Minimizing the Illicit Market for Cannabis

Summary: Adult-use and medical cannabis legalization in the United States has reduced the overall size of illicit markets in legalized jurisdictions. Despite these reductions, a sizeable illicit market for cannabis continues to thrive in every legalized jurisdiction and undermines the benefits which legalized cannabis offers. These illicit markets rob state and local governments of tax dollars while continuing to drive up law enforcement and incarceration costs as unregulated market participants amass large volumes of unbanked revenue. There is ample evidence in cities throughout North America that when illicit markets exceed low levels, policing efforts consistently fail to remedy the situation (see, e.g. San Jose, Santa Ana, Detroit, Toronto). The primary driver of cannabis illicit markets is the combination of: (i) policies which overly restrict the availability and ease of purchasing cannabis through legal channels, (ii) high effective tax rates and compliance costs on legal cannabis and (iii) insufficient quantity and quality of legal cannabis for sale in a market. As elected officials, regulators and voters move towards more defined legalization on a state and local level, it is critical that cannabis policy reforms be designed with a goal of reducing illicit markets.

Policy Recommendations:

- **Ensure sufficient retail access.**
- **Set appropriate tax rates that properly balance tax revenue generation and illicit market reduction.**
- **Provide for safe and diverse cannabis supply.**
- **Establish cannabis advertising policies that both protect public safety and allow licensed operators to reasonably advertise across various mediums.**
- **Ensure access to capital.**
- **Enable regulators to reactively adjust policy as needed.**
- **Require data collection, monitoring, and responsible safety procedures.**

Factors that Contribute to Illicit Markets

Low Dispensary Density

Restrictive licensing caps and zoning rules impede patient and adult-use consumer access and inflate costs, often forcing consumers to turn to the illicit cannabis market. Convenience is one of the most important factors in determining whether or not someone will patronize the legal market, therefore it is crucial that enough licenses are issued to meet consumer demand. Cities failing to license are not eliminating cannabis consumption, they are simply eliminating consumption of legal cannabis.

While opponents of comprehensive cannabis policy reforms often make false claims about dispensaries contributing to crime, a robust and growing body of research makes clear that the siting of cannabis dispensaries is not associated with increases in property and violent crimes.[1] One study examining the relationship between cannabis laws and violent crime in California found no relationship between counties that permit cannabis retailers and violent crime.[2] Another study funded by the Department of Justice found that states with legalized adult-use cannabis had no noticeable impact on crime rates in bordering states.[3] Lawmakers looking to make their jurisdictions safer should focus on ensuring that there are enough cannabis retail licenses issued to successfully eliminate the illicit market.

Lack of Delivery Options

Delivery services are a key factor to (i) ensure mobility restricted medical patients can maintain access, (ii) help cover poorly serviced areas for cannabis retail and (iii) provide customer convenience that exceeds that found on the illicit market. Whether it be convenience or mitigating poor local legal access – the ability to obtain delivery from the legal market, even in jurisdictions which have banned licensing, is key to tamping down illicit market scale. Allowing cities to ban legal delivery into their jurisdiction ensures a robust illicit market that plagues surrounding jurisdictions that conduct delivery.

Limitation to In-State or In-City Operators or Employees

Policy models that prohibit operators from outside the applicable jurisdiction to either own, operate, or finance cannabis businesses push business owners to the illicit market or into unfavorable licensing agreements. Both outcomes lead to a loss of control for the jurisdiction. Limiting licensees to in-state or in-city operators encourages handshake deals, licensing or management agreements, or other marked up services to extract de facto ownership economics. For example, Washington State has some of the most restrictive out-of-state ownership and lending rules, making it extremely difficult for small in-state operators to access expansion or startup capital.

Well-Funded Incumbents Losing Licensing

Artificially limiting the number of licenses at the state or local level through licensing caps or other schemes effectively forces otherwise compliant, safe, and experienced businesses outside of the legal market. Many of these operators are well funded and fully capable of satisfying all local licensing and code requirements and, in many cases, have been paying taxes in an attempt to achieve legitimacy. These operators will have the capital and the experience to quickly open legal operations, but will likely choose to remain operating without a license to maintain their livelihoods.

Constrictions on Accessing Capital (Debt or Equity)

Inability to access capital to either start legalized operations or expand and professionalize increases unlicensed operators and hurts the compliance levels of legal operators. Capital constrictions commonly happen due to the following: (i) limitations on lenders or investors from outside the jurisdiction, (ii) requirements that lenders or minority investors go through rigorous qualification as a license owner, and (iii) rules that would prohibit lenders from taking control of assets in the event of a bankruptcy or insolvency.

High Effective Tax Rates

While there is considerable tax revenue to be generated from the cannabis market, tax rates that exceed a certain threshold will only serve to prop up the illicit market and bring in suboptimal tax revenue to local and state governments. High effective tax rates place the legal market at a significant competitive disadvantage relative to illicit market operators who do not pay taxes or any required licensing and administrative fees. For example, a survey of cultivators in California found that high tax rates are the biggest barrier to entry for small cannabis businesses.[4] In addition to keeping unlicensed operators from transitioning to the legal market, high tax rates will increase the price of legal cannabis dramatically, pushing consumers to turn to the illicit market. An analysis conducted by the C.D. Howe Institute found that as effective tax rates exceed 20%, there are diminishing returns on tax revenue generation and continued growth of the illicit market.[5] To establish a functioning legal cannabis market, tax rates must be narrowly tailored and appropriately set to compete with the well-established illicit market.

Over-Restriction of Advertising

There is a need for advertising limits to reduce public nuisance and to ensure advertising isn't attempting to target children; however, many states' advertising restrictions go so far that it is difficult for consumers to differentiate between licensed and unlicensed operators, while hurting the ability to build consumer trust and awareness around safe, lab-tested brands. Advertising is key for promoting consumer knowledge, fostering brand loyalty, and allowing small cannabis businesses to stay competitive. Licensed operators should be allowed to advertise on a variety of platforms and include information on pricing, available products, reasonable promotions, hours of operation, and other relevant information that will push consumers to patronize the legal market. Advertising policies can be constructed so that they both protect public safety and allow for legal operators to successfully grow their business and compete with the illicit market.

Constraints on Supply

Most top cannabis brands are not currently operated by dispensary owners, as many existing retail licensees lack the expertise and facilities to provide enough cannabis to meet consumer demand. Without licensing a sufficient and diverse population of independent cultivators, manufacturers, and processors, supply levels will drop and prices will rise. Similarly, to the extent newly licensed operators cannot produce product quality that meets or exceeds that found on the illicit market, consumers will lean towards purchasing the higher quality product.

Lack of Social Consumption Venues

In Barcelona and Amsterdam, cannabis consumption lounges have both prevented public nuisance and reduced illicit markets by allowing legal points of sale to justify higher costs with a social meeting space. Reducing, eliminating, or not authorizing such spaces removes one of the key areas in which legal cannabis retailers can gain a competitive advantage over their illegal counterparts. Prohibiting consumption lounges also restricts legal consumption for some medical and adult-use consumers, such as those living in dwellings where consumption is not permitted.

Public consumption of cannabis has emerged as a significant challenge for law enforcement in adult-use jurisdictions that fail to provide licensed venues for consuming cannabis. As an example, in the first year of adult-use cannabis sales in Denver, the number of public consumption citations increased 471 percent.[6] Ultimately these nuisances impose high costs on local law enforcement resources and taxpayers where solutions like safe, responsible areas for the public to consume are not embraced. Policies that enable consumption within regulated venues are critical for reducing public nuisance complaints as well as minimizing burdens on law enforcement.

Policy Recommendations

To reduce and ultimately eliminate the illicit cannabis market, policymakers should consider the following:

Ensure sufficient retail access.

Legal access must be reasonably convenient in order to encourage consumers to patronize the legal market. Legal access includes sufficient retail density, reasonable hours of operation, and available delivery services.

- ➢ Establish zoning rules that ensure a ratio of at least one dispensary or delivery service per every 10,000 residents.

- Ensure that the legal market can conduct home delivery and that such delivery can occur in all jurisdictions regardless of whether such jurisdiction issues local licenses. Tie home delivery with suitable safeguards such as inventory tracking and proof of delivery to the legal recipient.
- Set strong health and consumer protection standards while allowing for broad participation within the regulatory framework. Welcoming all businesses that can demonstrate compliance with the law to participate provides consumers greater access to safe and licensed cannabis, and facilitates a critical market clearing exercise that will deliver the lowest possible illicit market rate.
- Limitations should not be placed on operators or managers living in the jurisdiction; or if needed, should only apply to 25% or less of such individuals.
- Those who have been subject to criminal conviction solely for the manufacturing, cultivation or sale of cannabis should not be disqualified from receiving permits. Barring market participants with such previous infractions will negatively impact any social equity program a jurisdiction may be contemplating.
- Applications for permits should be reviewed and permits be issued within 30 to 90 days. Correspondingly, attempts to shut down existing operators should be commenced only after the issuance of the new licenses to avoid encouraging additional unlicensed operators.
- There should be enough testing labs to meet the needs of local cannabis business, and guidelines for responsible lab operations should be developed.
- Local governments should authorize dispensaries to have on-site consumption lounges and/or authorize independent consumption facilities that are not on the same premises as a cannabis retailer to reduce public nuisance and encourage purchase from legal sources.

Set appropriate tax rates that properly balance tax revenue generation and illicit market reduction.

Tax policies should be established with ample flexibility to be adjusted upward and downward quickly based on illicit market conditions, and tax proposals should only be made with a full understanding of how the resulting effective tax rate would contribute to either fueling or subduing the illicit market.

- State and local governments should set tax rates at levels that appropriately balance tax revenue generation and illicit market reduction. Effective tax rates, including local, state, and supply-chain taxes, should not exceed 20%.
- Taxes should generally only be placed on the sale to consumer to avoid multiplicative taxation through the supply chain.
- To the extent that state and local governments seek to generate revenue from up-supply chain operators (e.g. lab testing facilities, cultivators, manufacturers and processors), a flat annual licensing fee model as opposed to a taxation model should be adopted for these operators. Data from cities across the US shows a strong correlation between inflated effective tax levels on these operators and outsized illicit markets. Additionally, due to the federal 280E rules,[7] legislators should be mindful that these businesses already have inflated tax rates.
- In the case of the annual licensing fee for cultivators, consider setting the fee on a price per square foot of cultivation space model with such fee not to exceed $15.00 per square foot.
- State and local regulatory agencies should review and adjust tax rates annually based on several factors including illicit market levels.

Provide for safe and diverse cannabis supply.

Limits in regulated cannabis supply can cause legal cannabis prices to skyrocket while illicit markets can find alternative sources more fluidly. Despite this, the effect of price differences can be mitigated if there are higher quality products and desired brands being sold through legal channels. To accomplish this, there should be a trend towards more cultivation and processing licenses to ensure robust competition to create premium products and sufficient supply to legal points of sale.

- issuance of the new licenses to avoid encouraging additional unlicensed operators.
- Do not limit the number of cultivation, processing, manufacturing and distribution permits. Instead use zoning rules that are designed to ensure that there are low barriers to entry to the legal market, which—unlike the unregulated market—is subject to inspection, monitoring and taxation rules. Cities can create a thriving export business to other parts of the State as well as enable operators to become innovators and leading operators within the industry.
- Allow co-location and sublicensing of cultivation, processing and manufacturing permits on compliant premises to ensure that the hundreds of brands and companies operating can deal with possibly limited space for operation without resorting to the illicit market.
- Provide permits for processing using both volatile and non-volatile solvents. Consumer taste for concentrate products overwhelmingly leans towards BHO and other products utilizing volatile solvents. Additionally, there is a growing body of evidence that the products made using these extraction methods have a more diverse set of therapeutic uses including for the treatment of PTSD and opioid dependence. Failure to permit and allow for processing using volatile solvents will drive a massive underground market. When state and local governments properly regulate the manufacturing and extraction of cannabis concentrate products using volatile solvents, this process is no different from and poses no greater risks than the manufacturing processes utilized at a much larger scale for products like decaffeinated coffee, perfume, and vanilla extract.[8]
- Mandate an open-source Seed-to-Sale tracking system to monitor inventories and movement and enable identification of any suspicious patterns; such a system could be the same as that mandated by the State.
- Ensure the ability to conduct spot audits during regular business hours on cannabis products at any point in the supply chain to carry out lab testing or look for safety issues.
- Allow cultivators, processors, and manufacturers to obtain lab testing and directly distribute their products to retail points of sale.

Establish cannabis advertising policies that both protect public safety and allow licensed operators to reasonably advertise across various mediums.

The rush by jurisdictions to place draconian advertising laws can thwart the move to reduce unlicensed operations while providing little social benefit. Overly-burdensome advertising restrictions make it very difficult for consumers to differentiate between legal and illicit market operators.

- Allow cannabis brands and dispensaries enough advertising options to create brand recognition for trademark protection purposes and to differentiate themselves from unlicensed operators.
- Prohibit advertising that features or targets individuals under the age of 21. Adopt a touch and feel approach to advertising rules as opposed to carte blanche restrictions on the use of cartoon logos or whimsical trademarks.

- ➢ Allow dispensaries to have visible storefronts to force them to compete on store quality, cleanliness and curbside appeal. This has the added benefit of increasing build-out expenditure by dispensary owners which, in turn, increases their desire to maintain compliance.
- ➢ Place reasonable restrictions on advertisements from making false or misleading claims on public health matters.

Ensure access to capital.

Failure to ensure sufficient access to capital creates a less professionalized industry and leaves unlicensed operators without the means to enter the legal market. More open access to capital can help encourage local small business owners and ensure that business ownership is not just limited to high net worth individuals. While state and local governments may be tempted to embrace policies designed to benefit incumbent operators over those from outside of their jurisdiction, these protectionist policies often have the unintended consequence of constraining the flow of capital to cannabis businesses for business improvements and expansions.

- ➢ Only place ownership restrictions and registration requirements on persons who own 20% or more of the applicable business.
- ➢ Do not place in-state ownership or lending requirements, or if there is a feeling such policies are needed, only have such rules apply to a percentage of the licenses.
- ➢ Ensure that lenders have the ability to take control and operate licenses in the event of a bankruptcy or insolvency. Provide an accelerated path for lenders to liquidate and transfer licenses to purchasers who have been approved by the applicable regulatory authority.
- ➢ Allow for the free transfer of licenses in the secondary market subject to approval of the purchaser by the licensing authority.
- ➢ Set aside a portion of state tax revenue for a financing fund to provide startup financing for social equity operators.

Enable regulators to reactively adjust policy as needed.

The legal cannabis market is still in its early stages of development and continues to evolve rapidly. Accordingly, policy should enable regulators to adjust density and operation of cannabis businesses to quickly respond to spikes in illicit market usage.

- ➢ Organize a dedicated cannabis regulatory agency that is authorized to increase the number of operators on a rolling schedule based on several factors including illicit market operating levels, and has the ability to offer licensing in regions where data shows illicit markets remain high.
- ➢ Review tax rates and distribution of cannabis points of sale and adjust to minimize remaining illicit market levels.

Require data collection, monitoring, and responsible safety procedures.

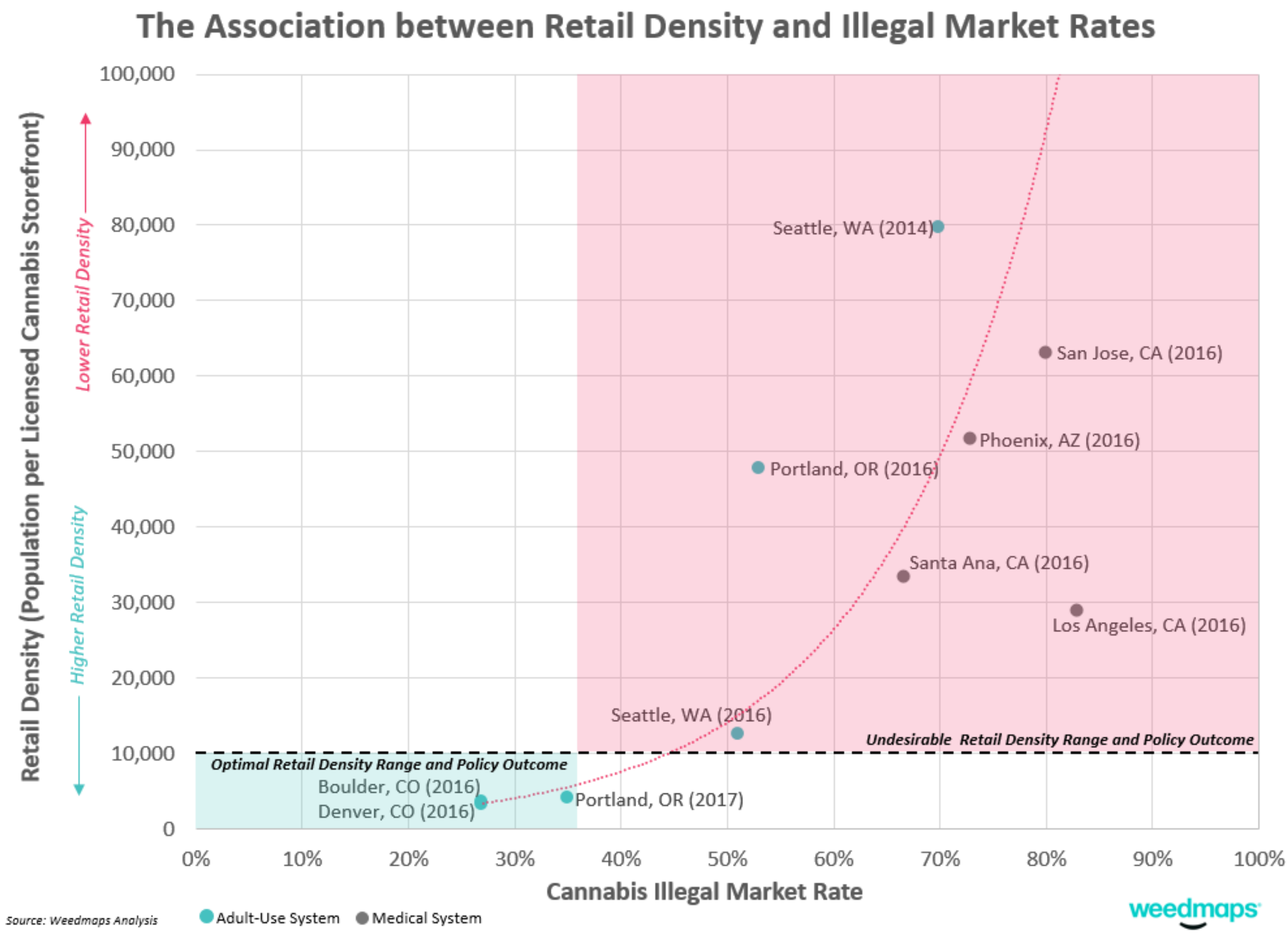
The illicit market for cannabis is poorly understood in most jurisdictions. Regulators must be given robust and real-time data to quickly adjust cannabis policy to effectively undercut illicit markets before they become rooted. At the same time, the data collected must be well tailored to avoid driving up already high administrative and compliance costs for operators.

- ➢ Regulators at the state and local level should be required to review data and adjust the foregoing to meet a series of criteria including illicit market levels.

- Cannabis regulatory agencies and local governments should prepare annual reports on the estimated illicit market levels in the city which identifies key causes and geographic areas where illicit sales are a concern. Licensing, zoning, taxation and other rules should be reviewed and adjusted considering these findings.
- All cannabis businesses should be required to provide periodic data to the cannabis regulatory bodies that includes volume and tracking data from the Seed-to-Sale systems as well as retail data from point of sale systems.
- Cannabis businesses should be required to have security measures which are at least commensurate with those for alcohol and pharmaceutical products. These security requirements should not place crippling cost or administration requirements on the businesses but should be at least sufficient to enable accurate monitoring and control by law enforcement.

Appendix A. Chart Demonstrating the Association between Retail Density & Illicit Market Rates

The below chart demonstrates the clear association between retail density and illicit market rates. As retail density falls below a ratio of one retail storefront per 10,000 people, the illicit market rate increases considerably.



Endnotes

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