15. Margolin, *supra* note 8.

16. Josh Sanburn, *States Lean Left on Local Votes*, TIME, Nov. 21, 2016, at 16.

17. LEGISLATIVE ANALYST’S OFFICE, PROPOSITION 64: MARIJUANA LEGALIZATION INITIATIVE STATUTE 1 (July 20, 2016), available at <http://www.lao.ca.gov/ballot/2016/Prop64-110816.pdf> (on file with *The University of the Pacific Law Review*).

18. See Thomas Fuller, *Marijuana Industry Presses Ahead in California’s Wine Country*, N.Y. TIMES (Mar. 18, 2017) https://www.nytimes.com/2017/03/18/us/california-marijuana-wine-country.html?_r=0 (on file with *The University of the Pacific Law Review*) (describing California local official’s eagerness to embrace the marijuana industry).

19. See Michael Vitiello, *Legalizing Marijuana and Abating Environmental Harm: An Overblown Promise?*, 50 U.C. DAVIS L. REV. 773, 782 (2016) (discussing that additional tax revenue depends on “many variables, including methods of implementation of Marijuana laws”).

20. See MILES LIGHT ET AL., MARIJUANA POL’Y GRP., THE ECONOMIC IMPACT OF MARIJUANA LEGALIZATION IN COLORADO 20 (2016) (observing the variance between “regulatory structures” due to the unique “legalization processes” in each state).

21. KILMER ET AL., *supra* note 11, at 88.

22. See *id.* at 78 (discussing how high prices will benefit “bootleggers” in the black and “fake medical market” rather than the legal market).

23. See *id.* (observing how lower prices will cause a decline in revenue generated from marijuana sales).

24. BRC Report, *supra* note 10, at 15.

25. *Id.* at 15.

26. *Id.* at 12.

Accordingly, a sound cannabis tax scheme must plan for these and other uncertainties.²⁷

A tax regime that strives for fast income will be more susceptible to the unstable conditions of the market.²⁸ While most of the current discussion focuses on how those unpredictable conditions will negatively impact the cannabis industry's potential for tax revenue, this Article seeks to broaden the discussion of those factors within the legislature's control to maximize revenue.²⁹ Specifically, this Article focuses on how to minimize risk in the recreational market and facilitate its growth.³⁰ This Article will demonstrate that California should adopt several mechanisms for adjusting the marijuana tax rate, as recommended in the RAND report, because the current tax scheme is too aspiring and will result in slower market growth over time.³¹ Examples of such mechanisms include scheduling future tax rate increases and exploiting untapped tax bases.³² Indeed, a tax scheme that focuses on a short rate of return rather than long term gain will fail to optimize cannabis tax revenue.³³ By minimizing risk and facilitating market growth, California could be the golden standard of the cannabis industry.³⁴

Part II of this Article is divided into five parts. Part II examines how federal law may impact the amount of revenue generated from the recreational market.³⁵ It then provides background on various methodologies used to measure and collect marijuana taxes.³⁶ It will also examine the tax schemes in the recreational markets of Colorado and Washington.³⁷ Part II then discusses California's unique history with marijuana, as well as its medical and recreational marijuana structures.³⁸

Part III discusses the potential issues that may percolate under Proposition 64's tax regime,³⁹ such as the implications of the tax base and collection point

27. Pat Ogelsby, *Best Marijuana Taxes Yet: California's Proposition 64*, HUFFINGTON POST (Nov. 8, 2016, 5:38 PM), http://www.huffingtonpost.com/pat-ogelsby/best-marijuana-taxes-yet-_b_12354248.html (on file with *The University of the Pacific Law Review*).

28. KILMER ET AL., *supra* note 11, at 88.

29. *Infra* Part IV.

30. *Infra* Part IV.

31. *Infra* Part V.

32. *Infra* Part IV.B.

33. See KILMER ET AL., *supra* note 11, at 88 (predicting that the "marijuana market will not soon be stable" and that "revenue would suffer from too ambitious a tax plan").

34. *Infra* Part V.

35. *Infra* Part II.A

36. *Infra* Part II.B

37. *Infra* Part II.C

38. *Infra* Part II.D

39. *Infra* Part III.A

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under Prop. 64.⁴⁰ It also examines how federal law may impact the success of California's tax scheme.⁴¹

Part IV considers potentially unexploited tax bases, and where opportunities for tax evasion may exist.⁴² Lastly, part IV examines practical implications of adopting mechanisms for adjusting the tax rate, alongside additional tax bases.⁴³ Part V concludes that the proposed changes, if adopted, would reduce tax evasion in California, reduce the illicit market, facilitate the legal market, and minimize the future risk in the market.⁴⁴

II. PUTTING THE PUZZLE OF MARIJUANA POLICY TOGETHER

This part addresses the history and present status of marijuana under federal law.⁴⁵ Next, it provides background information on different types of excise tax bases commonly used for taxing marijuana.⁴⁶ Then, it discusses at what point in the supply chain marijuana taxes are levied and collected.⁴⁷ Additionally, this section describes the current marijuana tax regimes in both Colorado and Washington.⁴⁸ Finally, it details the history of California's unique relationship with marijuana, as well as its current medical and recreational marijuana structures.⁴⁹

A. *Federal Law*

Marijuana's relationship with the federal government is not only long and complex, but also highly unstable.⁵⁰ Beginning in the 1930s, Harry Anslinger undertook an unfounded, propaganda filled campaign, establishing a demonized caricature of cannabis in the public discourse.⁵¹ This effort culminated in 1937,

40. *Infra* Part III.B

41. *Infra* Part III.C

42. *Infra* Part IV.A

43. *Infra* Part IV.B

44. *Infra* Part V.

45. *Infra* Part II.A.

46. *Infra* Part II.B.

47. *Infra* Part II.C.

48. *Infra* Part II.D.

49. *Infra* Part II.E.

50. See generally Bonnie & Whitebread, *supra* note 2 (reviewing the historic origin of marijuana prohibition and public discourse in the United States).

51. See Michael Vitiello, *Legalizing Marijuana: California's Pot of Gold?*, 2009 WIS. L. REV. 1349, 1357 (2009) (reviewing Harry Anslinger's aggressive enforcement of marijuana laws through the use of unscientific claims and "appeal to racism and hysteria").

when Congress essentially criminalized possession of marijuana with the passage of the Marijuana Tax Act.⁵² This theme continued with the passing of the Boggs Act in 1951, which increased punishments for marijuana possession.⁵³ In 1970, the passing of the Controlled Substances Act classified marijuana a Schedule 1 substance.⁵⁴ Drugs classified as Schedule 1 are found to have a high potential for abuse and no known medical use.⁵⁵ In *Gonzalez v. Raich*, the Supreme Court held that it was constitutional for Congress to regulate marijuana under the Commerce Clause to the U.S. Constitution.⁵⁶ Thus, even in states where cannabis is legal, like in California, it remains illegal under federal law.⁵⁷ The punishment for possessing, selling or manufacturing⁵⁸ a Schedule 1 substance is severe.⁵⁹ Hence, the potential negative impact of federal law on state recreational markets is hard to ignore.⁶⁰

In 2013, under the Obama administration, the Department of Justice (DOJ) outlined eight enforcement priorities for U.S. attorneys in a memorandum issued by Deputy Attorney General James Cole (Cole Memorandum II).⁶¹ In 2014, the DOJ and U.S. Treasury Department's Financial Crimes Enforcement Network (FinCEN) released new banking guidelines aimed at lessening restrictions on access to financial services for the marijuana industry.⁶² In other words, the DOJ and FinCEN intended for the documents to leave alone those market participants who are following state law.⁶³ While this was an improvement from the federal government's past enforcement policies, it was ineffective in resolving many of

52. Marihuana Tax Act of 1937, 75 P.L. 238 (repealed 1970).

53. Act of Nov. 2, 1951, ch. 666, 65 STAT. 767, as cited in Bonnie & Whitebread, *supra* note 2, at 1054.

54. 21 U.S.C. § 812(c) (2012); BRC Report, *supra* note 10, at 56.

55. 21 U.S.C. § 812(b)(1) (2016); Erwin Chemerinsky et al., *Cooperative Federalism and Marijuana Regulation*, 62 UCLA L. REV. 74, 81–82 (2015).

56. *Gonzales v. Raich*, 545 U.S. 1, 32–33 (2005) (holding that Congress may criminalize marijuana under the Commerce Clause to the U.S. Constitution).

57. BRC Report, *supra* note 10, at 56.

58. Controlled Substance Act, 21 U.S.C. § 841(a)(1) (2016).

59. Chemerinsky et al., *supra* note 55, at 82–83; Memorandum from James M. Cole, Deputy Attorney General to All U.S. Attorneys 1-2 (Aug. 2013) [hereinafter Cole Memo II], available at <https://www.justice.gov/iso/opa/resources/3052013829132756857467.pdf> (on file with *The University of the Pacific Law Review*).

60. See Robert Mikos, *State Taxation of Marijuana Distribution and Other Federal Crimes*, 2010 U. CHI. LEGAL F. 223, 248–249 (2010) (highlights the increased risk for tax evasion when considering federal law).

61. Cole Memo II, *supra* note 59; Chemerinsky et al., *supra* note 55, at 77–78.

62. See, FIN. CRIMES ENF'T NETWORK, U.S. DEP'T OF THE TREASURY, FIN-2014-G001: BSA EXPECTATIONS REGARDING MARIJUANA-RELATED BUSINESSES (Feb. 14, 2014), available at <http://1.usa.gov/1U11dIK> (on file with *The University of the Pacific Law Review*) [hereinafter FinCEN Guidance]; Rachel Cheasty Sanders, *To Weed or Not to Weed? The Colorado Quandary of Legitimate Marijuana Businesses and the Financial Institutions Who Are Unable to Serve Them*, 120 PENN ST. L. REV. 281, 295 (2015).

63. See Sanders, *supra* note 62 (reviewing the specific procedures under FinCEN guidance that banks must follow).

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the significant problems that arise under federal law in relation to recreational marijuana.⁶⁴ Moreover, Jefferson Sessions, the current Attorney General, under the new administration, has signaled his intent to increase the level of enforcement of federal drug laws.⁶⁵ But action has yet to be taken, and some in the industry believe that the momentum of legalization might be enough to stop any strict enforcement policy.⁶⁶ Recently, legislators have proposed laws to reform marijuana laws at the federal level, but the effect of this remains to be seen.⁶⁷

Nevertheless, issues with banking and tax law create several uncertainties for the recreational market.⁶⁸ First, businesses in the marijuana industry have limited access to banking services.⁶⁹ This forces the industry to operate on a cash only basis.⁷⁰ One consequence of this is that “dispensaries that operate as cash businesses... [become]... targets of robbery and violent crime.”⁷¹ Further, “it leads to massive cash payments being delivered to tax-collecting agencies.”⁷² Certainly, better access to banking will help the recreational marijuana market thrive.⁷³

Second, IRS tax rules present another challenge facing the recreational market.⁷⁴ Federal Tax Rule section 280E “requires . . . businesses . . . in violation

64. Chemerinsky et al., *supra* note 55, at 89–90.

65. Alex Pasquariello, *Here’s How Jeff Sessions Has Disrupted the Marijuana Industry with Words Alone*, THE CANNABIST (Apr. 21, 2017, 8:14 AM), <http://www.thecannabist.co/2017/04/21/jeff-sessions-marijuana-legalization-impact/77938/> (on file with *The University of the Pacific Law Review*).

66. Aaron Smith, *Marijuana Businesses Worry About Trump, But Expect to Prevail*, CNN (June 8, 2017, 9:06 AM), <http://money.cnn.com/2017/04/17/smallbusiness/trump-sessions-marijuana/> (on file with *The University of the Pacific Law Review*).

67. Mollie Reilly, *New Legislation Would Force The Federal Government To Treat Marijuana Like Alcohol*, HUFFINGTON POST (Mar. 30, 2017, 2:15 PM), http://www.huffingtonpost.com/entry/marijuana-reform-bills_us_58dd2504e4b0e6ac7092d842 (on file with *The University of the Pacific Law Review*) (reviewing bills that have been “introduced in the U.S. Senate and House” to reform federal marijuana laws).

68. Chemerinsky et al., *supra* note 55, at 77 (noting that the conflict between state and federal marijuana laws “create debilitating instability and uncertainty” in states taking a novel approach to regulating marijuana).

69. BRC Report, *supra* note 10, at 17; Chemerinsky et al., *supra* note 55, at 91.

70. *See* BRC Report, *supra* note 10, at 17 (describing the risks dispensaries face operating as a cash only business because of limited access to banks); *see also* Chemerinsky et al., *supra* note 55, at 91 (pointing out how marijuana “businesses often have no choice but to keep large quantiles of cash on hand”).

71. BRC Report, *supra* note 10, at 17; Chemerinsky et al., *supra* note 55, at 91.

72. BRC Report, *supra* note 10, at 17; Chemerinsky et al., *supra* note 55, at 91.

73. *See* Alice Wallace, *New Federal Bill Would Allow Banking for Marijuana Businesses*, THE CANNABIST (Apr. 27, 2017, 12:20 PM), <http://www.thecannabist.co/2017/04/27/federal-marijuana-banking-bill-congress-perlmutter/78531/> (on file with *The University of the Pacific Law Review*) (highlighting the current issues with federal guidance on state marijuana regulations and the proposed changes to federal regulation of marijuana).

74. Chemerinsky et al., *supra* note 55, at 94.

of federal drug laws ... to pay federal income tax.”⁷⁵ But, section 280E does not allow businesses in the cannabis industry to deduct expenses before calculating taxable income.⁷⁶ For example, marijuana businesses cannot deduct “rent, employee payroll, lights, and heating and cooling;” which other businesses can normally deduct.⁷⁷ The only deductions allowed under section 280E are “the cost of goods sold [and] amounts paid to produce or purchase marijuana.”⁷⁸ Interestingly, Washington’s 37% excise tax at the point of sale may circumvent the issue under section 280E by shifting the tax to the consumer.⁷⁹ Nevertheless, section 280E presents another limitation to generating tax revenue from marijuana.⁸⁰

B. How Are Marijuana Taxes Measured?

Excise taxes are primarily used to measure tax rates for marijuana.⁸¹ An excise tax is “a specific tax on a product (as we have for alcohol, cigarettes, gasoline) that is above and beyond the standard sales tax charged on nearly all products.”⁸² An excise tax can have several different tax bases, and each tax base is subject to its own strength and weaknesses.⁸³ This section mainly focuses on three common bases used to measure marijuana excise taxes: (1) ad valorem, (2) weight-based, and (3) potency-based.⁸⁴ It also briefly considers real estate and electricity-based excise taxes.⁸⁵

1. Ad Valorem (percentage-of-price)

Most states that have legalized medical and recreational marijuana use an ad valorem (percentage-of-price) as a tax base.⁸⁶ Ad valorem taxes are cost efficient

75. I.R.C. § 280E (2006), as cited in Chemerinsky et al., *supra* note 55, at nn94.

76. Chemerinsky et al., *supra* note 55, at 94.

77. *Id.*

78. KILMER ET AL., *supra* note 11, at 87-88.

79. *Id.*

80. Chemerinsky et al., *supra* note 55, at 94.

81. See BRC Report, *supra* note 10, at 49 (noting that the “discussion of marijuana is mainly about excise taxes”).

82. *Id.*

83. See KILMER ET AL., *supra* note 11, at 76 (considering a list of 7 criteria when evaluating tax bases: (1) Prevention of after-tax price collapse; (2) swiftness of initial tax assessment; (3) potential for cheating; (4) simplicity; (5) cost to set up the tax; (6) cost to maintain the tax; (7) whether the base allows for revenue maximization as the industry evolves).

84. *Infra* Parts II.B.1–II.B.3

85. *Infra* Part II.B.4.

86. See KILMER ET AL., *supra* note 11, at 77 (highlighting that Colorado and Washington’s use of price

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and easy to set up.⁸⁷ At the same time, ad valorem taxes also have some disadvantages.⁸⁸ First, an ad valorem tax magnifies any fluctuation of marijuana prices.⁸⁹ Because this tax is based on a percentage of the price, if the pre-tax price fluctuates, a price-based tax will amplify that change.⁹⁰ Consequently, when legal sales begin, high pre-tax prices could polarize consumers toward the black and medical market and stall industry growth.⁹¹ On the other hand, a drop in price could undercut the state's expected revenue.⁹² Furthermore, low pre-tax prices could lead to higher rates of "youth use, abuse, and leakage to other states."⁹³ Second, priced-based taxes can be manipulated by using fake transfers or bundling.⁹⁴ Bundling occurs when marijuana is grouped together with other products and taxed at a lower rate.⁹⁵ Fake transfers occur when two parties, who are either the same or closely related, agree on a price that undercuts the tax rate.⁹⁶ On balance, the simplicity and ease of this type of base makes it an appropriate measuring tool for cannabis tax policy.⁹⁷

2. Weight

Alternatively, a tax on cannabis can be measured by weight.⁹⁸ Weight-based taxes guarantee revenue, even in the event of a price collapse.⁹⁹ But weight-based

based taxes for recreational marijuana, and that "many localities have enacted price based taxes on medical marijuana.")

87. *See id.* at 78. (discussing that price based taxes are "simple... [and do] not require indexing or equipment" like weight based taxes); *see also* BRC Report, *supra* note 10, at 49 (discussing the simplicity of price based taxes that do not require regulators to measure "the weight or potency of a product").

88. CAULKINS, KILMER & KLEIMAN, *supra* note 10, at 136.

89. CAULKINS, KILMER & KLEIMAN, *supra* note 10, at 136.

90. *Id.* at 136.

91. *See* KILMER ET AL., *supra* note 11, at 78. (discussing how high prices will benefit "bootleggers," in the black and "fake medical market" rather than the legal market).

92. *See id.* (observing how lower prices will cause a decline in revenue generated from marijuana sales).

93. *Id.*

94. *E.g.*, CAULKINS, KILMER & KLEIMAN, *supra* note 10, at 136 (pointing out that the problem with ad valorem taxes is that it can be "bundled with another product or service"); KILMER ET AL., *supra* note 11, at 78. (highlighting that a problem with price based tax is that it can be manipulated or gamed).

95. KILMER ET AL., *supra* note 11, at 78–79.

96. *Id.* at 79.

97. *See id.* at 78 (discussing that price based taxes are "simple . . . [and do] not require indexing or equipment" like weight based taxes); *see also* BRC Report, *supra* note 10, at 49 (discussing the simplicity of price based taxes that do not require regulators to measure "the weight or potency of a product").

98. *E.g.*, CAULKINS, KILMER & KLEIMAN, *supra* note 10, at 136 (noting that "marijuana taxes could be assessed per unit weight"); BRC Report, *supra* note 10, at 50–51 (Assessing the advantages and disadvantages of a weight based marijuana tax).

99. *See* BRC Report, *supra* note 10, at 50 (observing that marijuana revenue will still be generated with a weight base tax "even in the event of marijuana price collapse"); *see also* KILMER ET AL., *supra* note 11, at 77;

taxes are complex because they take longer to set up, and must be indexed for inflation.¹⁰⁰ For example, different parts of the cannabis plant, such as flower and trim, are usually taxed at different rates.¹⁰¹ The “flowering tops of female [cannabis] plants . . . which [are] valued for [their] high THC¹⁰² content, enhanced appearance, and a more intense aroma” produces marijuana.¹⁰³ These flowering tops are also commonly referred to as “bud,” and once dried and crushed, they can be smoked in a joint or bowl, vaporized, or used to make concentrates.¹⁰⁴ Trim, on the other hand, includes the rest of the plant material, such as the stems and leaves, and often contains a lower THC content.¹⁰⁵ Usually, marijuana growers process trim to make other forms of marijuana products, such as concentrates or edibles.¹⁰⁶ Because of the difficulty distinguishing between bud and trim, cultivators often attempt to mischaracterize their product to evade paying higher taxes.¹⁰⁷ Moreover, marijuana’s weight fluctuates as it loses moisture.¹⁰⁸ Thus, it is important to choose a collection mechanism that accounts for this factor.¹⁰⁹ In addition, taxing by weight encourages distributors to increase the total THC content in their product.¹¹⁰ By increasing the total value without increasing the weight, a cultivator can evade paying some taxes.¹¹¹ By extension,

Oglesby, *supra* note 27 (pointing out that “an indexed tax based on observable weight is inherently flexible and should survive a price collapse”).

100. KILMER ET AL., *supra* note 11, at 77; See Oglesby, *supra* note 27 (observing that weight based taxes take time to set up); See BRC Report, *supra* note 10, at 50–51 (highlighting the importance of properly indexing a weight-based marijuana tax for inflation).

101. See KILMER ET AL., *supra* note 11, at 82–83 (observing the different tax rates Colorado and other states apply to marijuana trim and bud).

102. See Rae Lland, *What is THC?*, LEAFLY, <https://www.leafly.com/news/cannabis-101/what-is-tetrahydrocannabinol> (last visited Mar. 30, 2017) (on file with *The University of the Pacific Law Review*) (THC or delta-9-tetrahydrocannabinol is “one of the main psychoactive ingredients in and one of the most responsible for its intoxicating effects”).

103. Lyle Craker & Zoe Gardner, *The Botany of Cannabis*, in *THE POT BOOK: A COMPLETE GUIDE TO CANNABIS* 35, 43 (Julie Holland ed., 2010).

104. KILMER ET AL., *supra* note 11, at 83–84; Craker & Gardner, *supra* note 103, at 43.

105. See KILMER ET AL., *supra* note 11, at 83 (highlighting that “bud is generally stronger than trim”).

106. *Id.*

107. See *id.* (pointing out the danger in tax evasion at the margins of determining what bud and trim actually are).

108. See BRC Report, *supra* note 10, at 50 (discussing the potential future issues about “how to account for the fact that, as a harvested plant, marijuana will change in weight as it loses moisture”).

109. *Id.*

110. *E.g., id.* (discussing how a weight based tax could encourage production of high the products); CAULKINS, KILMER & KLEIMAN, *supra* note 10, at 136 (highlighting the incentive in lowering “the tax per hour of intoxication”).

111. *E.g., BRC Report, supra* note 10, at 51 (discussing how a weight based tax could encourage production of high the products); CAULKINS, KILMER & KLEIMAN, *supra* note 11, at 136; KILMER ET AL., *supra* note 11, at 83 (highlighting the incentive in lowering “the tax per hour of intoxication”).

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this “pushes the industry away from mass production [and] toward organic, artisanal, and other high-value-added products.”¹¹² Although a weight-based tax has several flaws, its protection against a price collapse is important for a sound cannabis tax scheme.¹¹³

3. Potency

Like the alcohol industry, cannabis taxes could be based on potency.¹¹⁴ In theory, a potency-based tax would likely be correlated to the THC content of marijuana.¹¹⁵ Scholars have recommended lowering the tax rate based on the presence of cannabidiol (CBD).¹¹⁶ A potency-based tax can also be used as a secondary tax.¹¹⁷ For example, if there is no system in place for the state to check the validity of the alleged THC content of cannabis, one option is to “use the seller’s reported or claimed THC content as a secondary or backup alternative minimum tax.”¹¹⁸

However, there are several limitations to a potency-based tax.¹¹⁹ Although concentrates and edibles typically have a measurable THC content, the THC content of a marijuana flower is often inconsistent and varies immensely.¹²⁰ Because accuracy is the crux of assessing taxes based on potency, it is vital to have standardized testing in place.¹²¹ For instance, if the THC content is overstated, then consumers would be paying a higher tax for a lesser product.¹²²

112. KILMER ET AL., *supra* note 11, at 77.

113. See BRC Report, *supra* note 10, at 50 (observing that marijuana revenue will still be generated with a weight base tax “even in the event of marijuana price collapse”).

114. CAULKINS, KILMER & KLEIMAN, *supra* note 10, at 136.

115. See BRC Report, *supra* note 10, at 51 (discussing the potential for a potency based tax on THC in concentrate form prior to being processed into other products, such as edibles, “might yield reliable and predictable results”).

116. BRC Report, *supra* note 10, at 51; *What Is CBD?*, PROJECT CBD, <https://www.projectcbd.org/about/what-cbd> (last visited Aug. 6, 2017) (on file with *The University of the Pacific Law Review*) (“Cannabidiol—CBD—is a cannabis compound that has significant medical benefits, but does not make people feel ‘stoned’ and can actually counteract the psychoactivity of THC.”).

117. KILMER ET AL., *supra* note 11, at 84.

118. *Id.* (Emphasis removed).

119. KILMER ET AL., *supra* note 11, at 80–81; see also BRC Report, *supra* note 10, at 51 (observing that that a potency based tax may become more effective when “further capacity for testing, supply chain-management, and labeling are in place”).

120. BRC Report, *supra* note 10, at 51; CAULKINS, KILMER & KLEIMAN, *supra* note 10, at 136–37; KILMER ET AL., *supra* note 11, at 81–82.

121. BRC Report, *supra* note 10, at 51 (observing that that a potency based tax may become more effective when “further capacity for testing, supply chain-management, and labeling are in place”).

122. See, KILMER ET AL., *supra* note 11, at 84 (pointing out that “sellers could dodge the tax entirely by falsely understating the THC content”).

Alternatively, underreporting the THC content may result in tax evasion.¹²³ In addition, the price of cannabis does not always correlate to the THC content because factors such as the blend of cannabinoids or aesthetic appeal may be more important to the specific consumer.¹²⁴ Currently, there are no states that implement a potency based tax for cannabis.¹²⁵ As the industry evolves and testing standards improve, this type of tax base may become more prevalent.¹²⁶

4. *Electricity and Real Estate*

Taxes could also be measured by the amount of space used to grow marijuana.¹²⁷ For example, “Rancho Cordova, California, taxes each 12.5 sq. ft. of outdoor grow area at the same rate as one indoor square foot.”¹²⁸ This type of tax is easy to start, collect, and “overlaps with administrative oversight.”¹²⁹ However, “a square-footage base correlates poorly with potency,” making it unlikely that it becomes the primary tax base.¹³⁰

An excise tax on marijuana could be based on electricity used for indoor grows.¹³¹ For example, Arcata, California “presumes that abnormally high use of electricity correlates with marijuana growing under high-powered lights.”¹³² Accordingly, they city levies a higher electrical excise tax on those using higher amounts of electricity.¹³³ This not only creates additional revenue, but also minimizes environmental damage from heavy electricity use.¹³⁴ Because of the narrow nature of the taxes, they work best in conjunction with other tax bases.¹³⁵

123. *Id.*

124. *See id.* at 78 (observing that “high price does not always mean high potency”).

125. *Id.* at 80.

126. *See* BRC Report, *supra* note 10, at 51 (observing that that a potency based tax may become more effective when “further capacity for testing, supply chain-management, and labeling are in place”).

127. *See* KILMER ET AL., *supra* note 11, at 84–85 (noting that “for medical marijuana, many California localities tax growing area”).

128. *Id.* at 84.

129. *See id.* (stating that a square footage base tax would only be “moderately difficult to set up and collect . . . just requiring decisions about exactly what square footage to count”).

130. *Id.* at 85.

131. KILMER ET AL., *supra* note 11, at 85.

132. *Id.*

133. *Id.*

134. *Id.*

135. *Id.* at 84–85.

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C. Collecting Marijuana Taxes

Equally important for a sound cannabis tax scheme is determining where to collect the tax.¹³⁶ The collection point is usually determined by the type of base being used.¹³⁷ Taxes on cannabis are primarily assessed during (1) cultivation or (2) retail sales.¹³⁸ If there are additional stages of production, the state could assess taxes at that point too.¹³⁹

Ideally, the tax should be assessed at the point with the fewest number of people and locations; this is commonly referred to as a choke point.¹⁴⁰ For example, it is easier to collect taxes from a small industry with large corporations than a larger industry with smaller participants.¹⁴¹ However, taxing at the source of production, where there may be more market participants, allows regulators to collect taxes earlier, and identify illegal product sooner.¹⁴² Conversely, a tax assessed at retail has the advantage of increasing revenue.¹⁴³ That is because the price of cannabis is higher in the later stages of production.¹⁴⁴ Nevertheless, there is an advantage to multiple collection points:¹⁴⁵ it gives regulators more oversight, so the chance of tax evasion decreases.¹⁴⁶ Thus, selecting the right collection point is vital for ensuring consistent streams of revenue.¹⁴⁷

D. Cannabis Tax Policy in the ‘Mile-High’ and ‘Evergreen’ States

This part discusses the modern tax scheme in Colorado’s legal marijuana market.¹⁴⁸ It then examines the current tax regime in Washington’s recreational marijuana market.¹⁴⁹

136. *See id.* at 87 (observing that after deciding how the tax will be measured, “jurisdictions that decide to tax marijuana need to decide where the tax will be collected”).

137. *Id.* at 87.

138. BRC Report, *supra* note 10, at 52.

139. *Id.*

140. KILMER ET AL., *supra* note 11, at 87; *but see* BRC Report, *supra* note 10, at 52, 53 (observing the advantages of early tax collection, which would be “the opposite of a choke point”).

141. KILMER ET AL., *supra* note 11, at 87.

142. BRC Report, *supra* note 10, at 53.

143. *Id.*

144. *Id.*

145. *Id.* at 54.

146. *Id.* at 54.

147. *See* KILMER ET AL., *supra* note 11, at 87 (highlighting that selecting a collection point has “important implications for the industry structure, state budgets, and the black market”).

148. *Infra* Part II.D.1.

149. *Infra* Part II.D.2.

1. *Colorado*

In November 2012, Colorado legalized cannabis by passing Amendment 64.¹⁵⁰ The law allows persons 21 years or older to purchase up to one ounce of cannabis daily,¹⁵¹ while limiting home cultivation to six plants.¹⁵² The Department of Revenue oversees the marijuana industry, which shares similar features with the states regulatory structure on alcohol, particularly liquor.¹⁵³ Colorado does not limit potency, bans selling alcohol and/or tobacco and cannabis together, and allows coupons.¹⁵⁴

Initially, Colorado had two ad valorem taxes on marijuana.¹⁵⁵ Currently, the tax on producers “has been de facto converted to a weight based tax” to avoid fraud.¹⁵⁶ Now, retail marijuana is subject to a 15% excise tax on the average market rate.¹⁵⁷ Generally, flower is taxed at a higher rate than trim.¹⁵⁸ The excise tax is then calculated by “multiplying the quantity of retail marijuana product by the average market rate at the time, then multiplying [it] by the 15% (excise tax rate).”¹⁵⁹ When consumers purchase marijuana, the purchase is subject to “the 2.9% state sales tax, 10% state marijuana sales tax[,]”¹⁶⁰ and any local sales taxes.”¹⁶¹ Prior to giving recreational use the thumbs-up, Colorado legalized the

150. *Colorado Marijuana Legalization Initiative, Amendment 64 (2012)*, BALLOTPEDIA, [https://ballotpedia.org/Colorado_Marijuana_Legalization_Initiative,_Amendment_64_\(2012\)](https://ballotpedia.org/Colorado_Marijuana_Legalization_Initiative,_Amendment_64_(2012)) (last visited Mar. 30, 2017) (on file with *The University of the Pacific Law Review*); see also Matt Ferner, *Amendment 64 Passes: Colorado Legalizes Marijuana For Recreational Use*, HUFFINGTON POST (Nov. 6, 2012, 11:24 PM), http://www.huffingtonpost.com/2012/11/06/amendment-64-passes-in-co_n_2079899.html (on file with *The University of the Pacific Law Review*) (summarizing Colorado’s passing of amendment 64).

151. COLO. CONST. art. XVIII, § 16(3)(a) (West, Westlaw through Nov. 2016 general election).

152. *Id.* (limiting the amount of mature plants to three).

153. CAULKINS, KILMER & KLEIMAN, *supra* note 10, at 217.

154. *Id.* at 217–18.

155. KILMER ET AL., *supra* note 11, at 77.

156. *Id.*

157. COLO. REV. STAT. § 39-28.8-302 (West 2015) amended by SB 17-192, 71st Gen. Assemb., Reg. Sess. (Colo. 2017); *Marijuana Taxes/Quick Answers*, COLO. DEP’T OF REVENUE: TAX’N DIVISION <https://www.colorado.gov/pacific/tax/marijuana-taxes-quick-answers> (last visited Apr. 19, 2017) (on file with *The University of the Pacific Law Review*). See also *Excise 23: Excise Tax on Retail Marijuana*, COLO. DEPT. OF REVENUE: TAXPAYER SERV. DIVISION 1 (June 2016), <https://www.colorado.gov/pacific/sites/default/files/Excise23.pdf> (on file with *The University of the Pacific Law Review*) (summarizing Colorado’s tax methodology on marijuana).

158. See *Marijuana Taxes/Quick Answers*, *supra* note 157 (summarizing Colorado’s tax methodology on marijuana); see also KILMER ET AL., *supra* note 11, at 83 (noting that “bud is generally stronger than trim”).

159. COLO. REV. STAT. § 39-28.8-302 (West 2015), amended by SB 17-192, 71st Gen. Assemb., Reg. Sess. (Colo. 2017); *Marijuana Taxes/Quick Answers*, *supra* note 157.

160. COLO. REV. STAT. § 39-26-106(1)(a)(II) (West 2015).

161. See *Marijuana Taxes/Quick Answers*, *supra* note 158 (summarizing Colorado’s Tax methodology on marijuana).

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use of medical marijuana in 2000.¹⁶² Medical marijuana is only exempt from the 10% state tax.¹⁶³ Unfortunately, the lack of a standardized monitoring system prior to legalization limits data pertaining to the medical market's impact on the economy.¹⁶⁴

Colorado assesses 15% excise tax on the first sale or transfer point of marijuana.¹⁶⁵ This transaction could occur between a cultivator, retailer, or a producer.¹⁶⁶ In other words, a tax collector can collect taxes “as early as possible in the supply chain.”¹⁶⁷ There is also a tracking system in place to track marijuana from seed to sale.¹⁶⁸ If the program works as intended, it prevents tax evasion and reduces the illicit market.¹⁶⁹ Further, the Department of Agriculture calibrates the scales used to determine the amount of the weight tax.¹⁷⁰ After the tax is paid, the state must still be notified before transport, and the shipment must be accompanied “by shipping manifests [and] in bags not more than a pound.”¹⁷¹ At first, Colorado required all marijuana businesses to be vertically integrated.¹⁷² This means “that only one company handles marijuana from farm to market—all the way from seedling to retail sale, with no sellers in between.”¹⁷³ This potentially leads to fraud and tax evasion, however, because transactions normally labeled as sales are now intra-company transfers.¹⁷⁴ As follows, Colorado no longer requires vertical integration; however, many market participants have decided to remain vertically integrated.¹⁷⁵

162. *Colorado Medical Use of Marijuana, Initiative 20 (2000)*, BALLOTPEDIA [http://ballotpedia.org/Colorado_Medical_Use_of_Marijuana_Initiative_20_\(2000\)](http://ballotpedia.org/Colorado_Medical_Use_of_Marijuana_Initiative_20_(2000)) (last visited Apr. 20, 2015) (on file with *The University of the Pacific Law Review*).

163. *See Marijuana Taxes/Quick Answers, supra* note 157 (summarizing Colorado's Tax methodology on marijuana); *Colorado Sales/Use Tax Rates, see also* COLO. DEP'T OF REVENUE: TAXPAYER SER'V DIV. (Dec. 2016), <https://www.colorado.gov/pacific/sites/default/files/DR1002.pdf> (last visited Apr. 19, 2017) (listing Colorado “sales/use tax rates [on marijuana] throughout the state”) (on file with *The University of the Pacific Law Review*); BRC Report, *supra* note 10, at 53.

164. LIGHT ET AL., *supra* note 20, at 15.

165. *Excise 23, supra* note 157.

166. *Id.*

167. BRC Report, *supra* note 10, at 53.

168. KILMER ET AL., *supra* note 11, at 87.

169. *See* KILMER ET AL., *supra* note 11, at 87 (Describing the intention of Colorado and Washington to use their tracking system “to prevent leakage [&] diversion of legally grown product before collection of tax.” “The main argument for requiring vertical integration is that, when there is only one company to deal with, regulations are easier to administer and taxes are easier to collect”).

170. BRC Report, *supra* note 10, at 50.

171. *Id.*

172. KILMER ET AL., *supra* note 11, at 79.

173. *Id.*

174. KILMER ET AL., *supra* note 11, at 79; LIGHT ET AL., *supra* note 20, at 20.

175. KILMER ET AL., *supra* note 11, at 79; *see also* LIGHT ET AL., *supra* note 20, at 20–21 (summarizing

After a slow start, marijuana sales in Colorado have steadily increased tax revenue.¹⁷⁶ In 2014, Colorado made a total of \$63.4 million in tax revenue.¹⁷⁷ The following year, Colorado generated \$121.1 million in revenue from roughly \$1 billion in marijuana sales.¹⁷⁸ In 2016, Colorado generated close to \$200 million in revenue and nearly \$1.3 billion in sales.¹⁷⁹ Remarkably, in a study conducted by the Marijuana Policy Group (MPG), researchers found that the increase in total revenue is primarily driven by consumers transitioning from the illicit to recreational market, rather than an increase in overall demand.¹⁸⁰ In addition, the study found that tourism is also driving the increase in generating revenue from cannabis.¹⁸¹ In 2015, “77.7 million visitors who spent an all-time high of \$19.1 billion,” was a nearly 60% percent increase since 2012.¹⁸² In that same year, Denver’s hotel-room occupancy rate was at 76%, despite the opening of 14 new hotels in the metro area.¹⁸³ Similarly, after Oregon legalized cannabis, Washington noticed a decline in sales in counties along the border.¹⁸⁴

Additionally, the black market in Colorado continues to shrink but still takes up a share of the market.¹⁸⁵ Specifically, roughly 70% of market demand is met through legitimate retailers, while the rest is met through gray market suppliers (such as the medical market) or the black market.¹⁸⁶ In addition, legal but unregulated home growing accounted for 9% of the market.¹⁸⁷ Moreover, those

the history and current state of vertical integration in Colorado).

176. See Alicia Wallace, *Colorado Cannabis: \$1.3 Billion Worth of Marijuana Sold in 2016*, THE CANNABIST (Feb. 9, 2017, 5:25 PM), <http://www.thecannabist.co/2017/02/09/colorado-marijuana-sales-2016/73415/> (on file with *The University of the Pacific Law Review*) (summarizing the steady increase in generating revenue since legalization of marijuana in Colorado).

177. LIGHT ET AL., *supra* note 20, at 4, 18; Marijuana Tax Data, COL. DEP. OF REVENUE, <https://www.colorado.gov/pacific/revenue/colorado-marijuana-tax-data> (last visited Apr. 20, 2017) (on file with *The University of the Pacific Law Review*).

178. LIGHT ET AL., *supra* note 20, at 5.

179. *Here’s Where Colorado Spends Its Skyrocketing Pot Tax Revenue*, ENTREPRENEUR (Feb. 23, 2017), <https://www.entrepreneur.com/article/289613> (on file with *The University of the Pacific Law Review*); Wallace, *supra* note 176.

180. LIGHT ET AL., *supra* note 20, at 6.

181. *Id.* at 8.

182. Jason Blevins, *Colorado’s Mountain Resorts Again See Record Spending*, DENVER POST (Mar. 10, 2017), available at <http://www.denverpost.com/2017/03/10/colorado-mountain-resorts-record-spending/> (on file with *The University of the Pacific Law Review*) (Discussing the increase in tourism and spending in Colorado).

183. Ben Markus, *Denver Hotels See A ‘Quite Remarkable’ Year: Occupancy Up as Economy Grows*, COLO. PUBLIC RADIO (Jan. 27, 2016), <http://www.cpr.org/news/story/denver-hotels-see-quite-remarkable-year-occupancy-economy-grows> (on file with *The University of the Pacific Law Review*).

184. *Id.*

185. CAULKINS ET AL., *supra* note 10, at 219.

186. *Reeferegulatory Challenge*, THE ECONOMIST (Feb 13th 2016), <http://www.economist.com/news/briefing/21692873-growing-number-countries-are-deciding-ditch-prohibition-what-comes>.

187. LIGHT ET. AL, *supra* note 20, at 6.

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who had medical recommendations prior to Colorado legalizing marijuana continued to utilize the medical system to avoid paying the extra tax.¹⁸⁸ But does this revenue make an impact in the state?¹⁸⁹ Marijuana is making a small impact on the budget, but it is likely too early to tell.¹⁹⁰ Falling cannabis prices, alongside a greater number of states legalizing, leaves the future of Colorado's tax scheme uncertain.¹⁹¹ MPG predicts that sales in Colorado will slow down as the market saturates as more states continue to legalize.¹⁹² Thus, it remains unclear whether Colorado's success in generating tax revenue will continue.¹⁹³

2. Washington

In November 2012, Washington passed Initiative 502, legalizing recreational marijuana in that state.¹⁹⁴ Like Colorado, Washington has also based its model for the marijuana industry off of its alcohol model.¹⁹⁵ The Liquor and Cannabis Board is responsible for overseeing the marijuana regulatory system.¹⁹⁶ Washington voters first legalized medical cannabis in 1998 with the passage of Initiative 692.¹⁹⁷

Washington taxes marijuana by percentage of price.¹⁹⁸ Initially, Washington levied three 25% excise taxes at three different stages of production,¹⁹⁹ but issues began as soon as the legislature tried to fuse the recreational market and unregulated medical system together,²⁰⁰ leading to higher prices and slower growth.²⁰¹ Moreover, participants in the recreational market “complained of

188. CAULKINS, KILMER & KLEIMAN, *supra* note 12, at 228–29.

189. *Id.* at 218–219.

190. *Id.* at 218–219.

191. CAULKINS, KILMER & KLEIMAN, *supra* note 10, at 218; Jack Kaskey, *As Pot Prices Plunge, Growers Scramble to Cut Their Costs*, DENVER POST (Jan. 21, 2017, 11:07 AM), <http://www.denverpost.com/2017/01/21/marijuana-prices-plunge-growers-scramble/> (on file with *The University of the Pacific Law Review*).

192. LIGHT ET AL., *supra* note 20, at 6.

193. CAULKINS, KILMER & KLEIMAN, *supra* note 10, at 218–19.

194. *Washington Marijuana Legalization and Regulation, Initiative 502 (2012)*, BALLOTEDIA, https://ballotpedia.org/Washington_Marijuana_Legalization_and_Regulation,_Initiative_502_2012 (last visited Mar. 30, 2017) (on file with *The University of the Pacific Law Review*).

195. CAULKINS, KILMER & KLEIMAN, *supra* note 10, at 217.

196. *Id.*

197. *Washington Medical Marijuana, Initiative 692 (1998)*, BALLOTEDIA, [http://ballotpedia.org/Washington_Medical_Marijuana_Initiative_692_\(1998\)](http://ballotpedia.org/Washington_Medical_Marijuana_Initiative_692_(1998)) (last visited Apr. 20, 2017) (on file with *The University of the Pacific Law Review*).

198. BRC Report, *supra* note 10, at 49.

199. KILMER ET AL., *supra* note 11, at 77, citing WASH. REV. CODE § 69.50.535 (West 2015).

200. BRC Report, *supra* note 10, at 32; Ogelsby, *supra* note 27.

201. BRC Report, *supra* note 10, at 18.

unfair competition by medical dispensaries that were able to provide cheaper products [because of lower] tax rates.”²⁰²

Businesses in Washington then began to vertically integrate to evade paying the tax at different stages.²⁰³ In response, Washington legislators recently passed a bill reconciling the medical and recreational markets.²⁰⁴ Now, Washington levies a 37% ad valorem excise tax for both medical and recreational marijuana.²⁰⁵ The tax is assessed at the point of sale.²⁰⁶ Consequently, this has the added benefit of avoiding the federal tax issue under section 280E, and is discussed in more detail below.²⁰⁷ In addition, taxes are also assessed at the local level on both recreational and medical marijuana.²⁰⁸ However, medical marijuana is exempt from the 6.5% state sales tax.²⁰⁹ Moreover, Washington does not allow coupons or vertical integration and limits home grown marijuana only to medical patients.²¹⁰ The state also has a track and trace²¹¹ system in place, that if working as intended, should prevent tax evasion and leakage to other states.²¹²

202. *Id.* at 55.

203. Eliza Gray, *New Laws Chart Course for Marijuana Legalization*, TIME (Oct. 19, 2013), available at <http://nation.time.com/2013/10/19/new-laws-chart-course-for-marijuana-legalization/> (on file with *The University of the Pacific Law Review*) (Discussing the different approaches that Colorado and Washington have taken. For example, Colorado requires vertical integration, while Washington prohibits it”).

204. WASH. REV. CODE § 69.50.535 (West 2015); *FAQs on Taxes*, WASH. ST. LIQUOR & CANNABIS CONTROL BOARD, <http://lcb.wa.gov/mj2015/faqs-on-taxes> (last visited Aug. 5, 2017) (on file with *The University of the Pacific Law Review*); BRC Report, *supra* note 10, at 55; Rachel La Corte, *Washington State Pot Law Overhaul: Marijuana Tax Reset at 37%*, THE CANNABIST, <http://www.thecannabist.co/2015/07/01/washington-state-pot-law-overhaul-marijuana-tax-reset-at-37-percent/37238/> (last visited on Mar. 13, 2017) (on file with *The University of the Pacific Law Review*).

205. WASH. REV. CODE § 69.50.535 (West 2015); *FAQs on Taxes*, *supra* note 204; BRC Report, *supra* note 10, at 55; La Corte, *supra* note 204.

206. KILMER ET AL., *supra* note 11, at 87–88.

207. See BRC Report, *supra* note 10, at 18 (observing that Washington avoids the 280E issue “by shifting the tax to the retail level where the consumer pays”).

208. WASH. REV. CODE § 82.14.030 (West 2016).

209. WASH. REV. CODE § 82.08.020(1) (West 2016).

210. CAULKINS, KILMER & KLEIMAN, *supra* note 10 at 217–18; *Marijuana Licensing FAQ*, WASH. ST. LIQUOR & CANNABIS BOARD, http://lcb.wa.gov/mjlicense/mj_licensing_faq (last visited April 19, 2017) (on file with *The University of the Pacific Law Review*).

211. See KILMER ET AL., *supra* note 11, at 87 (describing the hope of Colorado and Washington to make the track and trace system efficient enough to “turn leakage and late collection into small problems”); see also Samantha Young, *California Considers Marijuana ‘Track and Trace’ system for Cannabis Industry*, GOV’T TECH. (Feb. 19, 2016), <http://www.govtech.com/state/California-Considers-Marijuana-Track-and-Trace-System-for-Cannabis-Industry.html> (on file with *The University of the Pacific Law Review*) (the “track and trace” system in states that have already legalized or have recently legalized, seeks to track cannabis from seed to sale to prevent tax evasion by tracking products from the beginning of production to the point of sale).

212. KILMER ET AL., *supra* note 11, at 87.

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In 2014, Washington collected \$16 million in excise tax revenue based on \$49 million in marijuana sales.²¹³ The following year, revenue reached a total of \$129 million based on \$486 million in total sales.²¹⁴ In 2016, Washington generated \$255 million in excise tax revenue and eclipsed \$1 billion in marijuana sales.²¹⁵ Washington does not limit potency and bans selling alcohol and tobacco where cannabis is also sold.²¹⁶ Like Colorado, tax revenue is making a small impact on the budget, but it is likely still too early to tell.²¹⁷ Like Colorado, falling prices and legalization in other states may significantly slow or even halt revenue growth in Washington.²¹⁸

E. The Road to Legalization in California

This subpart examines California's unique history with marijuana, as well as its medical and recreational marijuana structures.²¹⁹ It then discusses California's current medical marijuana regulations.²²⁰ Finally, it discusses the new tax scheme under Proposition 64 for California's recreational marijuana market.²²¹

1. California and Proposition 215

California's unique circumstances creates both advantages and challenges to regulating a recreational marijuana market.²²² For example, California is the most populous state in the country, with a population of 38 million people and home to some of the nation's largest cities.²²³ Further, California is home to a booming

213. See *Overview*, 502 DATA, <https://www.502data.com/> (last visited Apr. 1, 2017) (on file with *The University of the Pacific Law Review*) (summarizing overview of marijuana sales and revenue figures in Washington).

214. *Id.*

215. *Id.*

216. CAULKINS, KILMER & KLEIMAN, *supra* note 10, at 217–18.

217. See generally CAULKINS ET AL., *supra* note 10, at 218–19 (discussing the potential tax revenues in Colorado and Washington).

218. Keith Humphreys, *So, Something Interesting Happens to Weed After It's Legal*, THE WASH. POST (May 4, 2017), https://www.washingtonpost.com/news/wonk/wp/2016/05/04/the-price-of-legal-pot-is-collapsing/?utm_term=.61a8054bccf2 (on file with *The University of the Pacific Law Review*).

219. *Infra* Part II.E.1.

220. *Infra* Part II.E.2.

221. *Infra* Part II.E.3.

222. See BRC Report, *supra* note 10, at 10 (observing that California's unique circumstances “will require cannabis laws and regulations that are specifically tailored to California”).

223. *Id.*; see *Quick Facts: California*, U.S. CENSUS BUREAU, <https://www.census.gov/quickfacts/table/PST045215/06,00> (last visited Aug. 5, 2017) (on file with *The University of the Pacific Law Review*) (summarizing California's census data).

tourism industry with top destinations such as Golden Gate, Half Dome, and Hollywood and other attractions.²²⁴ But now, as pointed out by the Blue-Ribbon Commission, “some tourists will choose to consume cannabis,” which will require consideration post-legalization.²²⁵ Moreover, California’s constitution and political process may create unforeseen challenges.²²⁶ There are often difficulties in the legislative process that are present, especially in relation to taxation.²²⁷ “Normally, it is more difficult to change laws passed by citizen initiatives than laws passed by legislative measures or regulatory decisions.”²²⁸

California is also home to “millions of acres of rural land,” national parks, and state parks.²²⁹ In other words, the state is ripe to be sewn with seeds of new cannabis cultivation for the recreational system.²³⁰ And California already has a reputation for growing a lot of cannabis.²³¹ A reputation that usually starts and ends in the Emerald Triangle.²³² The Emerald Triangle is made up of “Humboldt, Mendocino, and Trinity, and other rural counties...”²³³ in Northern California, and is home to roughly 30,000 cannabis grow sites.²³⁴ There are no sound estimates on how much cannabis California grows, but there is agreement that California is a major exporter of cannabis.²³⁵ Indeed, California’s home grown marijuana makes up a significant amount of the cannabis in the black market in the United States.²³⁶ Most observers are unsure of precisely how much California actually consumes; but, NORML (National Organization for Reforming Marijuana Laws) estimates, “Californians consume between \$870 million and \$2 billion worth of medical marijuana per year.”²³⁷

224. BRC Report, *supra* note 10, at 12.

225. *Id.*

226. See BRC Report, *supra* note 10, at 13 (highlighting the difficulties that the California initiative system poses for regulators trying to navigate marijuana policy).

227. *Id.*

228. *Id.*

229. *Id.* at 10–11.

230. See Thomas Fuller, *Marijuana Goes Industrial in California* (Apr. 15, 2017), N.Y. TIMES, https://www.nytimes.com/2017/04/15/us/california-marijuana-industry-agriculture.html?_r=0 (on file with *The University of the Pacific Law Review*) (discussing California’s success in growing other crops is likely to extend over to marijuana production).

231. See BRC Report, *supra* note 10, at 12 (pointing out that California is home to the “nation’s oldest medical marijuana industry,” and is “also home to a substantial amount of cannabis cultivation”).

232. *Id.* at 11.

233. *Id.*

234. *Id.* at 12.

235. *Id.*

236. *Id.*

237. *California’s Billion-Dollar Medical Marijuana Market Offers Millions in Tax Revenues*, CAL. NORML, <http://www.canorml.org/background/OakFinancialReportRelse.htm> (last visited Apr. 1, 2017) (on file with *The University of the Pacific Law Review*).

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In 1996, Californians approved Proposition 215²³⁸ (Prop. 215) and became the first state to legalize medical marijuana.²³⁹ Today, the California medical industry has evolved and “includes entities involved in cultivation, retail sales, testing and many other functions;” but, is largely “unregulated at the state level.”²⁴⁰ For better or worse, most Prop. 215 regulations take place at the local level.²⁴¹ For many patients, the medical marijuana system legitimately provides the benefit of pain relief; however, many also use the system for recreational reasons.²⁴² The California Legislature must work out this issue, along with others, to tame the California marijuana market.²⁴³

2. *The New Medical Market: The Medical Cannabis Regulation and Safety Act (MCRSA)*

In 2015, California passed three bills: AB 243;²⁴⁴ AB 266;²⁴⁵ and SB 643;²⁴⁶ Together this legislation is known as the Medical Cannabis Regulation and Safety Act (MCRSA).²⁴⁷ The law will take effect in 2018, and run contemporaneously with the recreational system.²⁴⁸ MCRSA establishes the

238. CAL. HEALTH & SAFETY CODE § 11362.5 (West 1996).

239. *California Proposition 215, The Medical Marijuana Initiative (1996)*, BALLOTPEDIA, [https://ballotpedia.org/California_Proposition_215,_the_Medical_Marijuana_Initiative_\(1996\)](https://ballotpedia.org/California_Proposition_215,_the_Medical_Marijuana_Initiative_(1996)) (last visited Apr. 1, 2017) (on file with *The University of the Pacific Law Review*); see also BRC Report, *supra* note 10, at 11. (pointing out that California has the oldest medical marijuana industry in the nation).

240. BRC Report, *supra* note 10, at 12.

241. *Cannabis Regulation*, DEP’T OF CONSUMER AFF., BUREAU OF CANNABIS CONTROL PROPOSED TRAILER BILL LEGIS. (Apr. 4, 2017), available at http://www.dof.ca.gov/Budget/Trailer_Bill_Language/documents/200CannabisRegulationDraft.pdf (on file with *The University of the Pacific Law Review*).

242. See BRC Report, *supra* note 10, at 12 (observing that medical market has those “dedicated to responsible cultivation” and some “have past criminal records associated with their participation in the medical marijuana system”).

243. *Id.*; see BRC Report, *supra* note 10, at 10–13 (pointing out that California’s industry, people, land and government will present unique challenges for legislatures in approaching the complexities of marijuana policy).

244. AB 243, 2015 Leg., 2015–2016 Sess. (Cal. 2016).

245. AB 266, 2015 Leg., 2015–2016 Sess. (Cal. 2016).

246. SB 643, 2015 Leg., 2015–2016 Sess. (Cal. 2016); see generally *Bureau of Medical Cannabis Regulation*, CAL. BUREAU OF MEDICAL REG., <http://bmcr.ca.gov/> (last visited Apr. 13, 2017) (on file with *The University of the Pacific Law Review*).

247. *Cal NORML: A Summary of The Medical Cannabis Regulation and Safety Act (MCRSA)*, CAL. NORML, http://www.canorml.org/news/A_SUMMARY_OF_THE_MEDICAL_MARIJUANA_REGULATION_AND_SAFETY_ACT (on file with *The University of the Pacific Law Review*).

248. Steve Owens, *Understanding New California Medical Cannabis Regulatory Environment*, NEW CANNABIS VENTURES (May 19, 2016), available at <https://www.newcannabisventures.com/understanding-new-california-medical-cannabis-regulatory-environment/> (on file with *The University of the Pacific Law Review*) (discussing the impact of the three new laws).

regulatory structure and license types that Prop. 64 is based on.²⁴⁹ MCRSA limits cultivation licenses for indoor grows to 22,000 square feet, and outdoor grows to 1 acre.²⁵⁰ Prop. 64 adds Type 5 cultivation licenses, which sets no limit on size, but will not be available until 2023.²⁵¹

Under AB 266, the Bureau of Medical Cannabis Regulation under the Department of Consumer Affairs is the chief regulating agency for the recreational and medical markets.²⁵² AB 266 and SB 643 establish the licensing framework and cultivation limitation for both the medical and recreational market.²⁵³ SB 643 and AB 243 assign various agencies duties for regulating cannabis.²⁵⁴ For example, the laws require the Department of Food and Agriculture to oversee cultivation, and the Department of Public Health oversees production and testing.²⁵⁵ Although MCRSA was to be implemented in January of 2016, it will be up and running simultaneously with the recreational system in 2018.²⁵⁶

Recently, California Governor Jerry Brown, proposed a hotly contested bill to reconcile both systems, potentially delaying the first day of marijuana sales.²⁵⁷ The bill proposes several notable solutions to resolving the conflicts between MCRSA and Prop. 64.²⁵⁸ Most notably, it seeks to remove the ban on vertical integration under MCRSA.²⁵⁹

3. Proposition 64: California Legalizes Recreational Marijuana

Proposition 64 (Prop. 64), also known as the Control, Regulate and Tax Adult Use of Marijuana Act (AUMA), legalizes recreational marijuana in

249. *Cal NORML: A Summary of The Medical Cannabis Regulation and Safety Act*, *supra* note 247.

250. AB 243, 2015 Leg., 2015–2016 Sess. (Cal. 2015) (adding to CAL. BUS. & PROF. CODE §19332(g)).

251. Cal. Proposition 64 (2017) (*adding to* CAL. BUS. & PROF. CODE § 26061(d)).

252. AB 266, 2015 Leg., 2015–2016 Sess. (Cal. 2016); SB 643, 2015 Leg., 2015–2016 Sess. (Cal. 2016).

253. AB 266, 2015 Leg., 2015–2016 Sess. (Cal. 2016); SB 643, 2015 Leg., 2015–2016 Sess. (Cal. 2016).

254. SB 643, 2015 Leg., 2015–2016 Sess. (Cal. 2016); AB 243, 2015 Leg., 2015–2016 Sess. (Cal. 2015) (adding to CAL. BUS. & PROF. CODE §19332(g)).

255. *Cal NORML: A Summary of The Medical Cannabis Regulation and Safety Act*, *supra* note 247.

256. *Bureau of Medical Cannabis Regulation*, *supra* note 246; Owens, *supra* note 248 (“Regulatory agencies have until January 2018 to establish the rules adopted in MMRSA”).

257. *Cannabis Regulation*, *supra* note 241; see Patrick McGreevy, *Rift Opens Between the Brown Administration and Legislatures Over New Marijuana Laws in California*, L.A. TIMES (Apr. 14, 2017), <http://www.latimes.com/politics/la-pol-sac-medical-recreational-pot-rules-rift-20170414-story.html> (on file with *The University of the Pacific Law Review*) (discussing the political divide surrounding the drafting of regulations required to get the new cannabis market off the ground).

258. *Cannabis Regulation*, *supra* note 241.

259. *Id.* at 3–4.

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California for persons 21 years or older.²⁶⁰ Prop. 64’s “regulatory provisions are largely patterned on MCRSA.”²⁶¹ Specifically, AUMA legalizes the sale and possession of up to 28.5 grams (one ounce) of marijuana,²⁶² 8 grams of concentrated cannabis,²⁶³ and cultivation of 6 plants for personal use.²⁶⁴ Usually, initiatives are not amendable after they are passed in California.²⁶⁵ However, Prop. 64 allows the California Legislature, with a majority vote, to amend Prop. 64 with laws that are consistent with its purpose and intent.²⁶⁶ Playing a significant role in the drafting process were the Blue-Ribbon Commission (BRC) and the Marijuana Policy Project (MPP).²⁶⁷ Currently, it is legal to possess cannabis in California; however, there is no access to a legal source of cannabis until January 1, 2018 when retail sales are set to begin.²⁶⁸

Prop. 64 creates two new excise taxes to be imposed on both medical and recreational cannabis.²⁶⁹ First, it enacts a weight-based excise tax on cultivation.²⁷⁰ It taxes marijuana at a rate of \$9.25 per ounce for flowers,²⁷¹ and \$2.75 per ounce for leaves (trim).²⁷² Second, it levies an ad valorem (percentage-of-price) tax on marijuana purchases at retail.²⁷³ It taxes “at the rate of 15 percent of the gross receipts of any retail sale.”²⁷⁴ In addition, Prop. 64 emphasizes that the tax on marijuana applies fully to any purchase that contains both 1) marijuana

260. *California Proposition 64, Marijuana Legalization (2016)*, *supra* note 6.

261. *California NORML Guide to AUMA*, CAL. NORML http://www.canorml.org/Cal_NORML_Guide_to_AUMA (last visited Apr. 17, 2017) (on file with *The University of the Pacific Law Review*).

262. CAL. HEALTH & SAFETY CODE § 11362.1(a)(1) (enacted by Cal. Prop. 64, approved Nov. 8, 2016, eff. Nov. 9, 2016).

263. *Id.* § 11362.1(a)(2).

264. *Id.* § 11362.1(a)(3).

265. See Michael Vitiello, *Proposition 215: De Facto Legalization of Pot and the Shortcomings of Direct Democracy*, 31 U. MICH. J. L. REF. 707, 710–13 (1998) (observing that the typical legislative process involves amendments to “avoid ambiguity and accommodate competing voices,” while the initiative process is severely limited in how much an initiative can be amended by the voters).

266. CAL. BUS. & PROF. CODE § 26000(a) (enacted by Cal. Prop. 64, approved Nov. 8, 2016, eff. Nov. 9, 2016).

267. Vitiello, *supra* note 19.

268. Katy Steinmetz, *What to Know About Marijuana Legalization in California*, TIME (Nov. 9, 2016), <http://time.com/4565438/california-marijuana-faq-rules-prop-64/> (on file with *The University of the Pacific Law Review*).

269. See Oglesby, *supra* note 27 (summarizing California’s approach to taxing cannabis).

270. CAL. REV. & TAX CODE § 34012(a) (enacted by Cal. Prop. 64, approved Nov. 8, 2016, eff. Nov. 9, 2016).

271. *Id.* § 34012(a)(1).

272. *Id.* § 34012(a)(2).

273. *Id.* § 34011(a).

274. *Id.*

products and 2) other discrete items.²⁷⁵ In effect, “this prevents... bundling as a tax evasion scheme.”²⁷⁶ Additionally, medical marijuana is subject to an exemption from the 7.5% state sales tax.²⁷⁷ In 2020, Prop. 64 will give the Board of Equalization (Board) authority to adjust the ad valorem excise tax for inflation.²⁷⁸ The Board is responsible for administering and collecting the tax.²⁷⁹ Currently, Prop. 64 gives the Board broad authority to change the tax level, or tax base, or broaden the tax to include other categories of cannabis.²⁸⁰ Prop. 64 requires proof payment through “tax stamps or state-issued product bags,” which the state’s “track and trace program” can scan and trace.²⁸¹ Prop. 64 also sets certain sanctions for tax evasion.²⁸² If a person fails to pay the required tax, the state may compel them pay any outstanding debt.²⁸³ The state, additionally, may sanction them for half the amount owed or potentially revoke their license.²⁸⁴ Tax revenue, fines, licensing fees and other revenue streams will be deposited in the California Marijuana Tax Fund.²⁸⁵

Commentators predict the California recreational market to be the biggest yet.²⁸⁶ Prop. 64’s drafters and proponents of the measure predict that the new recreational cannabis market will generate millions of dollars in revenue needed to cover the costs of the new law and provide funding to the various groups.²⁸⁷ Further, the state analyst predicts the recreational market will generate “tax revenue that will start of in the millions, eventually reaching \$1 billion; including millions in revenue for local governments.”²⁸⁸ Factors that could vary the measure’s intended fiscal effects are: (1) local government regulations; (2) the

275. *Id.* § 34011(b).

276. Oglesby, *supra* note 27.

277. CAL. REV. & TAX CODE § 34012(j) (enacted by Cal. Prop. 64, approved Nov. 8, 2016, eff. Nov. 9, 2016) (allowing exemption for qualified patient or care giver under “§ 11362.1 of the Health and Safety Code ... in accordance with the Compassionate Use Act”).

278. *Id.* § 34012(k).

279. *Id.* § 34013(a).

280. *Id.* § 34013(d).

281. *Id.* § 34102(e)–(g).

282. *Id.* § 34013(e).

283. *Id.* § 34013(e).

284. *Id.*

285. LEGISLATIVE ANALYST’S OFFICE, *supra* note 17, at 8.

286. See Thomas Fuller, *Marijuana Goes Industrial In California*, N.Y. TIMES (Apr. 15, 2017) <https://www.nytimes.com/2017/04/15/us/california-marijuana-industry-agriculture.html> (on file with *The University of the Pacific Law Review*) (pointing out that California’s reputation as an agricultural state for producing fruits and vegetables will likely reflect the size of its new marijuana market).

287. Cal. Proposition 64 § 2 (2016) (Findings and Declarations); see *California Proposition 64, Marijuana Legalization (2016)*, *supra* note 6.

288. LEGISLATIVE ANALYST’S OFFICE, *supra* note 17, at 1.

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federal government; and (3) variance in marijuana price and consumption.²⁸⁹ Arcview group, a leading investment and market research firm in the cannabis industry, estimates “[i]legal cannabis sales in California could be worth about \$6.2 billion in five years.”²⁹⁰ Further, California NORML estimates the state could generate tax revenue up to \$1.5–\$2.5 billion per year.²⁹¹ Finally, a recent study conducted by the University of the Pacific’s Center for Business and Policy Research predicts, “a legal cannabis industry that creates over 20,000 jobs and \$4.2 billion in total annual economic output in the Sacramento region alone.”²⁹² One example of the California cannabis industry’s potential is Steve Deangelo, the owner of several prominent dispensaries in the Oakland area and co-owner of the Arcview group.²⁹³ Mr. Deangelo averages \$44 million in sales annually, and runs FLRish Inc., a marijuana venture backed by Silicon Valley investors.²⁹⁴ Further, some observers state that, “in California, there are more than 20 ventures seeking large-scale commercial growing permits, and officials predict pot agriculture could bring in \$20 million to \$30 million annually in new tax revenues.”²⁹⁵

Potential savings are cited as another source of revenue.²⁹⁶ Some claim that legalization would save \$8 billion to \$16 billion in taxes, “not counting the economic benefits of hemp agriculture and other spinoff industries.”²⁹⁷ Savings on incarceration and other criminal justice costs underlie this argument.²⁹⁸ But, this also depends on several key variables in the legal market, such as the “reduction in criminal justice costs, the effect on public health and the amount of money spent regulating cannabis.”²⁹⁹

289. *Id.*

290. Zusha Elinson, *California’s Next Buzzy Varietal May Not Come From Grapes*, WALL STREET J. (Feb. 5, 2017 2:04 PM), <https://www.wsj.com/articles/mendocinos-most-promising-varietal-cannabis-with-notes-of-lavender-and-gas-1486321479> (on file with *The University of the Pacific Law Review*).

291. Dale Gieringer, Ph. D., *Economics of Cannabis Legalization: Detailed Analysis of The Benefits of Ending Cannabis Prohibition*, NORML (June 1994), <http://norml.org/component/zoo/category/economics-of-cannabis-legalization> (on file with *The University of the Pacific Law Review*).

292. Daniel Conway, *Cannabis Can Go From Conundrum to Catalyst*, COMSTOCK’S (Feb. 27, 2017), <http://www.comstocksmag.com/commentary/cannabis-can-go-conundrum-catalyst> (on file with *The University of the Pacific Law Review*).

293. Peter Hecht, *The Other Side of Eden: Commercial Marijuana Takes Root in Steinbeck Country*, SACRAMENTO BEE (Mar. 26, 2017 4:00 PST), <http://www.sacbee.com/news/state/california/california-weed/article140700623.html> (on file with *The University of the Pacific Law Review*).

294. *Id.*

295. *Id.*

296. See Vitiello, *supra* note 51, at 1373–75 (observing that proponents often cite saved enforcement costs as part of their argument for legalization of marijuana).

297. Gieringer, *supra* note 291.

298. LEGISLATIVE ANALYST’S OFFICE, *supra* note 17 at 12–13.

299. *Id.*; see also Vitiello, *supra* note 51, at 1350 (opponent’s do not believe there will be any “significant

Assuming a recreational market generates revenue, how will this money get spent?³⁰⁰ Initially, California legislators will use tax revenue to cover administrative costs not covered by licensing fees.³⁰¹ The money is then allocated amongst various groups for different purposes.³⁰² First, the marijuana tax revenue will fund \$10 to \$50 million for social services in communities harmed by the War on Drugs.³⁰³ In 2018, the tax revenue will fund \$10 million and then increase by \$10 million each year thereafter.³⁰⁴ Second, from 2018 to 2029, the fund will allocate \$10 million to evaluate the measures effect.³⁰⁵ Next, from 2018 to 2029, the fund will allocate \$3 million annually to develop a detection system for driving under the influence of cannabis.³⁰⁶ Then, the fund will allocate \$2 million for medical marijuana research.³⁰⁷ Finally, the fund will distribute leftover money: (1) 60 percent to youth programs; (2) 20 percent to cover the costs of environmental harm from illegal marijuana grows; and (3) 20 percent for safety programs, including driving under the influence of cannabis.³⁰⁸

III. PERCOLATING ISSUES UNDER PROPOSITION 64

This Part first examines the potential issues that may manifest under Proposition 64's tax structure.³⁰⁹ Then, it considers potential concerns in collecting and enforcing the marijuana tax in California.³¹⁰ Finally, it examines how federal law may impact the amount of revenue generated from the recreational market in California.³¹¹

reduction in prison costs or significant increases in revenue").

300. See LEGISLATIVE ANALYST'S OFFICE, *supra* note 17 at 8–9 (stating how the revenue generated from marijuana will be spent).

301. See *id.* (stating how the revenue generated from marijuana will be spent).

302. *Id.*

303. *Id.*

304. *Id.*

305. *Id.*

306. *Id.*

307. *Id.*

308. *Id.* at 9.

309. *Infra* Part III.A.

310. *Infra* Part III.B.

311. *Infra* Part III.B.

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A. Potential Issues Under Prop 64's Tax Structure

The sweet spot for taxing cannabis is elusive.³¹² If the tax is too low the state will not be able to achieve optimal revenue; but if the tax is too high, the market may be polarized towards illegal sales, along with all the potential revenue.³¹³ Naturally, marijuana will be taxed at a higher rate than other goods; but, a tax too high can amount to de facto prohibition.³¹⁴ High cultivation taxes can also have the unintended effect of blocking access to small producers and allow corporate takeover of the industry.³¹⁵ Indeed, a sound tax base and level are the crux of having an efficient cannabis tax policy.³¹⁶

Prop. 64 levies an ad valorem (percentage-of-price) tax on marijuana purchases at retail.³¹⁷ It taxes at the rate of “15 percent of the gross receipts of any retail sale.”³¹⁸ In addition, it emphasizes that the tax on marijuana applies fully to any purchase that contains both (1) marijuana products and (2) other discrete items.³¹⁹ This prevents “bundling as a tax evasion scheme.”³²⁰ Still, several problems may emerge with ad valorem taxes under Prop 64.³²¹

First, it is important for California legislatures to consider marijuana prices when they determine the soundness of California's 15 percent excise tax.³²² That is because this type of tax base “amplifies change in pretax price automatically.”³²³ Prices, therefore, may largely depend on the type of cannabis economy that emerges.³²⁴ Optimistic progressives foresee a marijuana market that is a weed lover's gourmet of high-quality organic products; cynics predict

312. See Oglesby, *supra* note 27 (observing that “even the soundest tax structure” will not guarantee fiscal success for proposition 64”)

313. BRC Report, *supra* note 10, at 54.

314. Miron, *supra* note 1, at 447, 449.

315. BRC Report, *supra* note 10, at 54.

316. See KILMER ET AL., *supra* note 11, at 776 (highlighting the importance of deciding taxations levels, goals and how to actually tax marijuana).

317. CAL. REV. & TAX CODE § 34011(a) (enacted by Cal. Prop. 64, approved Nov. 8, 2016, eff. Nov. 9, 2016).

318. *Id.*

319. *Id.* §34011(b).

320. See Oglesby, *supra* note 27; see also BRC Report, *supra* note 10, at 49–51 (discussing the difficulty of determining the actual price of cannabis).

321. See KILMER ET AL., *supra* note 11, at 78 (pointing out that a price based tax has the potential to make marijuana prices too high or too low because it “amplifies changes in pretax price automatically”); see also BRC Report, *supra* note 10, at 49–51 (discussing the difficulty of determining the actual price of cannabis).

322. See KILMER ET AL., *supra* note 11, at 78 (observing that if the price of marijuana is too high or low, a price based tax will make is significantly higher or lower than the original pretax price”); see also BRC Report, *supra* note 10, at 49–51 (discussing the difficulty of determining the actual price of cannabis).

323. KILMER ET AL., *supra* note 11, at 78.

324. CAULKINS, KILMER & KLEIMAN, *supra* note 10, at 148–49.

the good stuff (high quality marijuana) will be reserved for the bourgeoisie, while the general public consume mass-produced, lower-quality products.³²⁵ Still, no one knows precisely what kind of market will emerge.³²⁶

Regardless of the marijuana industry that emerges, most scholars agree that after a state legalizes cannabis, the price will likely start high, and then steadily decline.³²⁷ For example, when legalization first took effect in Colorado and Washington, the industry struggled to keep up with consumer demand, which resulted in high prices.³²⁸ Because ad valorem taxes magnified the cost of marijuana, the black and medical markets retain a share of the market in those states.³²⁹ Hence, when California gears up for legal sales, it may incur sizable start-up costs, which if combined with a cannabis supply shortage, will cause the price of cannabis to sky rocket.³³⁰ The one caveat to this would be if California had a high demand for reasonably priced legal cannabis initially, a higher tax may prove successful.³³¹

Plausibly, California's unique circumstances could make low initial costs a significant challenge.³³² First, California is a significantly larger state geographically and in population.³³³ Consequently, this makes getting the industry off the ground a big challenge.³³⁴ Adding to this, California's large and loosely regulated medical industry may complicate pricing scenarios even further.³³⁵ Like California, Washington also had a largely unregulated medical market.³³⁶ This led to a situation where medical dispensaries threatened to undermine the legal market by providing cheaper products with less taxes.³³⁷ Thus, the California's recreational market, like other states, will likely experience

325. Geoffrey Mohan, *What Would a Recreational Marijuana Market in California Look Like?*, L.A. TIMES (Nov. 10, 2106), <http://www.latimes.com/business/la-fi-marijuana-market-20161110-story.html> (on file with *The University of the Pacific Law Review*) (discussing how some buyers, like in the wine industry, have "more sophisticated tastes ... or have demands that go beyond price and availability").

326. CAULKINS, KILMER & KLEIMAN, *supra* note 10, at 148–49.

327. *Id.*

328. KILMER ET AL., *supra* note 11, at 78.

329. *Id.*

330. BRC Report, *supra* note 10, at 49.

331. *See id.* (explaining that a high demand combined with supply shortage will "leave cannabis companies with plenty of cash flow" and may create no problems in the market).

332. *See* BRC Report, *supra* note 10, at 10 (observing that California's unique circumstances "will require cannabis laws and regulations that are specifically tailored to California").

333. BRC Report, *supra* note 10, at 11.

334. *See* BRC Report, *supra* note 10, at 10 (reasoning that California's marijuana laws "will require careful planning and monitoring to ensure safe and effective implementation" because "the state is just bigger").

335. *Id.* at 12.

336. *Id.* at 32.

337. *Id.* at 55.

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higher cannabis prices at first.³³⁸ Nevertheless, as the industry evolves, lower production costs will drive down the cost of cannabis for the consumer.³³⁹ As was the case in Colorado and Washington, where both states experienced a significant price drop.³⁴⁰ Because an ad valorem tax contains no price floor, a price collapse would significantly reduce revenue.³⁴¹ However, this result comes with the advantage of lower prices that could curb the presence of a black market.³⁴² Basing estimates on cannabis prices in Colorado and Washington today comes with several limitations.³⁴³ Specifically, national legalization could significantly alter the cannabis pricing scenario, and current federal policy is subject to constant change.³⁴⁴

Selecting the appropriate taxation level is equally important when considering cannabis prices.³⁴⁵ The ability to maintain high state taxes becomes difficult if neighboring states have lower taxes because of the ease of transport across state lines.³⁴⁶ That is, tax prices may tempt individuals to buy in a low-tax state and resell in a high-tax state.³⁴⁷ Since Nevada, Colorado, Oregon, and Washington are all located near California, it may be important to keep tax prices relative to those states.³⁴⁸ Further, comparing the taxation level that California

338. See Dennis Romero, *Pot Prices Could Actually Rise After Legalization*, LA WEEKLY (Nov. 4, 2016, 6:49 AM), <http://www.laweekly.com/news/pot-prices-could-actually-rise-after-legalization-7575349> (on file with *The University of the Pacific Law Review*) (citing inventory, compliance with laws, demand, testing and experiences of other states as all possible variables that may contribute to an increase in the price of marijuana).

339. BRC Report, *supra* note 10, at 49–50.

340. Keith Humphreys, *Falling Prices Mean Trouble for States That Have Legalized Marijuana*, THE CANNABIST (Jan. 18, 2017, 12:20 PM), <http://www.thecannabist.co/2017/01/18/marijuana-price-drops-state-revenue/71657/> (on file with *The University of the Pacific Law Review*).

341. See KILMER ET AL., *supra* note 11, at 77, 78 (indicating that a weight-based tax provides more stable revenue than a price base; and pointing out that if the pretax price is too low, a price based tax could push the price of marijuana down to levels that are dangerous for an industry in its infancy); see also BRC Report, *supra* note 10, at 50 (observing that if the price of marijuana falls the revenue brought in by a price based tax would drop alongside it; while a weight based tax can create a “floor under the market”); Oglesby, *supra* note 27 (pointing out that “an indexed tax based on observable weight is inherently flexible and should survive a price collapse”).

342. *Cf.*, BRC Report, *supra* note 10, at 49 (observing that when prices are too high, prices in the black-market may seem more attractive for consumers).

343. CAULKINS, KILMER & KLEIMAN, *supra* note 10, at 140.

344. *Id.* at 140–41.

345. See BRC Report, *supra* note 10, at 54 (predicting that when a tax rate is too high it may polarize consumers to the black market, while a tax rate too low may cause greater access to youth and problem users).

346. CAULKINS, KILMER & KLEIMAN, *supra* note 10, at 258–59.

347. *Id.*

348. Alicia Wallace, *Where Is Weed Legal? Map of U.S. Marijuana Laws by State*, THE CANNABIST (Oct. 14, 2016, 12:59 PM), <http://www.thecannabist.co/2016/10/14/legal-marijuana-laws-by-state-map-untied-states/62772/> (on file with *The University of the Pacific Law Review*) (showing a map of states that have legalized marijuana).

assessed to levels in Washington and Colorado may provide useful insight into California's policy.³⁴⁹ In addition to the 15% excise tax, California levies a 7.5% sales tax and local taxes at purchase.³⁵⁰ In comparison, Colorado levies a "2.9% state sales tax,³⁵¹ 10% marijuana tax[,] and any local sales taxes."³⁵² Meanwhile, Washington currently imposes a 37% excise tax, which the state assesses at the point of the sale³⁵³ alongside any additional state sales and local taxes.³⁵⁴

There are several notable differences between the taxing schemes in Washington, Colorado, and California.³⁵⁵ Besides being 5% higher, one important distinction between California's 15% tax rate and Colorado's 10% tax rate is that California includes the excise tax and sales tax at the point of purchase.³⁵⁶ Currently, there is a bill in the Colorado legislature to lower the tax to 8%, to help the recreational market undercut the black market, but recently the bill has been postponed indefinitely.³⁵⁷ While Washington maintains a significantly higher retail tax, having one collection point compensates for the higher price.³⁵⁸ So, the comparison between the taxation levels turns on the viability of tax collection points.³⁵⁹

In addition, as some scholars have pointed out, the excise taxes in Washington and Colorado are too high and fail to optimize revenue in those states.³⁶⁰ Similarly, the tax in California is high even without considering the second excise tax California levies on producers.³⁶¹ Thus, because the level of tax

349. BRC Report, *supra* note 10, at iv.

350. Ben Adlin, *California Moving Quickly to Tax Medical Cannabis*, LEAFLY, <https://www.leafly.com/news/politics/california-moving-quickly-to-tax-medical-cannabis> (last visited on July 31, 2017) (on file with *The University of the Pacific Law Review*).

351. COLO. REV. STAT. § 39-26-106(1)(a)(II) (2015).

352. *Marijuana Taxes/Quick Answers*, *supra* note 157.

353. BRC Report, *supra* note 10, at 55.

354. WASH. REV. CODE § 82.14.030 (West 2015).

355. See Oglesby, *supra* note 27 (comparing proposition 64 to Washington and Colorado's marijuana tax regime).

356. See *What Is an Excise Tax and How Does it Differ From Sales Tax?*, ACCURATE TAX (Sept. 10, 2015), <https://www accuratetax.com/blog/what-is-excise-tax-and-how-does-it-differ-from-sales-tax/> (on file with *The University of the Pacific Law Review*) (describing the difference between a sales tax and an excise tax).

357. H.R. 17-1345, 71st Leg., 2017 Reg. Sess. (Colo. 2017) (Retail Marijuana Sales Tax) (scheduled to take effect July 1, 2017).

358. See BRC Report, *supra* note 10, at 18 (highlighting the fact that with one collection point Washington has a "one time tax").

359. *Infra* Part III.B.

360. Jeremy P. Gove, *Colorado and Washington Got Too High: The Argument for Lower Recreational Marijuana Excise Taxes*, 19 RICH. J. L. & PUB. INT. 67, 68 (2016).

361. See Patrick McGreevy, *Taxes Get Higher on Newly Legalized Pot as California Cities and Counties Move to Make Their Own Cut*, LA TIMES (Nov. 18, 2016, 12:45 PM), <http://www.latimes.com/politics/la-pol->

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in Colorado and Washington has failed to reduce the illicit market, a higher or similar tax rate in California is likely to do the same, or worse.³⁶²

In addition, Prop. 64 enacts a weight-based excise tax on cultivation.³⁶³ Colorado assesses a similar tax and offers a useful comparison.³⁶⁴ It taxes marijuana at a rate of \$9.25 per ounce for flowers,³⁶⁵ and \$2.75 per ounce for leaves (trim).³⁶⁶ Meanwhile, Colorado calculates their cultivator excise tax by taking the average market weight (AMW) of the cannabis product and multiplying it by the 15% excise tax.³⁶⁷ At the time of this writing, rates for the period of January 1, 2017 to June 30 2017 are \$ 1,471 per pound of flower and \$499 per pound of trim.³⁶⁸ If a cultivator sold one pound at the AMW, and multiplied that price by the 15% excise tax, then the tax owed for the marijuana flower would be \$221.³⁶⁹ Thus, when selling one pound of marijuana in Colorado, the tax rate per ounce of flour would be around \$14, which is significantly higher than the \$9.25 tax in California.³⁷⁰ If a Colorado cultivator sold a pound of trim at AMW, they would pay \$75 total in taxes, which is nearly \$4.67 in taxes per ounce.³⁷¹ Notably, even though California has generally a lower tax rate on cultivation when compared to Colorado, the cannabis industry in California is already feeling the heat from the new tax regime.³⁷²

Some market participants oppose the tax structure because they find two excise taxes, in addition to state and local taxes, to be excessive.³⁷³ For example,

ca-pot-legalization-local-taxes-snap-20161118-story.html (on file with *The University of the Pacific Law Review*) (discussing the cloud of concern hovering over the cost of marijuana as “cities and counties pile their own taxes of up to 15% on top of the 15% state excise tax approved by voters”).

362. Cf. Gove, *supra* note 361 (arguing that high excise taxes in Colorado and Washington act “as a high barrier to entry” and help to perpetuate the black market).

363. CAL. REV. & TAX CODE § 34012(a) (enacted by Cal. Prop. 64, approved Nov. 8, 2016, eff. Nov. 9, 2016).

364. *Id.* §§ 34012(a)(1), 34012(a)(2).

365. *Id.* § 34012(a)(1).

366. *Id.* § 34012(a)(2).

367. See *Marijuana Taxes/Quick Answers*, *supra* note 157 (explaining that excise tax is calculated by multiplying the quantity of retail marijuana product by the average market rate at the time, then multiplying by the 15% excise tax rate).

368. *Id.*

369. $\$1,471 \times .15 = \220.65 in taxes for one pound of flower.

370. $\$220.65/16 = \13.79 .

371. $\$499 \times .15 = \74.85 .

372. See McGreevy, *supra* note 362 (discussing the cloud of concern hovering over the cost of marijuana as “cities and counties pile their own taxes of up to 15% on top of the 15% state excise tax approved by voters”).

373. See *id.* (discussing the pushback from the industry with rising cost of entry into the marijuana market).

NORML, a marijuana policy reform group, has labeled the tax as burdensome.³⁷⁴ Although California's excise tax of 15% is not too high, or low, when compared to other states.³⁷⁵ Some people, though, believe the best tax policy moving forward would start low and steadily increase.³⁷⁶

B. Issues of Tax Enforcement and Collection Under Prop. 64

Taxing cannabis also seeks to modify behavior; anytime a tax modifies behavior, it requires enforcement.³⁷⁷ The alcohol and tobacco industries industry spend billions annually to fight tax evasion.³⁷⁸ Nevertheless, some portion of marijuana tax evasion will always occur.³⁷⁹ As discussed above, some argue the end of prohibition means the end of enforcement costs.³⁸⁰ They reason that because the government will not need to spend money on arrests, the cost of enforcement will likely go down.³⁸¹ When trying to achieve maximum revenue in a marijuana economy, however, cannabis taxes would still require enforcement to eliminate the black market and illegal grows.³⁸²

Intuitively, the more enforcement required, the more expensive enforcement becomes, and the cost of enforcing California's regulations will be great.³⁸³ Some observers estimate there are 50,000 marijuana growers supplying the black market in California, which is "six times the number of wineries in the whole country."³⁸⁴ The State Board of Equalization "estimates there are 1,700 dispensaries in the state."³⁸⁵ There are also concerns about possible violence

374. *See id.* (predicting a strong presence of the black market because the excise tax levied by proposition 64 is too high).

375. *See* Ogelsby, *supra* note 27.

376. *Id.*

377. CAULKINS, KILMER & KLEIMAN, *supra* note 10, at 138–39.

378. *Id.*

379. Mikos, *supra* note 60, at 239.

380. MIRON, *supra* note 1, at 447.

381. *Id.*

382. *See* Vitiello, *supra* note 19, at 799 (discussing how much additional tax revenue depends on "many variables, including methods of implementation of Marijuana laws").

383. *Id.*; *With Marijuana Legalized, California Plans How to Collect Taxes*, SACRAMENTO CBS (Nov. 30, 2016, 3:36 PM), <http://sacramento.cbslocal.com/2016/11/30/with-marijuana-legalized-california-plans-how-to-collect-taxes/> (on file with *The University of the Pacific Law Review*).

384. Joel Warner, *California's Looking For New Tax Revenue? Weed 'Em and Reap*, WIRED (Mar. 3, 2017, 7:00 AM), <https://www.wired.com/2017/03/californias-looking-new-tax-revenue-weed-em-reap/> (on file with *The University of the Pacific Law Review*).

385. *With Marijuana Legalized, California Plans How to Collect Taxes*, *supra* note 384.

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against tax collectors and officials who investigate illegal grows.³⁸⁶ Indeed, tax collectors will have a lot of work ahead of them.³⁸⁷

But how much will it cost to enforce the new marijuana laws in California?³⁸⁸ In 2017, Governor Jerry Brown allocated 52.2 million for the regulation of cannabis, California, however, already loaned money to the agencies during the pre-regulation period.³⁸⁹ Further, the State Board of Equalization admitted they would need to revise their financial estimates soon.³⁹⁰ Moreover, the industry criticized the budget for falling short of the amount required to get regulations off the ground.³⁹¹ In short, the cost of enforcement is likely to be significantly more than initially expected.³⁹²

Determining the proper point to collect marijuana taxes is important for minimizing enforcement costs.³⁹³ Prop. 64 collects the excise taxes at two points.³⁹⁴ First, Prop. 64 levies an ad valorem (percentage-of-price) tax on marijuana purchases at retail.³⁹⁵ In addition, under Prop. 64, both excise taxes would be included in the price when local and state taxes are assessed.³⁹⁶ Because the price of marijuana increases as it moves down the supply chain, collecting an ad valorem tax at this stage increases revenue.³⁹⁷ Also, taxing later in the supply chain means lower costs for consumer because distributors will usually add to the cost, “including the cost of taxes.”³⁹⁸ Thus, implementing the tax at this stage would be effective in preventing the growth of the black market.³⁹⁹

386. *Id.*

387. *See id.* (discussing the years it may take to work out issues in the system).

388. *See id.* (identifying a need for more funding in order to effectively enforce marijuana regulations in California).

389. Patrick McGreevy, *Governor Brown’s Budget Includes \$52.2 Million for Marijuana Regulation Under New System*, L.A. TIMES (Jan. 10, 2017, 3:42 PM), <http://www.latimes.com/politics/essential/la-pol-ca-essential-politics-updates-gov-brown-s-budget-includes-for-1484090982-htmlstory.html> (on file with *The University of the Pacific Law Review*).

390. *With Marijuana Legalized, California Plans How to Collect Taxes*, *supra* note 384.

391. *Id.*

392. *See id.* (identifying a need for more funding in order to effectively enforce marijuana regulations in California).

393. KILMER ET AL., *supra* note 11, at 87 (arguing that tax enforcement will be cheaper as a whole if collected at a choke point where a smaller amount of market participants are paying).

394. CAL. REV. & TAX CODE §§ 34011(a), 34012(a) (enacted by Cal. Prop. 64, approved Nov. 8, 2016, eff. Nov. 9, 2016).

395. *Id.* § 34011(a).

396. *Id.* at § 34011(e).

397. BRC Report, *supra* note 10, at 53 (“For instance, a 20% retail tax will collect more revenue than a 20% production tax, since the retail price is normally higher than the production price”).

398. *Id.*

399. *See id.* at 54 (observing how lower consumer prices allows the legal market to compete with illicit one).

Second, it assesses a weight-based excise tax on cultivation.⁴⁰⁰ Because California is the largest exporter of cannabis in the United States, collecting at this point would help stop leakage and keep revenue in the state.⁴⁰¹ In addition, because it is a weight-based tax, it shields incoming revenue from a potential price collapse.⁴⁰² But weight-based taxes are more complex, take longer to set up, and must consider inflation.⁴⁰³ Moreover, issues that arise under federal law may also increase California's problem of high taxes and high prices when legalization occurs.⁴⁰⁴ enforcement.⁴⁰⁵ Additionally, because the weight-based tax separates cannabis into two distinct types, bud and trim, the potential for tax evasion increases.⁴⁰⁶ Naturally, those paying the tax may try to label their product, which would be taxed at a higher rate, as trim (which is the lower rate).⁴⁰⁷ Distributors could also make their product extra strong to evade paying taxes.⁴⁰⁸

In addition, the state's ability to observe the market is important for successful tax collection.⁴⁰⁹ But the potential size of California's market could easily burden regulators.⁴¹⁰ To aid in overseeing the industry, the state is implementing a track and trace system, that will track each plant from the point of origin to point of sale.⁴¹¹ But the feasibility of such a system is still up in the air.⁴¹² Although, two collection points will help with this problem because it will

400. CAL. REV. & TAX CODE § 34012(a) (enacted by Cal. Prop. 64, approved Nov. 8, 2016, eff. Nov. 9, 2016).

401. BRC Report, *supra* note 10, at 55.

402. *See id.* at 50 (observing that marijuana revenue will still be generated with a weight base tax "even in the event of marijuana price collapse"); *see also* KILMER ET AL., *supra* note 11, at 77 (indicating that a weight base excise tax "provides more stable revenue than a price base"); *see also* Oglesby, *supra* note 27 (pointing out that "an indexed tab based on observable weight is inherently flexible and should survive).

403. Oglesby, *supra* note 27.

404. Mikos, *supra* note 60, at 226–27.

405. *See* Mikos, *supra* note 60, at 226–27 (arguing that tax proponents do not consider the issue of federal law when considering the amount of revenue that will be generated from the tax).

406. *See* KILMER ET AL., *supra* note 11, at 83 (identifying the issue of "sellers . . . [having] an incentive to put bud, normally more potent than trim, into the trim pile").

407. *Id.*

408. CAULKINS, KILMER & KLEIMAN, *supra* note 10, at 136; KILMER ET AL., *supra* note 11, at 83; *see also* BRC Report, *supra* note 10, at 50 (discussing the incentive producers would have to increase the potency of their product to receive a higher return without paying the tax).

409. Mikos, *supra* note 60, at 239.

410. *Id.* at 226–27.

411. CAL. REV. & TAX CODE § 34012(g) (enacted by Cal. Prop. 64, approved Nov. 8, 2016, eff. Nov. 9, 2016).

412. Meadow, *Tracking \$16+ Billion of Cannabis in California: The Solution*, MEADOW (May 15, 2016), <https://blog.getmeadow.com/tracking-16-billion-of-cannabis-in-california-the-solution-f0f200385ea3> (on file with *The University of the Pacific Law Review*).

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allow regulators more oversight, it still may not be enough.⁴¹³ This is where the recent discussion on vertical integration plays a role in tax policy in California.⁴¹⁴ Recently, Governor Brown’s reconciliation proposal suggested removing the ban on vertical integration under MCRSA.⁴¹⁵ Vertical Integration means “what different licenses the same entity can have in the supply chain.”⁴¹⁶ Consequently, regulators would not have to oversee as many businesses.⁴¹⁷ However, vertical integration allows businesses to circumvent different tax stages, like in Colorado and Washington.⁴¹⁸ But, as the BRC pointed out, it is important to “set limits on vertical integration” to minimize the negative consequences that may come with a corporate take-over of the marijuana industry.⁴¹⁹

C. The Federal Government’s Effect on Revenue in California

California does not have to wait until legalization to know what a buzzkill⁴²⁰ the federal government can be.⁴²¹ If someone pays their taxes under state law, nothing stops Uncle Sam from taking all that information, turning around, and putting the tax payer in prison.⁴²²

413. See BRC Report, *supra* note 10, at 54 (suggesting three collection points at cultivation, processing and sales, and recommending that the more check points there are the less likely tax evasion will occur).

414. See *id.* (suggesting three collection points at cultivation, processing and sales, and recommending that the more check points there are the less likely tax evasion will occur).

415. *Cannabis Regulation*, *supra* note 241, at 5.

416. BRC Report, *supra* note 10, at 28.

417. KILMER ET AL., *supra* note 11, at 79 (discussing the issue of no transfer occurring when one company “transfers to themselves”).

418. *Id.*

419. BRC Report, *supra* note 10, at 28.

420. *Buzzkill*, URBAN DICTIONARY, <http://www.urbandictionary.com/define.php?term=buzzkill>, (last visited May 11, 2017) (on file with *The University of the Pacific Law Review*) (defining a buzzkill is something that spoils or ruins an otherwise enjoyable event).

421. See Patrick McGreevy, *California Officials and the Marijuana Industry Prepare to Fight a Federal Crackdown*, L.A. TIMES (Feb. 25, 2017, 12:05 AM), <http://www.latimes.com/politics/la-la-pol-ca-federal-pot-crackdown-response-20170225-story.html> (on file with *The University of the Pacific Law Review*) (observing the problems that may arise with conflicts between federal and state law).

422. Mikos, *supra* note 60, at 258–59 (pointing out that the federal government could use state data on marijuana sales and distribution to help enforce the federal ban).

Just ask California's medical industry, which has dealt with this problem since 1996.⁴²³ That fear resulted in a large chunk of the market going underground and sales going off the books.⁴²⁴ Fear of expanding business and attracting too much attention forced the medical industry into small, fragmented parts.⁴²⁵ Consequently, these difficulties will likely persist in the recreational market, either from old habits, or new enforcement.⁴²⁶ But even if Jeff Sessions did not charge a single Californian under the CSA, problems still exist.⁴²⁷

First, there is the issue with banks.⁴²⁸ Because banks block market participants from many banking services, participants must increase security and carry around cash in large duffel bag.⁴²⁹ With cash and expensive product on hand, many businesses are like sitting ducks, waiting to get robbed.⁴³⁰ In addition, state regulators face the problem of accepting all-cash payments on Tax Day.⁴³¹ For example, one owner "deposited a \$400,00 payment... in 'a big bag'" while other reports have found payments as large as \$30,000 or \$150,000.⁴³² The Board reported receiving envelopes that do not fit through the teller windows and stacking cash around the office when there is no room in the safes.⁴³³ The Board is attempting to figure out how to approach the issue of large cash payments, and this must be done fast.⁴³⁴ Receiving larger cash payments will likely result in

423. See *California's Billion-Dollar Medical Marijuana Market Offers Millions in Tax Revenues*, *supra* note 237 (highlighting how federal penalties force cultivators to "operate underground completely unregulated and untaxed").

424. See *id.* (highlighting how federal penalties force cultivators to "operate underground completely unregulated and untaxed").

425. Mikos, *supra* note 60, at 256.

426. See, Mikos, *supra* note 60, at 258 (arguing that the federal ban makes monitoring marijuana in California difficult, and "to detect tax evasion, California would need adopt costly enforcement measures that may not yield positive returns").

427. See generally Elizabeth McErlean, Comment, *The Real Green Issue Regarding Recreational Marijuana: Federal Tax and Banking Laws in Need of Reform*, 64 DEPAUL L. REV. 1079, 1098-99 (analyzing how the issues of banking and tax as being a threat to the legal marijuana system's viability).

428. *Id.*

429. See *id.* at 1103-04 (pointing out that dispensary owners "are forced to operate like drug dealers-cash only" and are forced to take increased security measures as a result).

430. See Chemerinsky et. al., *supra* note 55, at 91 (highlighting the safety concerns of keeping "large quantities of cash on hand").

431. Anita Chabria, *Cash-Only Marijuana Dispensaries Flood California Tax Office with Paper*, THE GUARDIAN (Feb. 16, 2016, 7:00 PM), <https://www.theguardian.com/us-news/2016/feb/16/medical-marijuana-dispensaries-california-tax-cash-only> (on file with *The University of the Pacific Law Review*).

432. *Id.*

433. *Id.*

434. See *With Marijuana Legalized, California Plans How to Collect Taxes*, *supra* note 384 (identifying a need for more funding in order to effectively enforce marijuana regulations in California).

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difficulties counting and storing the money.⁴³⁵ It is hard to imagine that individuals would not misplace money or make accounting errors.⁴³⁶

But, some legislatures are beginning to think creatively about the problem.⁴³⁷ In Washington, legislators proposed that a bank could work if the “state, rather than the [FDIC], would guarantee deposits, providing additional protections from federal seizure,” while banks returned profits from the state.⁴³⁸ In 2014, the FinCEN guidance slightly loosened the restrictions on banking for the cannabis industry; but the effect remains to be seen, especially with the new administration.⁴³⁹ Notably, California is already brainstorming ideas to deal with the issues under Federal law.⁴⁴⁰ For instance, Assembly Bill 1578⁴⁴¹ prevents local authorities from working with federal agents.⁴⁴² Further, groups of cultivators and state officials met to brainstorm ideas on how to provide banking services to the industry.⁴⁴³ They discussed the idea of gathering community support for developing a non-profit financial institution.⁴⁴⁴

Second, Federal Tax Code section 280E treats legal and illegal drugs the same.⁴⁴⁵ This is a major threat to industry profits because “individuals involved in the sale of controlled substances, including legalized marijuana, cannot deduct standard business expenses on their federal income taxes.”⁴⁴⁶ Notably, in 2011,

435. See James Rufus Koren, *Why Some Pot Businesses Hide Their Cash—And Others Truck It Straight To A Federal Vault*, L.A. TIMES (July 17, 2017), <http://www.latimes.com/business/la-fi-cannabis-banking-20170707-story.html> (on file with *The University of the Pacific Law Review*) (discussing how some dispensary owners bury their cash in the backyard, while the city of LA had to purchase new cash counting machines because “office workers were spending so much time counting and recounting cash tax payments from marijuana businesses”).

436. See *id.* (discussing how some dispensary owners bury their cash in the backyard, while the city of LA had to purchase new cash counting machines because “office workers were spending so much time counting and recounting cash tax payments from marijuana businesses”).

437. See McErlean, *supra* note 428, at 1113 (noting that “a group of state lawmakers in Washington, unsure of the current prospects for federal legalization, proposed the establishment of a state bank that would deal with all marijuana business”).

438. *Id.*

439. *Id.* at 1093–94.

440. *California Strikes Back: Proposed Law Bans Locals from Working with Feds on Pot Crack Down*, ENTREPRENEUR (Apr. 18, 2017), <https://www.entrepreneur.com/article/292951> (on file with *The University of the Pacific Law Review*) (highlighting new legislation that would prevent local law enforcement from working with federal officials in enforcing federal marijuana law).

441. AB 1578, 2017–2018, Regular Session (Cal. 2017).

442. *California Strikes Back*, *supra* note 441.

443. Peter Hecht, *Amid California’s Pot Business Boom, Most Banks Run Away From All That Cash*, SACRAMENTO BEE (Apr. 18, 2017, 4:00 AM), <http://www.sacbee.com/news/state/california/california-weed/article145137489.html> (one file with *The University of the Pacific Law Review*).

444. *Id.*

445. I.R.C. § 280E (2006), as cited in McErlean, *supra* note 422, at 1107–08.

446. I.R.C. § 280E (2006), as cited in McErlean, *supra* note 422, at 1107.

the IRS claimed that Harborside Health Center, a dispensary in Oakland, “owed millions in taxes under the application of section 280E.”⁴⁴⁷ Steve Deangelo, owner of Harborside, stated, “[n]o business, including Harborside, could survive if it’s taxed on its gross revenue.”⁴⁴⁸ Indeed, 280E presents a threat to the entire marijuana industry.⁴⁴⁹

One way California could avoid the 280E problem altogether is by following Washington’s lead.⁴⁵⁰ In Washington, the 280E issue has been resolved “...by keeping the state tax separate from federal taxable income for businesses and shifting it to consumers[.]”⁴⁵¹ As noted by the RAND study: a “state can choose a collection mechanism that will reduce federal income taxes on marijuana businesses.”⁴⁵² One way of relieving the federal tax burden on marijuana is for a state to “structure any excise tax (on any base) to apply to the privilege of growing or doing business or to *production* rather than sale.”⁴⁵³ But, this comes with its own disadvantages, and so the industry and state must determine how to address this issue.⁴⁵⁴

IV. “AN OUNCE OF PREVENTION-IS WORTH A POUND OF CURE”

As pointed out by the RAND Study; no matter what policy is chosen, it “will not fit for long.”⁴⁵⁵ Indeed, the “industry will evolve in unpredictable ways,”⁴⁵⁶ and the law will need to be continuously revised and changed.⁴⁵⁷ This section examines potentially overlooked tax bases and identifies areas that may present a risk to the expected revenue goals under Proposition 64.⁴⁵⁸ Then, it evaluates the policy implications of a tax scheme that minimizes risk by focusing on long-term returns, as noted in the RAND study.⁴⁵⁹

447. Chemerinsky et al., *supra* note 55, at 94.

448. *Id.*

449. *Id.*

450. See BRC Report, *supra* note 10, at 18 (observing Washington’s “one-time tax of 37%...clearly avoids [the] federal tax problem”).

451. BRC Report, *supra* note 10, at 52.

452. KILMER ET AL., *supra* note 11, at 87–88.

453. *Id.* at 88.

454. See KILMER ET AL., *supra* note 11, at 87 (noting that the state must decide where the tax will be collected; see also BRC Report, *supra* note 11, at 10 (observing that California’s unique circumstances “will require cannabis laws and regulations that are specifically tailored to California”).

455. KILMER ET AL., *supra* note 11, at 88.

456. *Id.*

457. *Id.*

458. *Infra* Part IV.A.

459. *Infra* Part IV.B.

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A. *Untaxed Bases and Minimizing Risk*

This section examines home growing as a potentially untapped tax base.⁴⁶⁰ It then examines how issues with marijuana testing could negatively impact the expected revenue goals of Proposition 64.⁴⁶¹ Then, using California's medical marijuana market, it considers the potential for tax evasion.⁴⁶² Finally, it examines the potential impact tourism may have on expected revenue in the recreational marijuana market in California.⁴⁶³

1. *Home Growing*

Compared to most illicit substances, marijuana is relatively easy to grow.⁴⁶⁴ It only requires a little bit of knowledge, space, and time.⁴⁶⁵ California allows for a maximum limit of 6 plants for personal use.⁴⁶⁶ But, even with a limitation on the number of plants, cannabis plants can become quite large and dense.⁴⁶⁷ This, therefore, makes up for the loss in the actual number of plants.⁴⁶⁸ Even if California placed limitations by weight, compliance would be difficult because “one full-size outdoor plant can yield a pound of marijuana, which is more than three times the average annual per capita consumption.”⁴⁶⁹ Washington limits home grown marijuana only to medical patients.⁴⁷⁰

The one benefit in this limitation is using home growing as a buffer against big corporations and vertical integration.⁴⁷¹ The cost to start growing at home is “roughly \$100 to get started . . . and for the horticulturally challenged, there are numerous *idiot's guide* type books to show the way.”⁴⁷² But, if production costs are driven down in the commercial sector, would home growing production

460. *Infra* Part IV.B.1.

461. *Infra* Part IV.B.2.

462. *Infra* Part IV.B.3.

463. *Infra* Part IV.B.4.

464. *See* Gieringer, *supra* note 291 (highlighting that cannabis is cheaper than other recreational drugs, such as alcohol).

465. CAULKINS, KILMER & KLEIMAN, *supra* note 10, at 175.

466. CAL. HEALTH & SAFETY CODE § 11362.1(a)(3) (enacted by Cal. Prop. 64, approved Nov. 8, 2016, eff. Nov. 9, 2016).

467. CAULKINS, KILMER & KLEIMAN, *supra* note 10, at 175.

468. *Id.*

469. *Id.*

470. *Id.* at 217–18.

471. BRC Report, *supra* note 10, at 29.

472. Mikos, *supra* note 60, at 238–39.

become cheaper and better, too?⁴⁷³ Selling do-it-yourself type equipment would surely make a profit, and consequently, could generate the state more tax revenue.⁴⁷⁴

In addition, home growing would likely be most attractive to heavy users.⁴⁷⁵ Statistics show that heavy cannabis users account for a large portion of the total market.⁴⁷⁶ Specifically, some estimates observe daily users “account[ing] for 60% of the total market.”⁴⁷⁷ In Colorado, it has been observed that unregulated home growing accounted for around “9%” of the market.⁴⁷⁸ Likely, it may be years before states know the exact number of home growers, but home growers are there, and they have potential to take a big chunk of revenue from the state.⁴⁷⁹ When considering potential tax savings, home cultivation will most likely take up a portion of the market.⁴⁸⁰ Thus, it is worth the legislatures consideration to develop a tax scheme before this becomes a problem.⁴⁸¹

473. See Zara Stone, *The “Grow Your Own Marijuana at Home” Industry Is Booming*, THE HUSTLE (Nov. 3, 2015), <https://thehustle.co/the-grow-your-own-marijuana-at-home-industry-is-growing-fast> (on file with *The University of the Pacific Law Review*) (predicting that the accessory market [such as home growing equipment] for cannabis will eventually be worth more than the direct sale market); cf. Debra Borchardt, *Marijuana Prices Fall In 2016 As Growers Flood The Market With Pot*, FORBES (Jan. 31, 2017, 8:00 AM), <https://www.forbes.com/sites/debraborchardt/2017/01/31/marijuana-prices-fall-in-2016-as-growers-flood-the-market-with-pot/#ac5f502f7f3> (on file with *The University of the Pacific Law Review*) (predicting that “growers will turn to agricultural technology in order to drive down the cost of producing a pound of marijuana”).

474. See Stone, *supra* note 466 (predicting that the accessory market (such as home growing equipment) for cannabis will eventually be worth more than the direct sale market); cf. Borchardt, *supra* note 466 (predicting that “growers will turn to agricultural technology in order to drive down the cost of producing a pound of marijuana”); see also KILMER ET AL., *supra* note 11, at 78 (pointing out that a price based tax has the potential to make marijuana prices too high or too low because it “amplifies changes in pretax price automatically”); see also BRC Report, *supra* note 10, at 49–51 (discussing the difficulty of determining the actual price of cannabis).

475. See Gieringer, *supra* note 291, at 8 (reasoning that home-growing would “be most attractive to heavy users with little money”).

476. See *id.* (highlighting that heavy consumers “are estimated to account for 60% of the total market”).

477. *Id.*

478. LIGHT ET AL., *supra* note 20, at 6.

479. See Gieringer, *supra* note 291, at 8 (highlighting that heavy consumers “are estimated to account for 60% of the total market”); see also Mikos, *supra* note 60, at 246 (arguing that the ease of growing marijuana at homes means that it has the capability of limiting the amount of revenue the state is able to generate on marijuana sales).

480. See Mikos, *supra* note 60, at 246 (arguing that the ease of growing marijuana at homes means that it has the capability of limiting the amount of revenue the state is able to generate on marijuana sales).

481. See *id.* (arguing that the ease of growing marijuana at homes means that it has the capability of limiting the amount of revenue the state is able to generate on marijuana sales).

2. Testing

Regulations requiring every package to be individually tested and labeled have the potential to make a detrimental impact on the amount of revenue earned.⁴⁸² On the other hand, the risk of contaminated cannabis presents a significant threat to public health, as well as a major impact on revenue loss.⁴⁸³ The cost of such a system could be detrimental to the industry.⁴⁸⁴ Lately, it has been made known that cannabis in California is dirty.⁴⁸⁵ For example, in the 2015 Emerald Cup, a Marijuana Festival in the Humboldt County area, 15% of the entries were found to contain contaminants, such as mold or pesticide.⁴⁸⁶ In 2016, “[f]orty flower entries tested positive for pesticides,” and “25% of concentrate entries” tested positive for banned chemicals.⁴⁸⁷ In contrast to this recent data, the Emerald Cup is typically an organic-minded competition that typically has cleaner bud than is found at most dispensaries.⁴⁸⁸

Additionally, recent investigations and sample testing of legal cannabis in Los Angeles has shown most of the product contains high levels of pesticides, levels that would not be allowed in states that have adopted pesticide standards for legal cannabis.⁴⁸⁹ Per Dr. Don Land, a UC Davis chemistry professor and chief scientist for Steep Hill Labs, “most (70-85%) samples they test contain pesticides and ‘somewhere close to a third to a half [of the samples] would fail, say, by Oregon standards.’”⁴⁹⁰ And while most cannabis consumers and growers know that pesticides have been used for decades in illegal grows, testing is new, and the market may react differently.⁴⁹¹

482. CAULKINS, KILMER & KLEIMAN, *supra* note 10, at 138–39; *see also* Romero, *supra* note 339 (citing testing as a variable that may contribute to an increase in the price of marijuana).

483. CAULKINS, KILMER & KLEIMAN, *supra* note 10, at 138–39; *see also* Romero, *supra* note 339 (citing testing as a variable that may contribute to an increase in the price of marijuana).

484. CAULKINS, KILMER & KLEIMAN, *supra* note 10, at 138–39; *see also* Romero, *supra* note 339 (citing testing as a variable that may contribute to an increase in the price of marijuana).

485. Chris Roberts, *Leafly Investigation: California Has a Dirty Cannabis Problem*, LEAFLY (Feb. 15, 2017), <https://www.leafly.com/news/politics/leafly-investigation-california-dirty-cannabis-problem> (on file with *The University of the Pacific Law Review*).

486. *Id.*

487. *Id.*

488. *Id.*

489. Joe Klare, *Legal Pot’s Pesticide Problem: What Can Be Done About It*, THE MARIJUANA TIMES (Mar. 24, 2017), <https://www.marijuanatimes.org/legal-pots-pesticide-problem-what-can-be-done-about-it/> (on file with *The University of the Pacific Law Review*).

490. *Id.*

491. *Id.*

In response, the Bureau of Medical Cannabis (BMC) promised a refurbishment of testing regulations.⁴⁹² Previously, Lori Ajax, head at the BMC, stated that her biggest concern was “whether there will be enough licensed labs to test all of the marijuana.”⁴⁹³ The state, however, will need to spend a lot of money to do this.⁴⁹⁴ Ajax further stated that the barrier to testing is “expensive equipment and rigorous certifications.”⁴⁹⁵ Whatever the cost of getting a system up and running, customers need a legitimate testing system to “give [them] confidence in California’s market place,” and to mitigate any problems that may arise in the event of a marijuana recall.⁴⁹⁶

To begin with, California should review the Blue-Ribbon commission’s suggestion for testing.⁴⁹⁷ That is, the “[t]esting of cannabis—for potency as well as for pesticides, molds and other contaminants—should occur near the points of harvesting and/or processing.”⁴⁹⁸ Further, they recommend testing to be included at each stage of inspection, to test every product and include key information about the product on each label.⁴⁹⁹ But again, multiple testing points are costly.⁵⁰⁰ One possible avenue is to allow the industry to regulate itself with audits, but this could also prove costly in the long run.⁵⁰¹ Nevertheless, California must address the problem before it is too late.⁵⁰²

492. *Id.*

493. David Garrick, *Regulating Marijuana in California will be Turbulent: State Official Says*, THE SAN DIEGO TRIBUNE (Mar. 24, 2017, 4:50 PM), <http://www.sandiegouniontribune.com/news/politics/sd-me-state-pot-20170324-story.html> (on file with *The University of the Pacific Law Review*).

494. *Id.*

495. *Id.*

496. Hillary Bricken, *Dirty Weed? California’s Marijuana Pesticide and Quality Assurance Issues*, ABOVE THE LAW (Apr. 4, 2017, 4:20 PM), <http://abovethelaw.com/2017/04/dirty-weed-californias-marijuana-pesticide-and-quality-assurance-issues/> (on file with *The University of the Pacific Law Review*).

497. See BRC Report, *supra* note 10, at 24 (recommending that “testing of cannabis-for potency as well as for pesticides, molds and other contaminants-should occur near the points of harvesting and/or processing” and to be included at multiple points in the inspection process).

498. BRC Report, *supra* note 10, at 24.

499. *Id.* at 25.

500. See Garrick, *supra* note 494 (noting that “testing labs need expensive equipment and rigorous certifications, creating significant barriers to entry”); see also CAULKINS, KILMER & KLEIMAN, *supra* note 10, at 139 (pointing out that testing “every package” would make “the cost of testing...prohibitive,” while less frequent testing could lead to a “greater risk of quality variations or contamination”).

501. CAULKINS, KILMER & KLEIMAN, *supra* note 10, at 138–39.

502. See, CAULKINS, KILMER & KLEIMAN, *supra* note 10, at 139 (pointing out that testing “every package” would make “the cost of testing...prohibitive,” while less frequent testing could lead to a “greater risk of quality variations or contamination”); see also Garrick, *supra* note 486 (stating concerns over ensuring the proper testing procedures in time for the first day of recreational marijuana sales).

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3. Abuse of the Medical Marijuana System

The medical marijuana system presents another avenue for tax evasion.⁵⁰³ In California's current medical marijuana system, patients with legitimate medical needs coexist with many who utilize the medical system as a workaround.⁵⁰⁴ In Washington, the potential of completely avoiding a large excise tax gives users a lot of incentive to stay.⁵⁰⁵ Heavy users, and those who generally spend more on cannabis, may see the medical market as a very attractive alternative for the price break.⁵⁰⁶ In addition, "[b]alanced against [market] benefits is the danger that some growers will also sell to the illicit market."⁵⁰⁷

According to state officials in Colorado, the legal market, as opposed to the illegal market, accounts for "70% of total estimated demand for marijuana, with much of the rest covered by a 'grey' market of legally home-grown pot illegally sold."⁵⁰⁸ But, "overtime, more than 90% of the market is expected to be supplied by regulated vendors."⁵⁰⁹ Hence, currently many avoid paying the tax by purchasing through the medical market, rather than the recreational market.⁵¹⁰ In Colorado, medical marijuana is not subject to the 10% sales tax at the point of sale, but it is still subject to the 15% excise tax.⁵¹¹ California exempts medical marijuana users from the 7.5% state sales tax.⁵¹² Likely, the effects of reconciliation between the markets will not be known for some time; however, tax evasion through the medical market is a point worth paying attention to.⁵¹³ On the other hand, the medical marijuana industry has a special relationship with certain members of the California community, and the state should give it some

503. See *California's Billion-Dollar Medical Marijuana Market Offers Millions in Tax Revenues*, *supra* note 236 (observing that because of federal penalties many participants in the medical marijuana market "operate underground completely unregulated and untaxed").

504. BRC Report, *supra* note 10, at 31–32.

505. See *id.* at 32 (observing that where there is no excise tax on the medical market then those participating in it "are unlikely to move to the recreational system").

506. See KILMER ET AL., *supra* note 11, at 99 (describing the importance of a "tax break for heavy users because marijuana makes up a significant fraction of their personal budgets," and have higher rates of use).

507. BRC Report, *supra* note 10, at 29.

508. *Reeferegulatory Challenge*, *supra* note 186.

509. LIGHT ET AL., *supra* note 20, at 6.

510. CAULKINS, KILMER & KLEIMAN, *supra* note 10, at 148.

511. See *Marijuana Taxes/Quick Answers*, *supra* note 157.

512. CAL. REV. & TAX CODE § 34012(j) (enacted by Cal. Prop. 64, approved Nov. 8, 2016, eff. Nov. 9, 2016) (allowing exemption for qualified patient or care giver under "§11362.1 of the Health and Safety Code. . . in accordance with the Compassionate Use Act").

513. See *California's Billion-Dollar Medical Marijuana Market Offers Millions in Tax Revenues*, *supra* note 236 (summarizing a report in 2006 that "Californian's consume between \$870 million and \$2billion worth of medical marijuana per year").

level of respect.⁵¹⁴ Thus, state observation of the medical marijuana market, will likely have a large impact on minimizing tax evasion.⁵¹⁵

4. *California Dreaming: The Impact of Tourism on the Cannabis Economy*

In Colorado, the Marijuana Policy Group (MPG) found visitor demand was one of the major factors contributing to the state's revenue return.⁵¹⁶ In 2015, Colorado hosted "77.7 million visitors...[who] spent an all-time high of \$19.1 billion."⁵¹⁷ In that same year, Denver's hotel-room occupancy rate was at 76%, despite the opening of 14 new hotels in the metro area.⁵¹⁸ Similarly, after legalization of cannabis in Oregon, Washington began to notice a decline in sales in counties along the border.⁵¹⁹ In 2017, a survey by a market research firm specializing in cannabis showed "that one-in-five tourists are more interested in visiting an American state if it has legalized cannabis."⁵²⁰ Listed at the top is Colorado and California, followed by Washington, Oregon and Nevada.⁵²¹

To everyone's "surprise," the novelty of marijuana edibles may be contributing to this large uptick in demand for cannabis tourism.⁵²² This may be because it is easy for tourists to consume them in public and in places that ban smoking in common indoor areas.⁵²³ Moreover, they usually provide more bang for the proverbial buck.⁵²⁴ In 2016, there were "268.6 million total person-trips" to the state of California.⁵²⁵ The U.S. Department of Commerce forecast this

514. See BRC Report, *supra* note 10, at 12 (stating that the nation's oldest medical marijuana "industry serves a large number of patients who legitimately need and benefit from medical marijuana").

515. See Mikos, *supra* note 60, at 235 (stating that the state's ability to observe the marijuana market will have a large impact on detecting tax evasion).

516. LIGHT ET AL., *supra* note 20, at 8.

517. Jason Blevins, *Colorado Breaks Tourism Record with 77.7 Million Visitors Spending \$19.1 Billion*, DENVER POST, (July 21, 2016, 9:55 AM) <http://www.denverpost.com/2016/07/20/record-colorado-tourism-2015/> (on file with *The University of the Pacific Law Review*).

518. Markus, *supra* note 183.

519. *Id.*

520. James Mclure, *California And Colorado Are The Top Destinations For Cannabis Tourism, Says Survey*, CIVILIZED LIFE (Mar. 29, 2017), <https://www.civilized.life/articles/california-colorado-cannabis-tourism/> (on file with *The University of the Pacific Law Review*).

521. *Id.*

522. See CAULKINS, KILMER & KLEIMAN, *supra* note 10, at 220–21 (pointing out that the biggest surprise is the emergency room visits caused by ingesting high amounts of potent edibles).

523. *Id.*

524. See *id.* (highlighting the "low cost of extraction done at a large scale" and the difficulties encountered when people eat more than the recommended dose of candy).

525. *California Statistics & Trends*, VISIT CAL., <http://industry.visitcalifornia.com/Find-Research/California-Statistics-Trends/> (last visited on Apr. 20, 2017) (on file with *The University of the Pacific Law Review*).

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figure will continue to rise.⁵²⁶ With the legalization of marijuana, and evidence showing that there is a small market for cannabis tourism, it is important that California does not allow this potential revenue to slip through the cracks.⁵²⁷

B. Policy Implications of Adopting the RAND Findings

This section analyses the practical implications of adopting additional tax bases to optimize revenue in California's recreational marijuana market.⁵²⁸ It then considers the practical implications of adopting a tax policy that maximizes revenue through minimizing risk.⁵²⁹ Finally, it evaluates the benefits of California introducing its taxes one by one rather than all at once.⁵³⁰

1. Tapping into the Power of Untaxed Bases

By utilizing other tax bases, California could minimize tax evasion and optimize revenue.⁵³¹ Specifically, developing real-estate-, electricity-, and potency-based excise taxes in advance will allow California to minimize the risk of tax evasion and optimize potential revenue.⁵³² As noted above, indoor home growing could make up a portion of the market and help fuel the illicit market.⁵³³ This is particularly so if heavy consumers are the ones doing the growing.⁵³⁴ Accordingly, California could utilize electricity-based taxes to capture this untapped market and simultaneously shrink the illicit market.⁵³⁵ For example,

526. *Id.*

527. See Patrick McGreevy, *Legal Marijuana Could Be a \$5-Billion Boon to California's Economy*, L.A. TIMES (Jun. 11, 2017, 12:05 AM), <http://www.latimes.com/politics/la-pol-ca-pot-economic-study-20170611-story.html> (on file with *The University of the Pacific Law Review*) (predicting legalization to boost California's tourism economy because of an expected increase in tourists from states that have not legalized marijuana yet).

528. *Infra* Part IV.B.1.

529. *Infra* Part IV.B.2.

530. *Infra* Part IV.B.3.

531. See KILMER ET AL., *supra* note 11, at 85 (concluding that it might be effective to "consider combining several tax bases").

532. See BRC Report, *supra* note 10 at 51 (reasoning that because "legalization is a process...the state may benefit from implementing tax rules in phases or steps...and those phases and steps may coexist with an evolving and maturing market place"); see also KILMER ET AL., *supra* note 11, at 85, 90–91 (concluding that it might be effective to "consider combining several tax bases," and recommending a "staggered start for tax bases," and "introducing them one by one").

533. *Supra* Part IV.A.1. (reviewing the potential for missed tax revenue by not capturing the indoor home growing marijuana market).

534. See Gieringer, *supra* note 291 at 8 (highlighting that heavy consumers "are estimated to account for 60% of the total market").

535. See KILMER ET AL., *supra* note 11, at 85 (reviewing the approach of the city of Arcata, which utilizes an indoor-electricity add-on base, "has the advantage of taxing both legal and illegal growers).

Arcata, California “presumes that abnormally high use of electricity correlates with marijuana growing under high-powered lights.”⁵³⁶ When high electrical use triggers the presumption, the state assesses the tax.⁵³⁷ Although tax collectors would tailor this type of tax toward indoor growing, it is easy to set up and is cost efficient.⁵³⁸ Further, it is difficult to conceal the amount of electricity one is using, making this a difficult tax to evade.⁵³⁹ This not only creates additional revenue, but it also works to curb environmental damage from excessive electricity use and deter tax evasion.⁵⁴⁰ However, the utility of such a tax would be doubtful if most growing took place outdoors or in a green house.⁵⁴¹ On balance, an electricity excise tax, as part of a broader taxation scheme, may help capture the indoor grow market.⁵⁴²

In addition, a potency-based tax would likely correlate to the THC or CBD content of marijuana.⁵⁴³ This tax measures the psychoactive components of cannabis and could capture another untapped tax base. Eventually, California could use a potency-based tax as a type of secondary tax.⁵⁴⁴ That is, if there is no system in place for the state check the validity of the alleged THC content of cannabis, then one option is to “use the seller’s *reported* or claimed THC content as a secondary or backup alternative minimum tax of sorts.”⁵⁴⁵ Accordingly, this would be an excellent supplement to weight-based taxes.⁵⁴⁶ Likely, a potency-based tax will take years to develop, so the process should start sooner rather than later.⁵⁴⁷ Thus, developing a potency-based tax could become part of a

536. *Id.*

537. *Id.*

538. *Id.* at 86, Table 5.1.

539. *Id.* at 85 (reviewing the approach of the city of Arcata, which utilizes an indoor-electricity add-on base, “has the advantage of taxing both legal and illegal growers); *see also id.* at 86, Table 5.1 (noting a low potential for gaming).

540. *Id.* at 85.

541. *See id.* (pointing out that a tax base based on electricity will not be effective in detecting growing done outdoors or in green houses).

542. *See id.* (concluding that “this base would best serve as a green add-on to another, more substantial base”).

543. BRC Report, *supra* note 10, at 51 (the “tax rate could be . . . adjusted down for the presence of CBD, which may have a mitigating effect on CBD”).

544. *See KILMER ET AL.*, *supra* note 11, at 84 (reasoning that although a potency based tax is to susceptible to “gaming” as a primary tax, it could be utilized as “an alternative minimum tax base;” triggering only when the primary tax base does not capture the true value of the product).

545. *Id.* at 84.

546. *Id.* (proposing that a weight based tax will motivate market participants to pack “the” into marijuana to make it stronger, and avoid paying taxes on the extra value).

547. *See* BRC Report, *supra* note 10, at 51 (suggesting that potency based taxes will become more relevant once the testing industry for marijuana evolves).

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broader taxing scheme that capitalizes on the potential of untaxed bases in the market and deters tax evasion.⁵⁴⁸

2. Scheduling Future Rate Increases: The “Low and Slow” Technique

A tax scheme that focuses on high rates of returns in the short run is riskier than a policy that errs on a lower rate of return over the long term.⁵⁴⁹ As noted above, California’s tax scheme is susceptible to the problem of high prices in a new recreational system, which could lead to devastating results.⁵⁵⁰ First, California’s weight-based tax will take time and money to set up.⁵⁵¹ Plus, because of California’s ad valorem tax will amplify changes in price.⁵⁵² Thus, if California experiences initial high prices, this could slow industry growth and polarize consumers to the black and medical markets.⁵⁵³ Furthermore, issues with potency testing an unregulated medical market, and issues under federal law, could exacerbate the problem.⁵⁵⁴

Likely, predicting the price of cannabis will be virtually impossible.⁵⁵⁵ But, the legislature can minimize risk by taking a less aggressive approach to taxing.⁵⁵⁶ That is, the state can err on the side of facilitating the industry and marginalizing the black market; as opposed to erring on the side of overtaxing the industry and expanding the illegal market.⁵⁵⁷ By taking a less aggressive

548. See KILMER ET AL., *supra* note 11, at 76–87 (concluding that “this base would best serve as a green add-on to another, more substantial base”).

549. *Id.* at 88 (predicting that the “marijuana market will not soon be stable” and that “revenue would suffer from too ambitious a tax plan”).

550. *Supra* Part III.A (reviewing potential issues that could arise under prop. 64).

551. See Oglesby, *supra* note 27 (stating that “a weight based tax takes time to set up”).

552. See KILMER ET AL., *supra* note 11, at 78 (pointing out that a price based tax has the potential to make marijuana prices too high or too low because it “amplifies changes in pretax price automatically”); see also BRC Report, *supra* note 10, at 49–51 (discussing the difficulty of determining the actual price of cannabis).

553. See KILMER ET AL., *supra* note 11, at 78 (pointing out that if the pretax price is too low, a price based tax could push the price of marijuana down to levels that are dangerous for an industry in its infancy).

554. See *California’s Billion-Dollar Medical Marijuana Market Offers Millions in Tax Revenues*, *supra* note 236 (observing that because of federal penalties many participants in the medical marijuana market “operate underground completely unregulated and untaxed”); see also McErlean, *supra* note 422, at 1098–99 (analyzing how the issues of banking and tax as being a threat to the legal marijuana system’s viability).

555. See BRC Report, *supra* note 10, at 49–51 (discussing the difficulty of determining the actual price of cannabis).

556. See KILMER ET AL., *supra* note 11, at 88 (predicting that the “marijuana market will not soon be stable” and that “revenue would suffer from too ambitious a tax plan”); see also Oglesby, *supra* note 27 (pointing out that the “start low and go slow” technique is best for marijuana tax policy).

557. See KILMER ET AL., *supra* note 11, at 88 (predicting that the “marijuana market will not soon be stable” and that “revenue would suffer from too ambitious a tax plan”); see also Oglesby, *supra* note 27 (pointing out that the “start low and go slow” technique is best for marijuana tax policy).

approach to taxing, the legislature can help the industry by not working against it.⁵⁵⁸ In California, the tax system on marijuana should “start low and go slow,” with a goal toward long-term revenue gain.⁵⁵⁹ Especially when those who will be participating in the market already disgruntled over the taxes that are piling up at the county and local level.⁵⁶⁰

Likely, the price of cannabis will eventually fall; so as this happens, the legislature could mirror the projected drop-in-price with an increased tax rate.⁵⁶¹ But California already anchors the tax rate on cultivation and retail at a high rate, which will make it difficult to increase in the future.⁵⁶² If California needs to raise the current tax rate, the public outcry will surely be greater than if the tax went from 8% to 9%, or 9% to 10%.⁵⁶³ That is, even if California picked the right number, they should have started lower and allowed room to increase the rate.⁵⁶⁴

Indeed, California would be wise to adopt the RAND study suggestion to “schedule rate increases in advance” by specific amounts.⁵⁶⁵ By knowing what the market is generally going to do in advance, California should schedule future tax increases, then mirror the projected market price, and adjust as needed.⁵⁶⁶ As discussed in the BRC Report, this is similar to “gradually raising the minimum

558. See Oglesby, *supra* note 27 (identifying the benefit in taking a more conservative approach when taxing cannabis).

559. Oglesby, *supra* note 27.

560. McGreevy, *supra* note 422.

561. See Borchardt, *supra* note 474 (predicting that “growers will turn to agricultural technology in order to drive down the cost of producing a pound of marijuana”); see also BRC Report, *supra* note 10, at 51, 54 (reasoning that slowly increasing the tax “gives businesses the time to adjust,” and discussing how cannabis tax policy takes time, is a “process,” and should be flexible adapt to the needs of the market as it changes over time).

562. See McGreevy, *supra* note 422 (discussing the cloud of concern hovering over the cost of marijuana as “cities and counties pile their own taxes of up to 15% on top of the 15% state excise tax approved by voters”); see also KILMER ET AL., *supra* note 11, at 90 (highlighting the goal of scheduling future rate increases is to “try to maintain prices that consumers would pay”); see also Romero, *supra* note 339 (citing inventory, compliance with laws, demand, testing and experiences of other states as all possible variables that may contribute to an increase in the price of marijuana).

563. *Medical Marijuana Advocates Worry Pot Price Spike Coming to California*, CBS LOS ANGELES (Jun. 9, 2017, 1:37 PM), <http://losangeles.cbslocal.com/2017/06/09/medical-marijuana-price-spike-california/> (on file with *The University of the Pacific Law Review*) (observing the growing concern from advocates that the marijuana prices will rise after legalization).

564. See BRC Report, *supra* note 10, at 54 (reasoning that slowly increasing the tax “gives businesses the time to adjust”).

565. KILMER ET AL., *supra* note 11, at 90.

566. See BRC Report, *supra* note 10, at 54 (reasoning that slowly increasing the tax “gives businesses the time to adjust”).

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wage.”⁵⁶⁷ This would not only protect the industry from a shaky start but also a price collapse, and likely would lead to long term revenue gains.⁵⁶⁸

3. A Staggered Start for Tax Bases

California should introduce its taxes one by one, rather than all at once.⁵⁶⁹ That is because different taxes will need different amounts of time to set up.⁵⁷⁰ Less tax bases relieve industry pressure similar to lower starting prices.⁵⁷¹ Electricity, real estate, and ad valorem taxes are easy and inexpensive to set up.⁵⁷² On the other hand, weight-based taxes “require [the] establishment of standards, procedures, and weighing locations.”⁵⁷³ Clearly, some of the pressure put on the regulatory structure to perform would be alleviated by taking the time to properly set up the weight-based excise tax system.⁵⁷⁴ Especially considering if there is a rush to get the weight-based tax set up, there will likely be a significant learning curve.⁵⁷⁵ Hence, it would be best to take the time required to do the job right once and allow “price taxes to lead the way in the ‘tax-base march of progress.’”⁵⁷⁶

567. See BRC Report, *supra* note 10, at 54 (explaining that “scheduled rate increases, like the gradual increase in the minimum hourly wage in Los Angeles to \$15 by 2020, give businesses time to adjust”).

568. See KILMER ET AL., *supra* note 11, at 88 (predicting that the “marijuana market will not soon be stable” and that “revenue would suffer from too ambitious a tax plan”); see also Oglesby, *supra* note 27 (pointing out that the “start low and go slow” technique is best for marijuana tax policy).

569. See KILMER ET AL., *supra* note 11, at 75 (discussing the “undesirable side effects” of high taxes); see also *id.* at 75 (highlighting that “low taxes would tend to allow a nascent market to compete with local black and gray markets; to provide a low-cost product to consumers; to limit regressively; and to increase compliance with tax laws, thus reducing enforcement and collection costs”).

570. See *e.g.*, KILMER ET AL., *supra* note 11, at 90–91 (reviewing the benefits of introducing tax bases one by one); BRC Report, *supra* note 10, at 51 (noting that delaying some of the different tax bases could help the industry get on its feet).

571. See KILMER ET AL., *supra* note 11, at 90–91 (comparing real estate and electricity taxes, which can start immediately, to price-based taxes which require time to set up, and weight based taxes which take much longer than the aforementioned bases).

572. See BRC Report, *supra* note 10, at 51 (pointing out that a delay in implementing tax bases would allow the industry and board of equalization the proper amount of time to effectively set up the market).

573. See KILMER ET AL., *supra* note 11, at 90–91 (comparing real estate and electricity taxes, which can start immediately, to price-based taxes which require time to set up, and weight based taxes which take much longer than the aforementioned bases).

574. *Id.* at 91.

575. See BRC Report, *supra* note 10, at 51 (pointing out that a delay in implementing tax bases would allow the industry and board of equalization the proper amount of time to effectively set up the market).

576. See BRC Report, *supra* note 10, at 51 (recommending that the industry could benefit from the delay of a weight based excise tax).

Oglesby, *supra* note 27.

Further, as the market fluctuates, the industry can reflect those changes in the tax base that they use.⁵⁷⁷ Developing secondary taxes in advance, such as potency, real-estate, and electric, would help prepare for any unexpected fluctuations.⁵⁷⁸ Thus, allowing the market to adjust quickly to changing circumstances and avoid unnecessary delay that may slow industry growth.⁵⁷⁹ That way, the tax scheme could adjust quickly and maximize potential revenue in the market.⁵⁸⁰

V. CONCLUSION

California should adopt several mechanisms for changing the tax burden, as recommended in RAND for adjusting the marijuana tax rate.⁵⁸¹ For instance, by scheduling future increases in the tax rate,⁵⁸² alongside the addition of various tax bases, California could minimize revenue loss and account for potential untapped tax bases.⁵⁸³ A tax scheme motivated by profits in the short run will fail to optimize revenue in the long run.⁵⁸⁴ Hence, the legislature should pursue a cannabis tax policy that focuses on reducing risk and facilitating growth by mirroring its expected trajectory, rather than cutting against it.⁵⁸⁵ Accordingly, California could ground its tax structure so that uncontrollable and unknowable factors do not impact tax revenue as greatly.⁵⁸⁶ The state's achieved revenue largely depends on several unknowable and unpredictable variables.⁵⁸⁷ Hence, no

577. See BRC Report, *supra* note 10, at 48–52 (highlighting that the “steps in the process” may evolve with the market place).

578. See KILMER ET AL., *supra* note 11, at 85–86 (concluding it may be advantageous to “consider combining several tax bases”); see also, BRC Report, *supra* note 10, at 51 (highlighting that the “steps in the process” may evolve with the market place).

579. See BRC Report, *supra* note 10, at 51 (pointing out that a delay in implementing tax bases would allow the industry and board of equalization the proper amount of time to effectively set up the market); see also KILMER ET AL., *supra* note 11, at 91 (pointing out that some bases are easier to implement than others).

580. Cf. KILMER ET AL., *supra* note 11, at 88 (reasoning that the industry would “suffer from too ambitious a tax plan”).

581. See *supra* Part IV.B (discussing the policy recommendations as recommended by Rand for taxing marijuana).

582. See *supra* Part IV.B.2 (reasoning that a low and slow technique would minimize short term risk and maximize long term gain).

583. See *supra* Part IV.B.3 (discussing the implications of adopting a staggered start for tax bases, alongside adding additional tax bases).

584. See *supra* Part IV.B (discussing a slow and steady start for taxes that gradually increases with time).

585. See BRC Report, *supra* note 10, at 54 (reasoning that slowly increasing the tax “gives businesses the time to adjust”).

586. See *supra* Part III (discussing potential issues that may arise in California’s recreational market).

587. Vitiello, *supra* note 19, at 782 (discussing how much additional tax revenue depends on “many variables, including methods of implementation of marijuana laws”).

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matter what policy a state chooses, it “will not fit for long.”⁵⁸⁸ Irrefutably, the “industry will evolve in unpredictable ways,” forcing legislation to continuously revise and change the law.⁵⁸⁹ Thus, the key for any policy toward cannabis is flexibility.⁵⁹⁰ Regardless, one state at a time, legal cannabis is seemingly here to stay, and California’s sociopolitical weight is sure to take a prominent role in establishing the legal framework of the industry’s future.⁵⁹¹

588. KILMER ET AL., *supra* note 11, at 88.

589. *Id.*

590. *See id.* (stating that whatever policy is “chosen it will not fit for long”).

591. *See* Margolin, *supra* note 8 (discussing the inevitable industrialization of the marijuana industry, and California’s potential to further validate it).