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Lessons on Legalizing and Taxing Marijuana from the Colorado and Washington Experience

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Before the Joint Hearing of the
Committee on Business, Consumer and Regulatory Affairs and
Committee on Finance and Revenue

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Chairman Orange, Chairman Evans, and members of the Committee:

I appreciate the opportunity to testify today on proposed legislation that would legalize and tax marijuana in the District of Columbia. While the current draft of the legislation would impose a 6 percent tax on medical marijuana and a 15 percent tax on all other marijuana products, in addition to license fees ranging from $2,000 (retailer) to $6,000 (producer), it is my understanding that final tax and fee amounts are still under consideration.

I have attached a Tax Foundation report I recently authored, *Taxing Marijuana: The Washington and Colorado Experience*. This report summarizes those two states' experience with legalizing and taxing marijuana to date. Our study relied on revenue projections issued prior to legalization, actual revenue collections reported by the relevant state agencies, and discussions with legislative and administrative officials to relate their experience so far. As a non-partisan 501(c)(3) organization, we take no position on the proposed legislation, but we hope that the material we provide will be helpful in the Committee's consideration of the issue.

While legalization in both states is still new (Colorado legal sales began January 1, 2014, and Washington legal sales began June 1, 2014), both states have encountered similar challenges.

- **Both states had pre-existing medical marijuana programs and thus had to determine whether to wrap these programs into the larger retail scheme, or continue a separate existence which in turn required differentiating its purpose and administrative apparatus**. Colorado and Washington both have chosen to continue their separate medical marijuana programs, with the only tax imposed being the retail sales tax on all other goods and products. Both states apply this tax even to edibles and liquids that normally would be exempt from sales tax as grocery or food item, which required special legislation in Washington.

- **Both states limited the quantities of marijuana products that consumers may purchase**. Colorado, for instance, limits purchases by residents to one ounce of any kind of marijuana (non-residents can purchase up to one-quarter of an ounce), while Washington limits adults to one ounce of "bud" (the flowering part of the plant), 16 ounces of edible solids, 72 ounces of edible liquids, or 7 grams of concentrates or lotions.

- **Both states revised criminal laws** to ban public consumption, driving under the influence, and taking marijuana outside the jurisdiction. Out-of-state visitors are permitted to purchase marijuana, and make up an estimated 44 percent of Colorado sales. Additionally, regulations were adopted to address health and safety requirements for marijuana retailers and the use of marijuana by employees of marijuana retailers. Washington has also capped the number of retail locations, which required an administrative apparatus to award licenses on a lottery basis.

- **Both states had to determine the tax rate on retail marijuana**, and opted for very high taxes on a percentage basis. Marijuana taxes must be structured differently than other excise taxes because marijuana exists in a number of different forms: it can be smoked, eaten, drank, or applied to the skin. This affects purchase amount restrictions.
  - Colorado's approximately 29 percent tax on retail marijuana is about equivalent to the fairly punitive tax on tobacco products, almost four times the tax on liquor, and four times the sales tax on ordinary goods and services.
  - Washington's approximately 44 percent tax on retail marijuana is about half the cigarette tax rate, four times the beer tax rate, and five times the sales tax on ordinary goods and services.
  - Alaska's Measure 2 (on the November 4 ballot) would impose an approximately 21 percent tax, and Oregon's Measure 91 (also on the November 4 ballot) would impose an approximately 15 percent tax). Both states have no state sales tax on the purchase of general goods and services.

Both states have seen revenue collections underperform significantly compared with estimates prior to legal sales beginning, as our report details. Colorado expected $70 million per year and is only collecting about $30 million per year. Washington was less definite on its revenue expectation, with an official estimate of between zero and $1.9 billion over five years. Officials currently estimate approximately $122 million to $168 million per year, but tax receipts in the first month of sales totaled only $1 million.

Why have revenues fallen short? There are a number of possible explanations.

- **The programs are new and take time to gear up.** Washington, in particular, has awarded only a small number of its retail licenses so far.

- **The retail industry is capital-starved due to legal uncertainty relating to continued federal prohibition.** With marijuana still against federal law, the nascent industry consists mostly of small operations that operate on a cash basis. Large companies and banks are more risk-averse and have not entered the market to compete or make loans to marijuana businesses.

- **The limitations on per-individual purchases and interstate shipment have reduced sales**. Colorado estimates that 44 percent of its retail market are tourist purchases, suggesting an enormous untapped potential market for being one of the first states to legalize that is hobbled by the purchase and transport restrictions. However, these restrictions are important to neighboring states that have not legalized marijuana and to avoid direct conflict with federal drug laws.

- **The tax rates are too high, relative to both medical marijuana taxes and the black market**. Colorado revenue officials expected that most purchasers of medical marijuana would switch to retail marijuana, and this did not happen. Medical marijuana in both states is subject to only state and local sales taxes, many times lower than the taxes on retail marijuana. Colorado estimates that the black market continues to supply 6 percent of marijuana demand, which suggests that the combined tax rate of 29 percent is too high.

Public finance theory says that the purpose of excise taxes is to address externalities; that is, a special tax on a particular product should exist only to compensate society for net costs imposed by its use. If such net costs cannot be identified, the proper excise tax rate should be zero, with the product subject only to the ordinary sales and use tax.

Marijuana has been prohibited for a long time and there is great dispute over whether the costs of legalization outweigh its benefits, and if so, by how much. Colorado and Washington did not undertake such an analysis, instead implicitly picking high tax rates so as to generate a windfall. Since marijuana is generally a discretionary purchase and a large black market infrastructure presently exists, these punitively high taxes rates failed to eliminate the black market or generate the expected revenue. This should be a vital lesson for the District of Columbia and other jurisdictions considering legalizing and taxing marijuana.

Our report is attached to my written statement. I thank you for the opportunity to present to you today.