



Case Study 1: Taxing a New Industry

Legalization of recreational marijuana at the state level and how to tax it: Examples from Colorado and California.

Since 1970, marijuana has been classified a Schedule I controlled substance by the U.S. federal government. Despite this, voters and/or legislatures in 19 states and Washington, D.C. have voted to legalize growing, processing, selling, or consuming recreational marijuana for adults over 21 years of age.

More states are contemplating the tradeoffs associated with legalizing recreational marijuana and taxing it to obtain a new stream of revenue. In fact, a key point when legalizing recreational marijuana is tax design. Most states that currently allow and tax sales have opted for a price-based (*ad valorem*) excise tax and levy the general sales tax on recreational marijuana sales.

Problems and Considerations

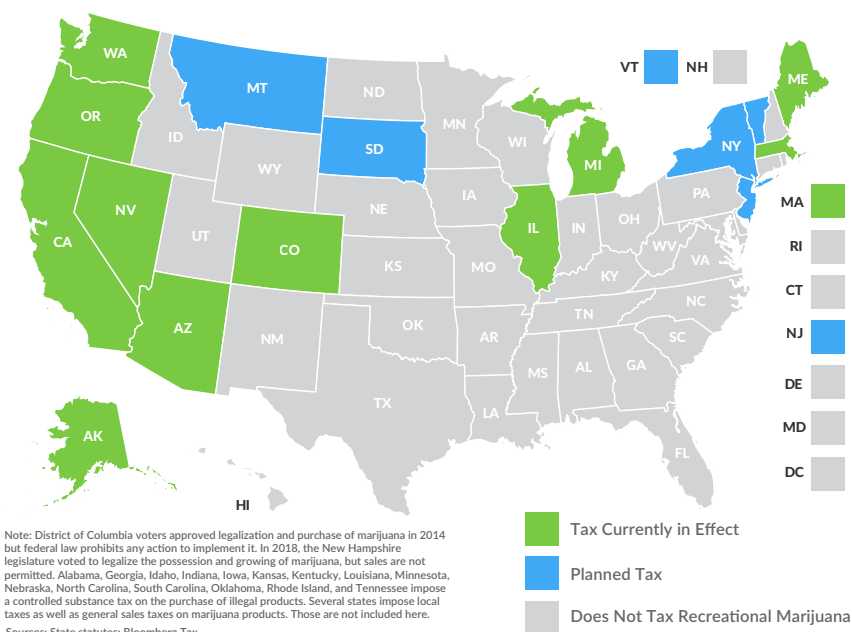
Some states have seen relative success in legalization, while others have struggled to integrate the new industry into communities, business practices, current legislative code, and taxation.

There are various options for taxing recreational marijuana. Some are best for government revenue, and some for small and new businesses and consumers. Some states have implemented multiple layers of tax and some collect only at the final point of transaction. *The difference in approach in legal states makes a direct comparison among current policies difficult.*

There are still many unknowns when it comes to the taxation of recreational marijuana, but as more states open legal marketplaces and more research is done to understand the externalities of consumption, more data will become available.

Does Your State Tax Recreational Marijuana?

State Recreational Marijuana Tax Rates, as of March 31, 2021



Colorado

Colorado voted to legalize recreational marijuana in 2012, permitting use by adults over 21 years old. The following year, a [proposition](#) was approved that allowed the state to levy an excise tax of up to 15 percent on unprocessed retail marijuana (based on Average Market Rate) and a retail sales tax of 10 percent. Retail sales of cannabis were also taxed under the general sales tax, but the product was exempt and the excise tax rate at retail was changed to 15 percent in 2017, despite the retail sales tax on most goods being 2.9 percent. The marijuana retail excise tax is levied on the *consumer*, while the cultivator excise tax is levied on the *grower* (cultivator).

The revenues from excise taxes are allocated to different areas of the budget. Retail tax revenue is split among various areas of the budget:

Colorado Marijuana Sales Tax Revenue

Marijuana Tax Cash Fund	64.67%
General Fund	14.00%
State Public School Fund	11.33%
Local Governments	10.00%

All revenue from the cultivator excise tax goes to the Building Excellent Schools Today (BEST) Fund, to finance costs of repairs and upkeep of public schools.

California

California legalized the sale and use of recreational marijuana in 2016, which went into effect in January 2018. The reform has had mixed success in the state: according to one [study](#), illicit sales still outnumber licensed sales three to one.

The state levies a cultivation tax based on weight and category, a 15 percent excise tax on wholesalers and distributors, and the state retail

sales tax of 7.25 percent. Localities levy local sales taxes of up to 1 percent, and a multitude of other business taxes.

By way of example, in Los Angeles, cannabis businesses are taxed according to this schedule:

Cannabis Taxes in Los Angeles

Business Type	Rate
Sales	10% of gross receipts
Transportation	1% of gross receipts
Testing	1% of gross receipts
Cultivation	2% of gross receipts
Miscellaneous	2% of gross receipts

Source: Los Angeles Office of Finance, Cannabis Tax Rate Table, <https://finance.lacity.org/cannabis-tax-rate-table>.

Levying taxes at every level of the supply chain results in tax pyramiding, which easily drives up effective tax rates above 45 percent and increases the complexity of the tax code. It becomes increasingly difficult for taxpayers to understand how much they are paying in taxes when several layers of government implement several layers of taxation throughout the supply chain.

The state tax is also rather complicated. The 15 percent cannabis retail excise tax is levied at the wholesale level, resulting in the California Department of Tax and Fee Administration (CDTFA) calculating an Average Market Price (AMP) value by marking up the wholesale value by 80 percent. This means that marijuana worth \$100 at wholesale will be taxed at 15 percent at the AMP value of \$180. The markup rate increased due to inflation as of January 2020.

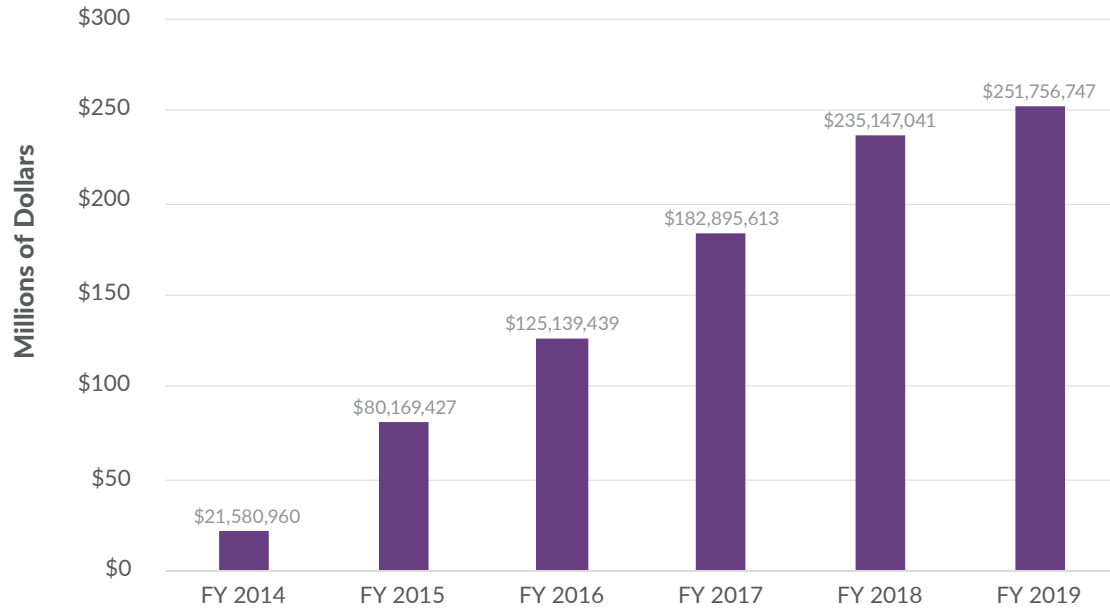
California Marijuana Excise Tax Revenue*

Youth Anti-Drug Programs	60.00%
Environmental Programs	20.00%
Public Safety Grants	20.00%

*Revenue after allocation to regulatory costs and research

Colorado's Excise Tax Revenue Is Growing Quickly after Sales Began in 2014

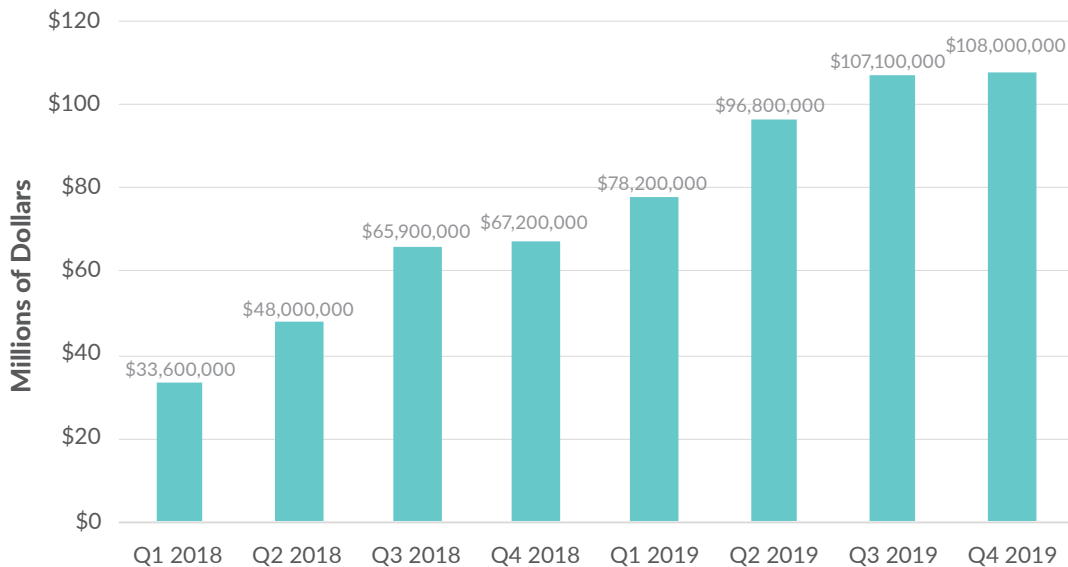
Recreational Marijuana Tax Revenue by Fiscal Year



Source: Colorado Department of Revenue.

California's Marijuana Excise Tax Revenue Fails to Meet \$355 Million Projections for Fiscal Year 2019

Marijuana Tax Revenue by Quarter



Note: Figures include medical marijuana tax revenue.
Source: California Department of Tax and Fee Administration.

Summary of Policies

Complicated and burdensome tax structures and rates make it difficult for new, small, and especially minority-operated-and-owned businesses to open or remain open.

While both Colorado and California have multiple layers of tax, the magnitude of the taxes in California result in significant [tax pyramiding](#), and an environment where it can be more profitable to sell and more affordable to purchase in the illicit market.

This may explain why California's projections for marijuana tax revenue were not met. The tax system contributed to an environment where it became too difficult for licensed businesses to compete with illicit operations.

Conversely, Colorado operates with a relatively simple and less burdensome system for taxing recreational marijuana. This has better accommodated the legal market and allowed tax revenues to grow.

However, in both states, the taxation of recreational marijuana does not adequately meet the [principles of sound tax policy](#): simplicity, transparency, neutrality, and stability.

	Colorado	California
Simplicity	✓	✗
Transparency	✓	✗
Neutrality	✗	✗
Stability	✗	✗

Further Reading

Below are some resources regarding recreational marijuana legalization and taxation from Tax Foundation and other sources. Please conduct additional research on the case prior to discussion.

[A Road Map to Recreational Marijuana Taxation](#)

[How High Are Taxes on Recreational Marijuana in Your State?](#)

[Which States Have the Highest Taxes on Marijuana?](#)

[Several States Considering Legal Recreational Marijuana](#)

[New Jersey May Be the First State Without an Excise Tax Levy on Recreational Marijuana](#)

[Excise Tax Application and Trends](#)

[State Taxation of Cannabis](#)

Reflect on the following questions:

- What is the problem(s)?
- How do these policies meet (or not meet) the [Principles of Sound Tax Policy](#)?
- What general options are available to develop more sound policy?
- Who are the stakeholders and what are their interests?
- How has this problem been addressed in other states?