



COUNTY ADMINISTRATIVE OFFICE

COUNTY OF MONTEREY Intergovernmental and Legislative Affairs Division

MEMORANDUM

DATE: April 2, 2018

TO: Board of Supervisors Standing Cannabis Committee

FROM: Nicholas Chiulos, Assistant CAO

SUBJECT: Fiscal Analysis of Commercial Cannabis Industry

Recommendation

Receive report from HdL Companies on their report entitled “Fiscal Analysis of the Commercial Cannabis Industry” and direct staff to consider changes to the existing commercial cannabis tax rates based on data presented in the HdL Companies report. Staff believes a number of important factors should be considered before making a decision on adjusting commercial cannabis tax rates. It is recommended that the review of changes in tax rates should include a policy discussion of the proper balance between providing a reasonably stable and competitive business environment for the cannabis industry, versus the need for adequate revenues to regulate the industry and police illegal activities. Additionally, consideration should be given that the County’s commercial cannabis business tax ballot measure (“Measure Y”) contemplated that the legalization and taxing of the commercial cannabis industry would provide much needed new tax revenues to support governmental services to the community. Finally, should your Committee and ultimately the Board of Supervisors consider any adjustments to the taxes, it is recommended that the tax changes be implemented concurrent with the fiscal year, and structured to be flexible in the future with changes in other taxes levied on the industry.

Summary/Discussion

In 2016, the Board of Supervisors considered the possibility of adopting a regulatory framework to permit commercial medical cannabis operations in the County's unincorporated area, and if approved by the voters of California, to also adopt a regulatory framework to permit commercial adult use cannabis operations. HdL was hired to conduct an analysis of the potential tax revenue that could be generated annually by commercial cannabis operations in the County. HdL and County staff worked together to develop various scenarios of likely business activity and potential tax revenue generation. At that time, it appeared that the cannabis industry could generate revenue in multi-million dollar range. The Board of Supervisors placed Measure Y on the November 2016 ballot. Measure Y essentially provided that the County would create a regulatory structure to permit commercial cannabis activities if the voters approved a general tax on such commercial cannabis businesses. The text of the ballot measure included language which described the tax rates and stated that such taxes could potentially generate many millions of dollars annually to help fund County services.

Although the costs of administering a County cannabis program were not fully known at the time of the November 2016 election, the Official Argument in Favor characterized the tax as "critical to fund projected costs and demands on County services resulting from marijuana businesses." It went on to state "voting yes on this measure will support a local, regulated marijuana market that "will not exist without this tax" (emphasis added). The voters overwhelmingly approved Measure Y and the County began the process of implementing a well-constructed regulatory framework for the commercial cannabis program. The commercial cannabis business tax is codified in the Monterey County Code in Chapter 7.100.

Since early 2016, the cannabis business outlook in Monterey County has been challenged by various recent developments. These include the California voter approval of Proposition 64 legalizing adult-use or so called "recreational" use ("AUMA"). AUMA imposes significant taxes on the legal cannabis industry. Additionally, AUMA allows for the vertical integration of cannabis businesses, which was not allowed under the State's previous medical commercial cannabis law (e.g., a single business can now cultivate, manufacture and distribute commercial cannabis). It is important to note that the State taxes and vertical integration were not in place at the time that the tax rates under Measure Y were formulated.

To complicate matters, there has been a significant surge in illegal cannabis operations in Monterey County, predominately located outdoors or in hoop houses in various parts of the Salinas Valley and South County. Further, individuals from local legal commercial cannabis business have opined that they are facing serious business challenges. Specifically, they did not fully investigate and appreciate the cost of converting existing greenhouses built primarily for the cut flower industry into modern commercial cannabis greenhouses. Industry analysts have estimated that the failure rate of those attempting to get into the highly regulated and competitive cannabis market in California could be as high as 30%. Finally, based on testimony received to date, it appears that the Monterey County commercial cannabis industry supports the County lowering its tax rate, pointing to the cost of doing business in greenhouses within the County, diminishing prices due to high levels of supply, lower tax rates in other jurisdictions, and the high level of taxation imposed by the State.

Staff recommend returning to your Cannabis Committee at the end of this month to recommend what changes are recommended to the Cannabis tax rate, ordinance, and practices to achieve the multiple goals of supporting a sustainable and appropriately regulated industry within the framework of the provisions of Measure Y.

County Costs and Budget Outlook for FY 18/19

The Board of Supervisors Committee on Cannabis recently received and recommended consideration by the full Board of a CAO staff recommendation that the proposed budget for the 10 County Departments involved in administering and enforcing the County's cannabis program is estimated to be approximately \$3.5M for FY 18-19. Cannabis industry representatives have stated that even more resources than proposed by the CAO staff should be allocated to eradicate the extensive illegal operations in the Salinas Valley and South County, in order to ensure that legal operators are not undercut by the illegal operations.

Ultimately, the cannabis taxation level and the cost of administering the County program must be viewed in the context of the budget challenges facing the Board of Supervisors as FY 18-19 budget hearings approach. At the present time, the County budget faces a \$36M deficit. The ability for the County to continue overall program operations at the current level is in jeopardy. It has been preliminarily estimated that, in order to balance the FY 18-19 budget, a total of 283 positions would need to be eliminated. Of these, 160 are filled positions. In addition, through a community engagement process directed by the Board of Supervisors, extensive community needs have been identified that will be the subject of a separate report to the Board of Supervisors. It is anticipated that the Board's response to these identified community needs may result in priorities for the allocation of cannabis tax revenue at some level to be determined.