

Taxing Cannabis

The Importance of Proper State and Local Cannabis Tax Rates

Executive Summary

Establishing sound tax policy is a key component of state and local cannabis reform efforts. In order to support a safe, well-regulated, and successful cannabis industry, it is imperative that governments set appropriate tax rates. The total demand for cannabis in the U.S. (including the illicit market) is estimated to be around **\$52.5 billion annually**.¹ As such, there is considerable tax revenue to be made for state and local governments that adopt adult-use cannabis laws and implement sensible tax policies. However, if lawmakers advance tax structures that are overly-burdensome, a large and entrenched illicit market will persist—to the point where even traditional enforcement strategies will fail to meaningfully rein in the illicit market.

High Tax Rates Strengthen the Illicit Market

Tax revenue generation is a common justification for the adoption of adult-use cannabis laws, but tax rates that exceed a certain threshold will result in a robust illicit market. High tax rates fuel the illicit market (1) by incentivizing consumers to seek out lower prices in the illicit market and (2) by deterring existing cannabis operators from entering the legal market.

- **High Tax Rates Push Cannabis Consumers out of the Legal Market:** A growing body of research makes clear that cannabis consumers are highly price sensitive. According to a consumer survey by Deloitte, price is the most important factor influencing purchase decisions.² As a result, if tax rates push legal cannabis prices beyond a certain threshold, a majority of consumers will not shift their purchases from the illicit to the regulated market.
- **High Tax Rates Push Cannabis Businesses out of the Legal Market:** High tax rates are a major disincentive for existing cannabis operators to enter the regulated market. According to a survey of cannabis cultivators in California, the State's burdensome tax structure is the biggest barrier to entry for small cannabis businesses.³ High tax rates, therefore, are a major reason why unlicensed businesses refuse to transition into the legal market.

Studies by organizations like the RAND Institute and the C.D. Howe Institute illustrate how quickly the size of illicit markets grow as tax rates rise. Overall, once net effective tax rates exceed 20 percent, there are clear diminishing returns for tax revenue generation, but the illicit market will continue growing considerably.⁴

Other Jurisdictions with Adult-Use Cannabis Laws Highlight the Importance of Tax Policy

The experiences of other jurisdictions with adult-use cannabis laws underscore how flawed tax policies can severely undermine the launch of a well-regulated cannabis industry. In Washington State, a tax structure that pushes effective tax rates to 47.1 percent in Seattle has resulted in a deeply-entrenched illicit market that captured 50 percent of the State's cannabis sales in 2017. In California, a similarly-burdensome tax structure has thwarted the State's efforts to establish a legal cannabis market. The rollout of California's adult-use system has been so flawed that the State's illicit market rate increased from 74 percent in 2017 to 80 percent in 2018 and State tax collections have hundreds of millions of dollars short of projections.⁵

Policy Recommendations

In order to advance functioning adult-use cannabis markets, it is critical for policymakers to adopt cannabis tax structures that appropriately balance tax revenue generation and illicit market reduction. Accordingly, officials should consider the following recommendations as they set out to develop and revise policies for the emerging adult-use cannabis industry.

- Maintain aggregate net effective tax rates (inclusive of state, local, and supply chain taxes) at 20 percent or below.
- Enable local governments to generate cannabis tax revenue, but cap local tax rates at 3-5 percent.
- Restrict all state and local cannabis taxes to the final point of sale.
- Base tax rates upon final retail prices instead of by weight or THC content.
- Distribute a portion of state cannabis tax revenue to local governments on a pro-rata dispensary license basis.

As Taxes Rise, So Do Illicit Market Rates

Sound tax policies are critical for advancing a policy framework that enables the regulated cannabis market to succeed. A flawed tax structure that imposes high effective tax rates on cannabis will severely undermine the regulated market’s ability to compete with and ultimately displace the illicit market.

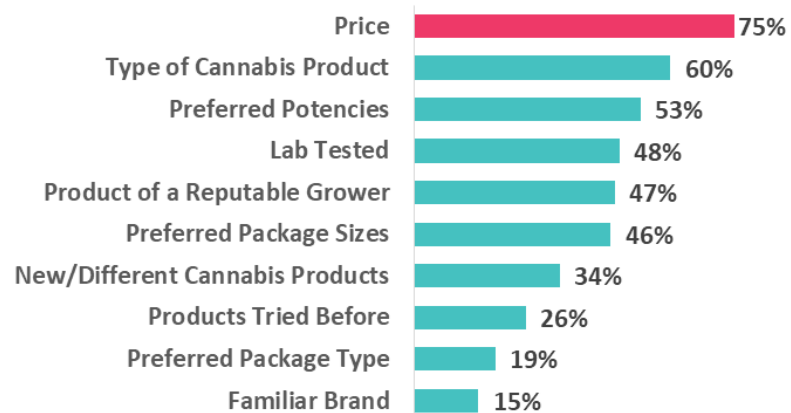
High tax rates strengthen the illicit market along two fronts: (1) by incentivizing consumers to seek out lower prices in the illicit market and (2) by deterring existing cannabis operators from entering the legal market. Simply put, if taxes raise the price of cannabis products past a certain threshold, consumers will continue to seek out the illicit market, and businesses will be far less likely to go through the hurdles to become licensed operations.

High Tax Rates Incentivize Consumers to Purchase Cannabis from the Illicit Market

States with newly-adopted adult-use cannabis laws face the unique challenge of convincing consumers to switch over to the legal market. While the vast majority of cannabis consumers express a preference for legal cannabis, their willingness to shift their consumption from the illegal to legal market is largely contingent on competitive pricing.

This stems from the fact that cannabis consumers—like consumers of most other products—are highly price sensitive. According to a recent survey of Canadian cannabis consumers conducted by Deloitte, **price is the most important factor influencing purchase decisions**. 75 percent of current consumers in Canada said that price is one of the main factors in buying cannabis. As a point of comparison, a mere 48 percent of current consumers selected lab testing (a prime source of differentiation for the regulated market) as a main consideration in their purchasing decisions.^{vi}

Figure 1. Considerations for Purchasing Decisions



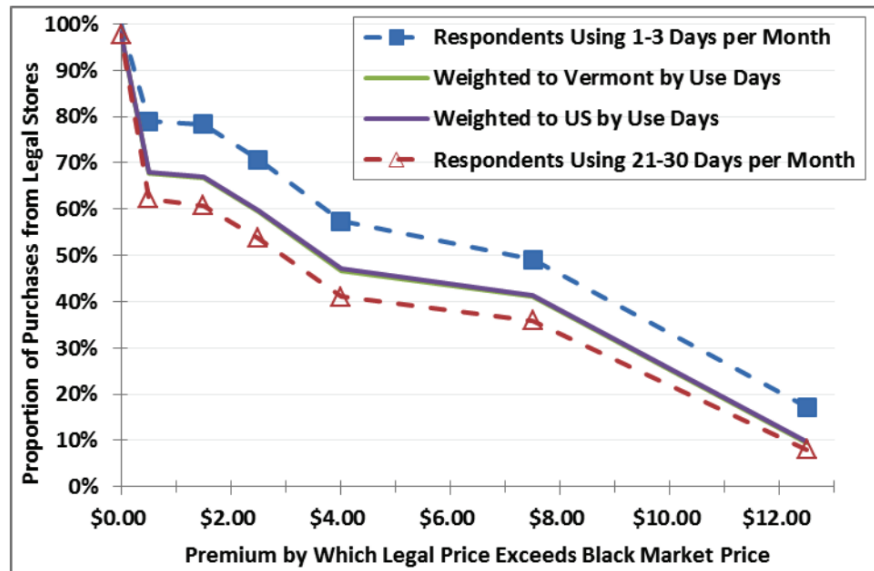
Source: Deloitte. *A Society in Transition, an Industry Ready to Bloom*. 2018.

Given this price sensitivity, cannabis consumers are inclined to purchase cannabis from the illicit market if the price of legal cannabis is too high. A growing body of research has uncovered the various price points at which consumers will revert back to the illicit market. A 2018 pricing analysis by Deloitte found that the typical Canadian consumer is only willing to pay a 9 percent premium for regulated cannabis.^{vii} In the U.S., the RAND Corporation’s Washington Cannabis Consumption Survey—one of the most referenced studies on cannabis consumer price sensitivity—found that if the cost of legal cannabis sold for \$4 more per gram than the illicit market, legal sales would make up less than half of the total market.^{viii} Another study found that when prices reach \$20 a gram, 64% of cannabis purchases are conducted through the illicit market.^{ix}

The bottom line is that cannabis consumers are willing to pay a premium for legal cannabis, but only up to a certain point. If tax rates are set in a manner that raises the legal market’s price premium too high,

then a significant share of consumers will refuse to transition into the regulated market, and a permanent and sizable illegal market will persist at the state and local levels.

Figure 2: The Washington Cannabis Consumer Survey
 Legal Supply's Market Share as a Function of Its Price Premium, Based on the Washington Cannabis Consumption Survey



Source: RAND. *Considering Marijuana Legalization*, 2015.

High Tax Rates Deter Existing Cannabis Operators from Entering the Legal Market

On the supply side of the cannabis industry, **burdensome tax structures serve as a major disincentive for illicit operators to enter the regulated cannabis market.** High taxation places legal cannabis businesses at a competitive disadvantage relative to the illicit market, so many unlicensed operators simply choose to remain within the illicit market.

This has proven to be a major challenge in California. According to a survey conducted by the California Growers Association, high taxes are the greatest barrier to entry for small cannabis businesses.^x California's burdensome tax structure (combined with a cumbersome state-level licensing process and restrictive bans on retail licensing at the local-level) is partially responsible for only a fraction of cannabis cultivators in California transitioning into the regulated market. In February 2018 (two months into the launch of California's adult-use cannabis system), a mere 0.78 percent of the State's cannabis cultivators had received licenses.^{xi}

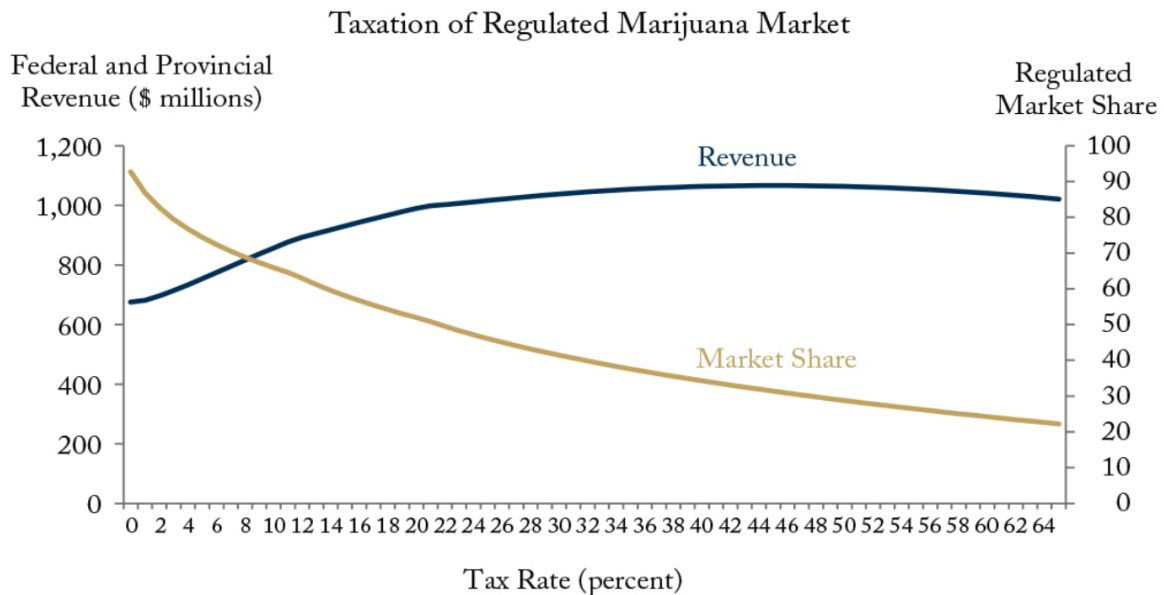
High Effective Tax Rates above 20% Have Clear Diminishing Returns

Given the adverse impact high tax rates have on both consumers and businesses' willingness to transition into the regulated market, it is critical for state and local policymakers to advance tax frameworks that enable the legal market to compete with the illicit market on price. As surveys by Deloitte and RAND have found, even modest tax rates have the potential to inflate the legal market's price premium to a point where a majority of consumers continue purchasing cannabis from the illicit market. The higher tax rates rise, the larger and more entrenched an illicit market will become.

Prior to the launch of Canada's adult-use cannabis market in 2018, researchers at the C.D. Howe Institute modeled how different tax rates would result in different levels of tax revenue generation and illicit market rates. This model (see Figure 3) clearly shows how rapidly the illicit market grows as tax rates

increase. Moreover, the C.D. Howe Institute’s analysis highlights that once effective tax rates exceed 20 percent, there are clear diminishing returns for tax revenue generation while the illegal market continues to grow considerably.^{xii}

Recognizing the association between high tax rates and outsized illicit markets, policymakers that have adopted adult-use cannabis laws more recently have typically adopted tax structures with lower tax rates. As examples, lawmakers in Oregon and Massachusetts both adopted tax rates of 20 percent for adult-use cannabis in 2015 and 2017, respectively.



Source: C.D. Howe Institute. “With legal Weed the Government Must Choose Revenue or Regulated Market, Not Both,” in *Intelligence Memos*, April 2017.

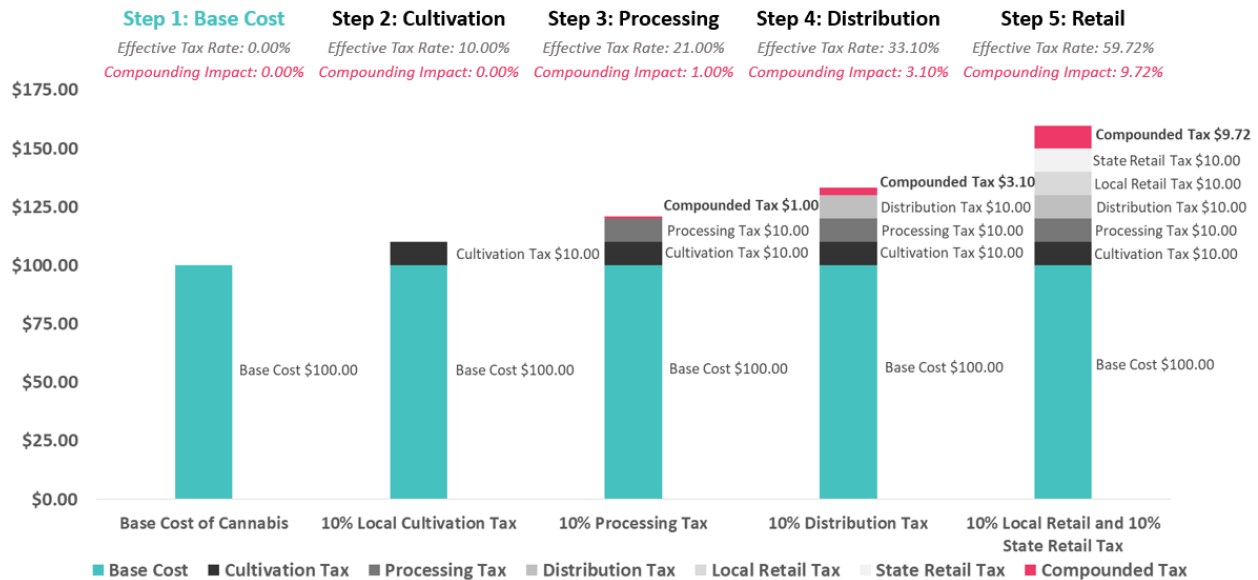
The Challenge Posed by Multiplicative State and Local Taxes

In certain jurisdictions, policymakers have imposed multiple layers of taxation across the cannabis supply chain (e.g. a jurisdiction that has a retail cannabis excise tax at the final point-of-sale may also have a tax on cultivators, manufacturers, and transporters).

This tax structure poses a major challenge for the regulated market since these multiplicative taxes compound as product moves through the supply chain. In other words, as product moves from one step in the supply chain to the next (e.g. from a cultivator to a processor), additional taxes are imposed on the previously taxed amount. This has a compounding effect on tax rates that can significantly increase the net effective tax rate on cannabis.

As the below scenario illustrates, if a tax structure incorporates a 10 percent cultivation tax, a 10 percent processing tax, a 10 percent distribution tax, a 10 percent local retail tax, and a 10 percent state retail tax, then *the compounded tax impact is 9.72 percent*—pushing the net effective tax rate from 50 percent to 59.72 percent. At such a high tax rate, a large and intractable illicit market is guaranteed.

Figure 4. The Compounding Impact of Multiplicative Cannabis Taxes*



*Note that for illustrative purposes the base cost of cannabis remains constant at \$100 throughout this example.

State and local policymakers often overlook the compounding impact of multiplicative taxation, which can inflate legal market cannabis prices well above what the vast majority of consumers are willing to pay. As a result, policymakers should avoid imposing taxes down the cannabis supply chain and instead restrict taxes exclusively to the final point of sale.

High Effective Tax Rates Have Challenged the Rollout of Regulated Cannabis Markets

While some states have made considerable progress towards reducing the size of illicit cannabis markets in their jurisdictions, high tax rates stand as a major obstacle for reducing the size of these illicit markets further. Even in Colorado, which is often regarded as the gold-standard of state-level cannabis policy, the illicit market captures approximately 30 percent of all cannabis sales—more than five years after adult-use cannabis sales began in the State.^{xiii} Colorado’s tax framework, which pushes net effective tax rates above 30 percent in Denver, is a leading contributor to the State’s lingering illicit market.

Unless tax rates are set at levels that enable competitive prices within the legal market, a large percentage of cannabis consumers will refuse to shift their consumption to regulated businesses, and a jurisdiction will continue to struggle with an entrenched illicit market. The experiences of other states with adult-use cannabis laws illustrate how poorly-structured tax policies severely undermine the health of the regulated market.

Washington State: The Flawed Tax Framework of an Early Adult-Use Cannabis Adopter

Washington State is the prime example of how flawed tax policies prevent the regulated market from displacing the illicit market. Under Initiative 502 (the adult-use cannabis ballot initiative Washington voters approved in November 2012), Washington’s regulated cannabis market faced an extremely burdensome tax framework: a 25 percent excise tax on cultivation, a 25 percent excise tax on processing, and a 25 percent excise tax on retail.^{xiv}

Recognizing the immense burden this tax framework placed on licensed businesses, Washington legislators passed a law that simplified the State’s cannabis tax structure to a single 37 percent tax rate at the final point of sale.^{xv} However, even this simplified state-level tax rate proved insufficient to make regulated market prices competitive with the illicit market. Including state and local taxes, Washington continued to have the highest cannabis tax rates in the U.S. by a wide margin. As an example, the effective tax rate on cannabis in Seattle—after factoring in local sales and use taxes—currently stands at 47.1 percent.

Consequently, despite becoming one of the first states to adopt an adult-use cannabis law, Washington State continues to have a deeply-entrenched illicit market. In 2017, the illicit market still captured 50 percent of all cannabis sales in Washington State.^{xvi} Policy experts, industry analysts, and journalists—including those at *The Economist*—have long highlighted how high tax rates stand as a leading contributor to Washington’s outsized illicit market.^{xvii}

California: High Tax Rates Undermining the Launch of the World’s Largest Legal Cannabis Market

California offers another example of how high effective tax rates undermine the establishment of a functioning adult-use cannabis market. Long before adult-use cannabis sales began in California on January 1, 2018, policy experts and industry analysts had warned that the State’s burdensome tax framework—which can exceed 45 percent after cultivation, excise, sales, and local taxes are taken into account—would challenge the shift to a well-regulated industry.

The most prominent of these forecasts came from Fitch Ratings. In October 2017, Fitch asserted in a Special Report that:

“High effective tax rates on California cannabis may complicate the state’s efforts to establish legal markets....Fitch Ratings estimates that effective state and local tax rates on nonmedical cannabis could be as high as 45%, which would place California at the upper end of the tax range for states that have legalized nonmedical cannabis. High tax rates raise prices in legal markets, reinforcing the price advantage of black markets. California’s black markets for cannabis were well established long before its voters legalized cannabis in November 2016 and are expected to dominate post-legalization production. Increased enforcement may ultimately constrain the illegal market, but high taxes may complicate such efforts by diverting in-state sales to the black market.”^{xviii}

The first year of adult-use cannabis sales in California largely bore out these predictions. Throughout 2018, industry sales and tax revenue fell far short of official forecasts. Overall, California brought in \$345 million in cannabis tax revenue, falling short of the projected \$643 million.^{xix} The launch of California’s adult-use cannabis market was so flawed that BDS Analytics estimated that the State’s illicit market rate increased from 74 percent in 2017 to 80 percent in 2018.^{xx} While there are many challenges that the industry faces—including widespread local government bans on cannabis businesses—high taxes stand as a key contributor to the struggled rollout of California’s adult-use system.

Recognizing the immense challenges the existing tax framework has placed on California’s legal cannabis market, State lawmakers seriously considered [legislation](#) to temporarily reduce the state excise tax from 15 percent to 11 percent and eliminate the cultivation tax until 2022.^{xxi}

California’s failure to place parameters around local governments’ ability to impose cannabis taxes is a major reason for the regulated market’s heavy tax burden. In addition to state-level cultivation, excise,

and sales taxes, county and local governments have complete authority to adopt any additional taxes and fees they choose. This has resulted in an inconsistent and disparate patchwork of cannabis tax structures throughout California, wherein some jurisdictions have imposed multiple layers of taxes.

The City of Los Angeles illustrates how complex and unruly tax frameworks can become when local governments have unlimited authority to tax cannabis.

Figure 5. Effective Cannabis Tax Rate in Los Angeles, California

CA Excise Tax	CA Cultivation Tax	CA Sales Tax	L.A. Excise Tax	L.A. Distribution Tax	L.A. Testing Tax	L.A. Cultivation Tax	L.A. Miscellaneous Cannabis Tax	L.A. Sales Tax
15.00%	4.66%	7.25%	10.00%	1.00%	1.00%	2.00%	2.00%	2.25%
Net Effective Tax Rate:								46.0%

California’s first year of adult-use sales demonstrates the importance of advancing reasonable tax policies that (1) appropriately balance tax revenue generation and illegal market reduction and (2) place clear limits on how local governments can tax the cannabis industry.

Policy Recommendations

The regulated cannabis industry presents a unique opportunity to generate significant state and local tax revenue, but exceedingly high tax rates will divert sales to the illicit market. The experiences of jurisdictions with adult-use cannabis laws illustrate the challenges that can emerge from flawed tax structures.

In order to avoid the missteps of other jurisdictions and advance functioning medical and adult-use cannabis markets, it is critical for state and local policymakers to adopt cannabis tax structures that appropriately balance tax revenue generation and illicit market reduction.

State and local officials should consider the following recommendations as they set out to develop and revise policies for the emerging adult-use cannabis industry.

Maintain Aggregate Net Effective Tax Rates at 20 Percent or Below

Research shows that effective tax rates (inclusive of state, local, and supply chain taxes) exceeding 20 percent have diminishing returns for tax revenue generation but significantly increase the size of the illicit market. As such, policymakers should follow the lead of a growing number of states like Oregon and Massachusetts and ensure that effective tax rates do not exceed 20 percent. Adopting a more burdensome tax structure guarantees that the regulated market will struggle to displace the illicit market.

Cap Local Tax Rates at 3-5 Percent

Tax revenue generation is an important incentive for local governments to permit cannabis businesses in their jurisdictions. However, providing local governments with unlimited authority to tax the cannabis industry will result in a patchwork of local tax structures that significantly increases effective tax rates and undermines the regulated market.

State lawmakers should advance tax policy frameworks that provide local governments with an incentive to permit cannabis businesses in their jurisdictions but also prevent local governments from imposing disparate and burdensome tax structures that fuel the illicit market. Capping local tax rates in the range of 3-5 percent (while ensuring that net effective tax rates do not exceed 20 percent) provides a meaningful incentive for local governments to organize policy reforms and helps to both simplify and standardize cannabis tax policy throughout the state.

Restrict State and Local Cannabis Taxes to the Final Point of Sale

Multiple layers of taxation throughout the cannabis supply chain significantly increase net effective tax rates and the regulated market's price premium. Accordingly, state and local taxes should generally only be placed on the final point of sale to consumers to avoid multiplicative taxation through the supply chain.

Base Tax Rates upon Final Retail Prices Instead of Weight or THC Content

In a few jurisdictions, policymakers have considered adopting alternative tax structures that tax cannabis by weight or by THC content. These policies are extremely flawed since (1) they are more difficult to operationalize than straightforward tax rates based solely upon price and (2) they disproportionately place the tax burden upon regular cannabis consumers, who are more price sensitive and, therefore, are far less likely to transition their purchases from the illicit market to the regulated market.

Distribute a Portion of State Tax Revenue to Local Governments on a Pro-Rata Basis, Based upon the Number of Licenses within Each Jurisdiction

As a way of incentivizing local governments to allow cannabis operations in their jurisdictions, a portion of annual state tax revenue should be redistributed to local governments based on the number of active licenses they issue.

Appendix A. State Tax Policy Frameworks

State	Retail Excise Tax	Cultivation Tax	Local Tax Authority
Alaska ²²	N/A	<ul style="list-style-type: none"> • Mature Flower: \$50/oz • Immature Flower: \$25/oz • Trim: \$15/oz • Clones: \$1/oz 	In addition to applicable local sales taxes, local governments can impose additional taxes on cannabis.
California ²³	15.00%	<ul style="list-style-type: none"> • Flower: \$9.65/dry-weight oz • Leaves: \$2.87/dry-weight oz • Fresh Plant: \$1.35/oz 	In addition to applicable local sales taxes, local governments can impose additional taxes on cannabis.
Colorado ²⁴	15.00%	15.00%	In addition to applicable local sales taxes, local governments can impose additional taxes on cannabis.
Illinois ²⁵	<ul style="list-style-type: none"> • 10.00% - Products with < 35% THC • 25.00% - Products with > 35% THC • 20% - Cannabis-infused products 	7.00%	In addition to applicable local sales taxes, cities can impose up to a 3.00% excise tax on cannabis, and counties may impose up to a 3.75% excise tax in unincorporated areas.
Massachusetts ²⁶	10.75%	N/A	Local governments can impose up to a 3.00% retail excise tax on cannabis.
Michigan ²⁷	10.00%	N/A	No additional local excise taxes are permitted, except for any applicable local sales taxes.
Nevada ²⁸	10.00%	15.00%	In addition to applicable local sales taxes, local governments can impose additional taxes on cannabis.
Oregon ²⁹	17.00%	N/A	Local governments can impose up to a 3.00% retail excise tax on cannabis.
Washington ³⁰	37.00%	N/A	No additional local excise taxes are permitted, except for any applicable local sales taxes.

* In many states, state and local sales taxes apply in addition to cannabis-specific tax rates. This chart does not include information on general sales tax rates.

End Notes

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- ² *A Society in Transition, an Industry Ready to Bloom: 2018 Cannabis Report*. Deloitte, 2018, <https://www2.deloitte.com/content/dam/Deloitte/ca/Documents/consulting/ca-cannabis-2018-report-en.PDF>.
- ³ *An Emerging Crisis: Barriers to Entry in California Cannabis*. California Growers Association, Feb. 2018, www.calgrowersassociation.org/crisisreport.
- ⁴ *Considering Marijuana Legalization: Insights for Vermont and Other Jurisdictions*. RAND Corporation, 2015, https://www.rand.org/content/dam/rand/pubs/research_reports/RR800/RR864/RAND_RR864.pdf; and *With Legal Weed the Government Must Choose Revenue or Regulated Market, Not Both*. C.D. Howe Institute, Apr. 2017, <https://www.cdhowe.org/intelligence-memos/rosalie-wyonch-legal-weed-government-must-choose-revenue-or-regulated-market-not>.
- ⁵ *Breaking Down Year 1 of Adult-Use Sales*. BDS Analytics, 2019, <https://bdsanalytics.com/wp-content/uploads/2019/02/Breaking-Down-Year-1-of-California-Adult-Use-Sales-Webinar.pdf>.
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- ²⁴ Colorado- Marijuana Taxes <https://leg.colorado.gov/agencies/legislative-council-staff/marijuana-taxes%C2%A0>
- ²⁵ Illinois Revenue- Cannabis Tax Frequently Asked Questions, <https://www2.illinois.gov/rev/research/taxinformation/other/Pages/Cannabis-Tax-Frequently-Asked-Questions.aspx#qst1>
- ²⁶ Massachusetts Tax Rates, <https://www.mass.gov/service-details/massachusetts-tax-rates>
- ²⁷ Michigan Marijuana Regulatory Agency- Laws, Rules, Bulletins, Grants, & Other Resources <https://www.michigan.gov/mra/0,9306,7-386-82631---,00.html>

²⁸ Marijuana in Nevada- Taxes, <https://marijuana.nv.gov/Businesses/Taxes/>

²⁹ Oregon: FAQ- Taxes, <https://www.oregon.gov/olcc/marijuana/Pages/FAQs-Taxes.aspx>

³⁰ Department of Revenue, Washington State. Recreational and medical marijuana taxes <https://dor.wa.gov/about/statistics-reports/recreational-and-medical-marijuana-taxes>