

February 2, 2016

M E M O R A N D U M

To: The Vermont Senate Committee on Finance

Re: Minimizing the Power of the Illegal Market, Maximizing Potential State Revenues and Encouraging Responsible Business Practices in a Regulated Cannabis Market in Vermont

Introduction: Balancing Two Competing Goals

In determining taxation policy for an erstwhile cannabis industry, the Committee on Finance has the delicate task of balancing two competing goals that are difficult to reconcile. On the one hand, it is imperative that retail cannabis prices in the regulated market be sufficiently low so as to attract consumers away from the existing, entrenched illegal market. On the other hand, sufficient tax revenues must be raised both to finance the operation of the regulatory system, and to fund important priorities such as drug education, prevention and treatment programs, and drugged driving enforcement. The former goal calls for keeping tax rates low, while the latter calls for higher rates.

This Memorandum will discuss several options for the Committee to consider in finding an effective balance, while at the same time encouraging responsible business practices by operators and financiers of cannabis establishments, and will conclude that, through appropriate policy choices, the State can, over time, achieve both goals.

Price Elasticity of Demand Across Parallel Markets

At its inception, the regulated cannabis market will be unlike any other market in place today, as it will exist alongside an entrenched, parallel underground market, to which consumers have become accustomed. The mere existence of a parallel market restricts the State's ability to reduce consumption through taxation (as has been successfully done with tobacco), as instead of consuming less cannabis overall in response to higher prices on the legal market, consumers – particularly heavy users – will simply shift their purchases to the illegal market as the price disparity increases.

This does not mean, however, that the regulated market must maintain prices below or at parity with the illegal market. There is some evidence from other states that consumers are generally willing to pay some premium in a regulated market. Policy analysts and cannabis business operators in other states have indicated that this acceptable premium ranges between 5% and 25%. Factors that drive consumers to pay more in a regulated market are varied, including consumer preference for a safe purchasing experience, reliable storefront operating hours, a wider product selection, and quality control improvement resulting from product-testing requirements.

The Committee should, in setting tax rates, aim to find the “revenue maximizing tax rate”. In economic parlance, this is the “Goldilocks” rate at which taxes are neither too high so as to drive consumers to the parallel illegal market without actually decreasing overall use, nor too low so as to reduce tax collections without the offsetting benefit of incentivizing additional consumers to transition to the regulated market.

Lacking a comprehensive cross-market price elasticity study, it is not presently possible to pinpoint the revenue maximizing premium that the State should target in setting tax rates, and thus the Committee should proceed cautiously. I respectfully suggest the Committee consider (i) mandating the Study Commission to consider the issue, including by commissioning an econometric study (which could be conducted quickly and at relatively low cost by eager UVM graduate students in collaboration with colleagues in Colorado and Washington), and (ii) initially targeting a 10% after-tax price premium over the illegal market, to be adjusted either by the Legislature or an appropriate regulatory body as conditions dictate. Thus, for example, if the prevailing illegal market price for an eighth-ounce of cannabis flowers is \$45, then the Committee should initially aim for a regulated retail price of about \$50, inclusive of applicable taxes.

It is probable that market prices will differ based on location, with higher prices prevailing seasonally in ski resort towns, and lower prices prevailing in less developed rural communities, and the Department should be mandated to consider such regional variations.

Tax at Both the Wholesale and Retail Levels

I recommend that the Committee consider two types of taxation on cannabis transactions: a wholesale excise tax, and a retail sales tax.

A wholesale tax should be applied upon the first transfer to a licensed retailer, rather than the first transfer from the licensed cultivator. In the initial structure envisioned by the current draft of S.241, there is no substantive difference between these two points of taxation. However, the Committee would do well by anticipating future changes, such as the possibility that marijuana-infused products (MIP’s) might be permitted at some point, and that additional players such as

wholesalers and producers may be included in the supply chain. In such an event, a tax applied at first transfer from the cultivator would not capture any of the value added by these additional intermediaries, while a tax applied at the first transfer to a retailer would. By addressing this issue proactively, the Committee would eliminate the risk that future political friction prevents the Legislature from addressing the issue after it has become ripe.

The Committee ought not set different tax rates based on the THC content of the cannabis being taxed. While this type of differentiation is common in the taxation of alcohol, such a regime in the nascent cannabis industry (where testing has not been perfected) may encourage cultivators and manufacturers to under-report THC content in order to pay less tax.

An additional retail sales tax will also play an important and beneficial role, particularly if municipalities are allowed to impose a local option tax on cannabis sales. At the State level, the retail sales tax should be decoupled from the ordinary sales tax to allow for market responsiveness (as further discussed below), but would likely be appropriately set somewhere between the ordinary sales tax rate and the on-premises alcohol tax rate. Allowing a local option tax would serve a dual purpose of (1) encouraging municipalities to participate in the regulated system, driving out local illegal dealers, and (2) funding any additional local law enforcement costs associated with local cannabis businesses.

The Major Drivers of Retail Prices

The core marginal costs of cannabis cultivation are a relatively small component of the ultimate retail price in the illegal market. The illegal grower does not typically pay non-wage benefits to hired hands, and uses public land or property already in his or her possession. A major component of price in the illegal market, however, is the risk premium associated with the illegality of the activities.

In a state-regulated market, this risk premium is significantly reduced, and is replaced with other cost components. Certain components, such as quantity of demand, employee wages and benefits, and commercial rents, are outside of the State's effective control. Others, however, are fully within the State's control, and present the State with powerful levers to impact the ultimate retail price. The most powerful levers are (1) exerting control over the level of supply (either shrinking supply to increase price, or increasing supply to decrease price), (2) establishing regulatory costs (license fees, cost of compliance), and (3) setting sales and excise tax rates. The more than the State can use the first two levers to push prices down, the more room is left for the State to increase tax rates without driving demand to the illegal market.

The Strongest Lever: Focus on Supply

As currently drafted, S.241 permits up to thirty licensed cultivators to initially supply up to forty licensed retailers. I respectfully submit to the Committee that the limited number of suppliers is likely to cause retail prices on the regulated market to be artificially inflated in excess of the illegal market price in the short and intermediate term, and propose that the number be increased.

By creating a system where retailers outnumber cultivators, the State will unintentionally grant greater pricing power to the cultivators. If, however, the State were to issue a larger number of licenses (particularly, in excess of the number of licensed retailers), several benefits can be attained. First, the cultivation market will fragment, giving licensed retailers greater purchasing power vis-à-vis any individual cultivator, which in turn reduces the wholesale price. Second, allowing a greater number of cultivators will lead to increased competition on the basis of variety and quality, which, as discussed above, will in turn lead to a greater tolerance among consumers for a tax-driven price premium within the regulated market. And, third, by allowing retailers to purchase from a larger subset of Vermont's existing producers will cause significant damage to the illegal market, as these producers are, by and large, very eager to enter the regulated market and pay their taxes and fair licensing fees. By diverting this existing supply away from the illegal market and into the hands of licensed retailers, the State would at the same time raise wholesale prices on the remaining illegal market, as all things being equal, underground dealers will have to pay more to attract the remaining available supply. This further ratchets up the State's ability to maximize tax revenues, as the parallel market pricing disparity thus shifts in favor of the regulated market.

I have heard concerns that a greater number of cultivators will make it difficult for the Department of Public Safety to effectively enforce regulations over the industry, or could flood the market with an over-supply of cannabis. Respectfully, I believe these concerns are well-intentioned but misplaced.

Illegal grows are happening today, and will continue to happen after S.241 passes – in each case outside of the scope of regulatory scrutiny. Rather than focusing on licensing a small number of cultivators, the Committee should focus on licensing that number of cultivators that maximizes the Department's ability to reduce the supply of illicitly grown cannabis and enforce the law over the entire market (i.e., licensed and otherwise). Even if this increased number of licensed cultivators would slightly reduce the frequency of inspection, the State would benefit greatly from a reduced supply and power of currently unregulated growers. Concerns about over-supply are based on an assumption that resultant low prices would encourage more use, but as wholesale price drops can be matched with increased taxes, there will be no net effect on quantity demanded.

Specifically, I urge the Committee to consider (1) increasing the number of cultivation licenses at the initial stage from 30 to at least 50, with a disproportionate

preference for applicants wishing to cultivate an area of under 5,000 square feet, and (2) instructing the Department, in determining the exact number of licenses both prior to and after 2018, to base its determination primarily on the Legislature's stated goal of making a sufficient and varied supply available to licensed retailers at low prices that support a reasonable wholesale tax rate. As currently drafted, the Department's determination would be based entirely on discretion, without guidance as to the Legislature's underlying policy preference.

Market-Responsive Tax Rates

While the need to maintain competitiveness against the parallel illegal market will necessitate lower tax rates in the early years of legalization, the State will gain the ability to increase rates over time (likely, 5-10 years out) if efforts to diminish the strength of the illegal market are successful. Once consumers are accustomed to purchasing from a regulated retailer, and have lost contact with their former underground suppliers, "switching costs" will work to prevent these consumers from reverting to the illegal market in response to higher prices. Ultimately, if the illegal market is sufficiently diminished, the State could in theory begin taxing marijuana in a manner intended to reduce overall consumption.

In the short term, however, it is in the State's best interest to start effective tax rates at a lower level, and continually adjust in response to actual market conditions. In Colorado, for example, the state's Department of Revenue analyzes wholesale market prices across multiple categories (flower, marijuana infused products, etc.) every six months, and applies the statutorily-fixed 15% tax rate to an adjusted average-market price in an effort to ensure that after-tax wholesale prices in the regulated market are competitive with the parallel market.

I urge the Committee to consider a mechanism allowing similar market responsiveness in Vermont, preferably on a quarterly rather than semi-annually as done in Colorado. The Legislature could, for example, set a band within which an agency (ideally one whose unrelated programs are not directly funded by cannabis taxes) can set the actual rate, or utilize a system similar to Colorado's which fixes the tax rate but applies that rate to an adjusted average market price, resulting in a flexible effective tax rate that disfavors inferior (lower-priced) producers. The Legislature could consider additional mechanisms such as requiring material changes to be approved by the Chairs and Ranking Members of the Finance, Ways and Means and Appropriations Committees, in order to maintain desirable separation of power.

Income Tax Considerations

The federal legal status of cannabis creates many complexities for State-level regulation, but one often-overlooked federal income tax complication in particular has the capability to sink otherwise successful cannabis establishments. Section 280E of the Internal Revenue Code disallows the deduction of most ordinary

business expenses (e.g., rent, insurance premiums, wages, interest, state and local taxes) in connection with the federally-illegal sale of drugs, including cannabis. The frequent result is that a marijuana establishment's federal tax bill can exceed its actual profits from operations.

While there is nothing Vermont can do to change Section 280E, the Committee should work to avoid unintentionally worsening its impact. Thus, for example, any tax provisions – whether applied at the wholesale or retail levels – should be written in such a way that the licensed business is not required to recognize the taxes collected as income to the business. In addition, I urge the Committee to re-allow, for State income tax purposes, all deductions disallowed under 280E for federal tax purposes, as Colorado has done.

Promoting Responsible Business Practices

The current draft of S.241 wisely attempts to impose substantial Vermont residency requirements upon applicants for cannabis establishment licenses. It is important that all cannabis retailers and cultivators have deep local roots, not only to encourage reinvestment of profits back into the community, but to maximize the beneficial impact of social pressure to behave responsibly. A retailer with deep local ties and a reputation to protect is far less likely to sell to underage consumers than an unknown newcomer. Unfortunately, as presently drafted, S.241 is riddled with loopholes and will fail to accomplish this goal.

Currently, S.241 requires that each 10% owner of a corporate applicant, and each financier, be a Vermont resident. The language, however, does not actually result in a requirement that at least 90% of a cannabis business' owners be Vermont residents. Rather, this language would permit, for example, ten separate non-residents to own 99.9% of a business between them, so long as each of them individually owned only 9.99%, and one officer of the business were a Vermont resident. This is clearly not a desirable result.

I urge the Committee to replace these provisions with simpler standards requiring that not less than 51% of the *ultimate beneficial ownership* of a licensed establishment be held by individual residents of Vermont. By focusing on ultimate beneficial ownership, the bill would eliminate the ability to skirt around residency restrictions through clever corporate structuring and domestic shell entities. This would also allow for the elimination of the artificial distinction attempted between “financiers” and owners (equity disguised as debt should be deemed equity for purposes of this calculation, a well-developed accounting concept that would not be novel or unique to this industry). Additionally, the Committee could require that the chief executive officer (or equivalent), and a majority of the board of directors (or equivalent), be Vermont residents. Further, I would urge the Committee to require that at least five percent (5%) of a licensed retail business be beneficially owned by residents of the municipality within which the business operates, in order to encourage even deeper local ties.

The recommendation for a 51% standard, rather than the 90% requirement attempted in the current draft, is based on a view that minority outside investment can, in fact, bring substantial benefits to Vermont, and that higher thresholds would create substantial inefficiencies and drive out desirable investment. Experienced operators of regulated marijuana establishments from other jurisdictions, in particular, should be welcomed for their expertise, though not allowed to control the business through majority ownership. Institutional investors can also help foster a culture of professionalism and compliance that could otherwise be lacking within young organizations and new industries.

Conclusion

I thank the Committee for its consideration of the issues and recommendations discussed above. By maintaining flexibility and fully utilizing the available non-tax levers to pressure prices downward, the Committee can forward to the full Senate a bill that harmonizes the goals of maintaining a strong regulated market that benefits consumers and the wider community, while still raising sufficient funds to pay for the regulatory regime and other important programs.

After decades of failed prohibition policies, it is immensely gratifying that legislators from across the political spectrum are devoting substantial time and energy to the complex issue of cannabis regulation with an open mind, and an eye towards harm minimization. Should the members of the Committee have any follow-up questions or concerns regarding the matters discussed above, I would be pleased to speak with you, either individually or collectively, at any time.

/s/ Dave Silberman

Dave Silberman is a corporate attorney residing in Middlebury, with 15 years' experience advising founders, executives and financiers of private and public companies in a wide range of industries, including medical devices, financial services, pharmaceuticals, education and logistics, and at every stage of corporate existence, from formation to sale. Mr. Silberman earned a B.A., *cum laude*, in Economics from Rutgers University in 1998, and a J.D., *cum laude*, from the Columbia University School of Law in 2001, where he was a John M. Olin Law and Economics Fellow and a Harlan Fiske Stone Scholar. This memorandum is provided in Mr. Silberman's personal capacity, and not as a representative of any client.