Microeconomics Internal Assessment Article

California Pot taxes lag as illegal Market flourishes

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A proposed spending plan projects the state will bank $355 million in marijuana excise taxes by the end of June. That's roughly half of what was once expected.

LOS ANGELES (AP) — Deep in Gov. Gavin Newsom's new budget is a figure that says a lot about California's shaky legal marijuana market: The state is expecting a lot less cash from cannabis taxes.

The Democrat's proposed spending plan, released Thursday, projects the state will bank $355 million in marijuana excise taxes by the end of June. That's roughly half of what was once expected after broad legal sales kicked off last year.

Industry experts say the diminished tax income reflects a somber reality: Most consumers are continuing to purchase pot in the illegal marketplace, where they avoid taxes that can near 50 percent in some communities. Tax collections are expected to gradually increase over time, but predicting what that amount will be remains something of a guess.

Tax collections for “a newly created market are subject to significant uncertainty,” the budget said.

Josh Drayton of the California Cannabis Industry Association credited Newsom with taking “a realistic look at the challenges” after a bumpy first year of broad legal sales.

Newsom also recommended a sharp increase in spending for regulatory programs, although it’s an open question whether it will be enough to help steady the state pot economy. The budget recommends just over $200 million for marijuana-related activities in the fiscal year that starts July 1, which would be over a 50 percent boost from the current year.

Initially “the state was too optimistic about how the implementation of legalization was going to work. This governor has paid attention to that,” Drayton said.

That said, Drayton added that legal businesses need a break from hefty tax rates that are driving consumers to the illicit economy. Various proposals have been made to cut state pot taxes.

State taxes include a 15 percent levy on purchases of all cannabis and cannabis products, including medical pot. Local governments are free to slap on taxes on sales and growing too, which has created a confusing patchwork of tax rates around the state.

The state’s top marijuana regulator, Lori Ajax, has said the state intends to get more businesses licensed and operating in 2019, while cracking down on rogue operators who continue to proliferate across the state.

At year’s end, California’s effort to transform its longstanding illegal and medicinal marijuana markets into a unified, multibillion-dollar industry remained a work in progress. By some estimates, up to 80 percent of sales in the state remain under the table, snatching profits from legal storefronts. Drayton said more than half the municipalities in the state do not have laws governing the industry. That means pot businesses cannot locate there, since companies are required to have a local license before seeking one from the state.

The budget also includes an additional $2.9 million for the California Department of Tax and Fee Administration to help chase down tax cheats. Meanwhile, the courts budget includes nearly $14 million for re-sentencing of thousands of drug offenders whose offences are no longer crimes since California legalised recreational pot.

Newsom, an advocate for legalised marijuana, said it has long been expected the new market would take five to seven years to settle in, with twists and turns along the way.

The issues he intends to look at include the distribution pipeline and claims that local governments are gouging the industry.

The state will “move expeditiously at licensing more and more dispensaries, making sure we go after the bad actors,” he said.

ANALYSIS

California state taxes in certain regions can reach up to 50% for legalised recreational cannabis. This is a major issue since cannabis is one of the most common recreation illegal drug used worldwide and has been purchased by the means of illegal black markets for a very long time since it was banned by the state. However, since the legalisation of Marijuana in certain states in the US, there has been a constant flow of people trying to open legal firms in order to sell this new good. Unfortunately, the governments of these various states have not particularly been helpful since they have had a shortage of licences being handed out to the cannabis dispensaries for them to legally sell Cannabis. So let's take a closer look at the effect of this heavy taxations on all the stakeholders involved using graph 1 :

Graph 1 : Taxes on Recreational Cannabis sold in California

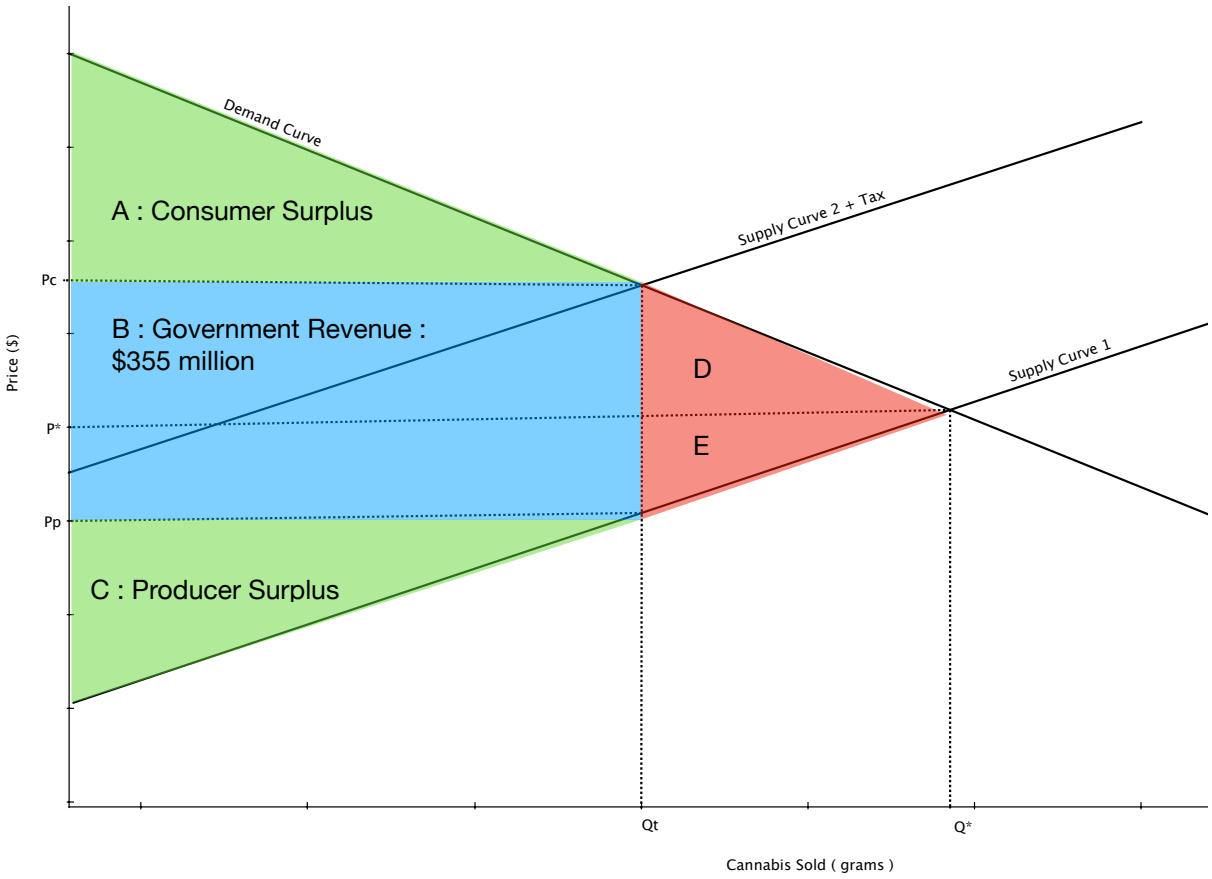


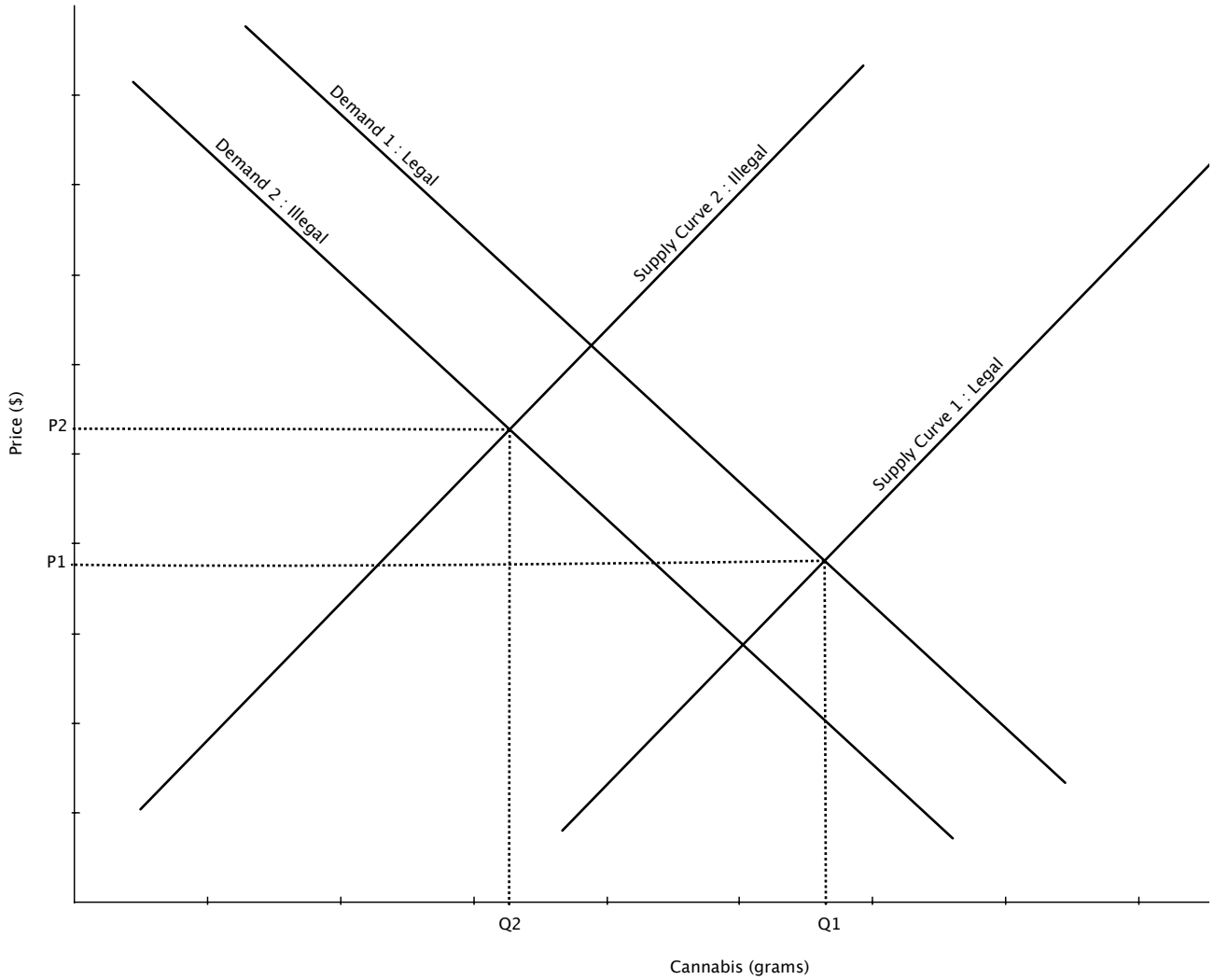
Table 1 : Key for Graph 1

Area	Definition
A : Consumer Surplus	The highest price consumers are willing to pay for a good minus the price actually paid
B : Government Revenue	The total revenue the government makes, which is generated from the taxes on the relative good
C : Producer Surplus	The price received by firms for selling their good minus the lowest price they are willing to accept to produce the good
D & E : Welfare Loss	Welfare benefits that are lost to society because resources are not allocated efficiently

Inserting the data from the article into the graph, we can see the change in the supply curve, S1 to S2 is caused by the intense taxation on cannabis by the government, which can be up to 50%. The Government revenue, Area B, is expected to be $355 million. However, there are still allocative inefficiencies due to the significant welfare loss caused by the government's intervention by taxation. If it were a competitive free market without any government intervention, we would have maximum social surplus, which can be defined as the amount of welfare (value or utility) that a society has gained from the present consumption of all goods and services produced or bought, or simply the sum of the consumer and producer surplus. Hence, reaching the maximum social surplus means that the consumer and producer surplus is also maxed out and this happens at the equilibrium. The consumer surplus would be the area below the demand curve and above the P*. Similarly, the producer surplus would be above the supply curve and below the P*. However, we can see on the graph that due to the taxes, significant parts of both the consumer and the producer surplus have become government revenue and welfare loss.

However, the market of a new good which has just recently been legalised is expected to be rather uncertain and shaky for the first 5 to 7 years as mentioned in the article. This is because the consumers of cannabis are used to buying it from the black market. Also, as mentioned in the article, it is estimated that up to 80% of the cannabis sold in California is still taking place in the black market, graph 2 below will help further our understanding :

Graph 2 : Illegal vs Legal Sales of cannabis in California



The illegal market for a drug is smaller than the legal market as we can see by the shift of the supply and demand curve leftwards. This is because the consequences of selling or buying such illegal goods is punishable by fine or imprisonment, so by reducing the size of the market for the drug, the chances of either parties of the transaction getting caught by the authorities is lowered. Especially the consequences for selling is more severe than simply possessing, which is why the supply curve has a greater shift than the demand curve. Moreover, we can see that the illegal price, P2, is higher than the legal price, P1. So why aren't consumers immediately more attracted to legal cannabis instead of buying from the black market, as they are? This is because of 2 main reasons ; Firstly, there is simply a shortage of legal cannabis production. As we have seen from Graph 1, the optimum quantity of the good is not being produced due to allocative inefficiency resulting in welfare loss, resulting in consumers resorting to the black market.

Secondly, due to the illegal market of cannabis flourishing over many years, it could have potentially reached a stable price which is lower than the legal, taxed price. This can't be said for certain due to the lack of data regarding the black market, but it could be a possibility. As previously stated, 80% of all cannabis sales are potentially taking place in the black market, so the total revenue for the black market, P2 x Q2, is 4 times larger than the total revenue in the legal market, P1 x Q1. This will give us a very different graph than the generic graph for illegal vs legal sales of similar drugs such as Xanax for example, graph 2, highlighting the uniqueness and the complexity of this particular case.

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