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# Fiscal Analysis of the

# Commercial Cannabis Industry

# EXECUTIVE SUMMARY

**Prepared for**

**the**

## County of Monterey

**March 30, 2018**

# I. Introduction

The County of Monterey contracted with HdL in 2016 to identify options for taxing the various types of commercial cannabis businesses and to assist in the development of a ballot initiative to gain voter approval of a cannabis tax. This effort led to the successful passage of Measure Y in November of 2016, which imposed a $15 per square foot tax on marijuana cultivators, a $2 per square foot tax on marijuana nurseries, and a 5% tax on gross receipts of marijuana businesses in the unincorporated areas of the county. These taxes were set to increase incrementally starting in July of 2020, eventually rising to rates of $25 per square foot, $5 per square foot and 10%, respectively, by June 30th of 2022.

Though Measure Y has been in place for only 15 months, the regulatory world around cannabis in California has changed dramatically since then. At the same time County voters approved Measure Y, California voters approved Proposition 64; the Adult Use of Marijuana Act. In the early part of 2017, the three State cannabis licensing agencies released a series of reports that provided a trove of valuable data about the industry. On June 27th the Governor signed SB 94, which merged the separate regulations for medical cannabis and adult use cannabis into a single regulatory framework. This was followed in September by the approval of AB 133 and, in November 2017 by the issuance of emergency regulations by the three licensing agencies.

These combined changes have created a very different world for Monterey County's commercial cannabis industry than existed at the time Measure Y was being developed. Key among these changes is the imposition of overlapping State taxes which hover around 26% at retail before any local taxes are even contemplated. At the same time, numerous other counties and cities have developed their own cannabis taxes, with many as low as $1 to $3 per square foot, making the up-to $25 per square foot rate imposed by Measure Y so high by comparison that the local cannabis industry struggles to remain competitive with players from other regions in the State.

Perhaps most notably, though, legalization and regulation of commercial cannabis has exposed this industry to competitive free-market forces that it was previously shielded from due to prohibition. This has driven down wholesale prices precipitously at the same time that regulatory costs are climbing. As little as a year ago, HdL would have used assumptions of around $1,500 per pound in our calculations. Today we commonly use a range of $700 to $1,000 per pound, depending upon the market sector. High tax rates may have been acceptable to the industry when it enjoyed high profit margins and few regulatory costs, but those same rates become prohibitive for what is now one of the most highly regulated industries in the State, struggling with declining profit margins.

Due to these changes, the County of Monterey requested that HdL revisit the tax rates and structure established by Measure Y and conduct a revised fiscal analysis of the County's tax ordinance. The County has not expressed interest in revising the existing voter-approved Measure Y, as that would subject the County to the time, expense and uncertainty of placing another measure on a future ballot. Instead, *HdL was directed to work solely within the existing parameters of Measure Y*, so that any recommended changes can be approved legislatively by the Board of Supervisors.

Additionally, the County desires to support and encourage innovation in this evolving and highly competitive statewide industry. Our analysis seeks ways to maximize flexibility for local cannabis businesses by addressing variables such as differing cultivation methods, crop loss, vertical integration and innovative business structures. If the County seeks to generate revenue from this industry through taxes, then it must consider tax rates and structures that are more equitable to those aspects of the industry it wishes to support or encourage. Simply put, the County will generate no revenue from businesses that fail in this highly competitive marketplace, or that choose to relocate in search of more favorable regulations and taxes.

This report also seeks to identify the local economic impacts of the cannabis industry, and to analyze any financial constraints, including the overall tax and regulatory burden, which may impact both the industry's long-term stability and its ability to successfully transition to a legal, regulated paradigm that can outcompete the existing black market.

Discussion of regulating and taxing the cannabis industry can too often overshadow the larger jobs and economic development issues that typically accompany efforts to attract new industry. Word that a new business or industry is looking to bring hundreds of new jobs to a community is more commonly met with open arms and offers of tax incentives. The cannabis industry is perhaps completely unique in that the inherent jobs and economic development benefits are welcomed more grudgingly and met with the disincentive of special taxes. While the tax revenue potential is attractive to local governments, imposing excessively high rates may reduce the number of businesses that step forward and decrease the likelihood that they will succeed in the regulated market. In this way, higher taxes could result in less revenue and more illegal activity.

Cannabis cultivation, manufacturing, distribution and retail sales each offer different challenges and opportunities for the County. Retailers serve the local population, so the amount of product they sell and the amount of revenue they collectively generate is not greatly affected by the number of retailers through which that product flows. From a tax perspective, retail sales are a zero-sum game in that, eventually, new retailers simply cannibalize sales from existing ones.

Cannabis manufacturing presents the best opportunity for growing new businesses and jobs, but this sector has a high degree of mobility. The manufacturing segment is growing and expanding and offers lots of opportunity for innovation and job creation. Clear regulatory policies and competitive tax rates will be essential for attracting or holding on to this sector.

Equally important to tax rates is setting a clear and unambiguous direction for regulatory policy. As with any other industry, the cannabis industry desires regulatory certainty. Monterey County was ahead of the curve in developing a full regulatory program for commercial cannabis. However, as noted above, the past year has been filled with dramatic changes for this industry in California, and the County must continue to adapt its program to address and incorporate these changes.

This is a pivotal moment in time for the cannabis industry, and delay can cause lost opportunities for those cannabis businesses that are trying to compete in this newly legal, regulated market. We encourage the County to continue to work proactively with this emerging industry so that it can remain competitive. Doing so will provide the greatest opportunity for the County's cannabis industry to succeed in a rapidly changing world.

## II. Findings

Based upon our analysis, HdL provides the following findings for the County to consider:

1. **New information provides a clearer picture of the local cannabis industry.** In our May 2016 report to the County, HdL provided revenue projections based upon a variety of assumptions as to the number and mix of cannabis businesses. These assumptions were developed by the County based on input received from the industry and the community at stakeholder meetings. The "high" estimate assumed a mix of 300 cultivation sites, 200 manufacturers, 15 retailers, and 5 distributors. The "low" estimate assumed 150 cultivation sites, 100 manufacturers, 10 retailers and 5 distributors.

   Both the County and the State have now been issuing permits or licenses that give us more concrete numbers. As of the date of this report, the County has 106 permitted cultivation sites, 48 nurseries (which were not considered in the 2016 report), 6 manufacturers, 15 retailers, and 4 distributors. CDFA's CalCannabis division has issued 219 temporary cultivation licenses and 46 nursery licenses in the County (this figure includes the cities within the County).

   If we include nurseries under cultivation, these figures align very closely with the "low" estimate from the 2016 HdL report, with the exception of the number of manufacturers.

2. **Legal cannabis cultivation in California has already exceeded its saturation point.** The California Department of Food and Agricuture's CalCannabis Division has estimated the amount of cannabis consumed by Californians at 2.5 million pounds per year, which provides a reasonable proxy for the size of the potential market. Of this, CalCannabis estimates nearly 30% will continue to be supplied by black market sources, which reduces the size of the available market for legal producers to around 1.75 million pounds.

   As of March 26th, 2018, CalCannabis has issued 2,848 temporary cultivation licenses Statewide, with the capacity to produce over 5.3 million pounds of cannabis per year. This is more than three times the estimated size of the legal market in California. This market over-saturation is a critical issue for local governments to consider, as there are far more growers seeking licenses in California than the limited size of the market can support.

   Local industry sources have identified a potential of 2 million square feet of available greenhouse space in Monterey County, and perhaps as much as 10 million square feet that could potentially be adapted for such use in the future. As with the State, however, the number of cannabis growers in Monterey County has likely already reached its saturation point. Because of this, the local cultivation industry is not likely to see significant expansion in coming years, and may even see contraction.

3. **Cannabis tax rates are settling and stabilizing around the State.** HdL's 2016 report for Monterey County provided a range of potential tax rates for consideration, from a "very conservative rate of $5 per square foot for cultivation and 2.5% of gross receipts for other cannabis businesses, to a "very aggressive" rate of $20 per square foot and 7% of gross receipts. The County ultimately chose "aggressive" rates of $15 per square foot for cultivation (increasing to $25), $2 per square foot for nurseries (increasing to $5) and 5% of gross receipts for all other cannabis businesses (increasing to 10%).

   The County's current tax rates are above what we see as the emerging norms for the industry. HdL is currently working with 25 local governments around California on tax measures for the upcoming

June and November 2018 ballots. The common rates we are seeing for mixed-light cultivation are between $4 and $7 per square foot. The range for nurseries is between $1 and $2 per square foot. The rates for other cannabis businesses are commonly from 2% up to 6% of gross receipts. Testing laboratories, as an exception, fall between 1% and 2%, in recognition of the quasi-regulatory function they provide. These rates are consistent with the "very conservative" rates from HdL's 2016 report.

**Figure 1:**

| Common Local Tax Rates Among 2018 Ballot Measures | | |
|---|---|---|
| **Cannabis Business Type** | **Initial Rate** | **Maximum Rate** |
| **Cultivation (greenhouse)** | $4 per square foot | $7 per square foot |
| **Nurseries** | $1 per square foot | $2 per square foot |
| **Manufacturing** | 2.5% of gross receipts | 4% of gross receipts |
| **Distribution** | 2% of gross receipts | 3% of gross receipts |
| **Retail** | 4% of gross receipts | 6% of gross receipts |
| **Testing** | 1% of gross receipts | 2.5% of gross receipts |

4. **The impact of current and future tax rates on cultivation.** Monterey County's current tax rate for cultivation is $15 per square foot, which is roughly equivalent to 6.5% of gross receipts for greenhouse cultivation. This is set to increase by steps to $25 per square foot by June 30th, 2022, which would be roughly equivalent to 11% of gross receipts. By comparison, a $4 per square foot rate would be roughly equivalent to 1.8% of gross receipts and the maximum rate of $7 per square foot would be equivalent to 3.1%.

   When combined with the dual State taxes on cannabis, the County's current rates contribute to a cumulative tax rate at retail of around 32%, or roughly $300 per pound. This is somewhat above the emerging norm of 30% for all cumulative taxes combined. When the future tax rates are applied, the cumulative rate will jump to 40%, or over $800 per pound at retail.

   The County's anticipated increases deter investment in the local cannabis industry, as they signal to both operators and investors that Monterey's business environment will become increasingly difficult and less competitive in the future. As with any other industry, cannabis businesses desire regulatory certainty and stability. Increasing tax rates translate into higher operational costs which may result in narrower profit margins and less stability.

   The cannabis cultivation industry is already dealing with a steady decline in cannabis prices due to intense competition and market saturation. These future increases will disadvantage the local industry by making it less competitive. Amending the County's current and future rates to reflect prevailing rates from around the State would encourage investment in the local cannabis industry by providing greater certainty and stability for the local industry.

5. **The impact of current and future tax rates on nurseries.** Monterey County is currently home to over 28% of all of the State-licensed cannabis nurseries in California. As of March 26th, 2018, CalCannabis has issued 167 Type 4 Nursery licenses Statewide, with 46 of them in Monterey County (there are 48 registered with the County). This is the highest number of licensed nurseries of any county, and the highest concentration of any one industry sector anywhere in the State. Second-placed Mendocino County has 30, followed by Riverside County with 19, and Santa Barbara County with 13. Clearly, Monterey County is well positioned to be the leader in this sector of the industry.

This abundance of nurseries is a symbiotic fit for an area with abundant available greenhouse space and has the potential to serve as an anchor for the entire cannabis industry in Monterey County. We would expect to see a strong network of support industries emerge to serve both nurseries and greenhouse cultivation.

Given the prevalence and significance of nurseries, we would encourage the County to take steps to support and encourage this sector. While the current tax rate of $2.00 per square foot is not particularly high, the scheduled increase to $5 per square foot would likely be very difficult for the current industry to absorb. By contrast, reducing the current rate down to $1.00 per square foot could help to secure the County's dominance in this sector, which would carry benefits to other industry sectors as well.

6. **Cannabis testing laboratories provide a semi-regulatory function.** The Medical and Adult Use of Cannabis Act requires that all dried cannabis flower or leaf must be tested for tetrahydrocannabinol (THC) and cannabidiol (CBD) content, contaminants, impurities and other factors before it can be sold to a manufacturer, distributor, dispensary or end user. The cost of this mandated testing and the loss of product for a testing sample can add around 7% to the wholesale cost.

   Testing is an independent, semi-regulatory function mandated by the State to protect consumer health and safety, and which amounts to a State-imposed cost on the product. HdL is not aware of any similar testing of agricultural products that is subject to a separate tax on top of the cost of mandated testing. More commonly, the costs for similar services for other agricultural products may be subsidized by the USDA or other sources that are not available to cannabis farmers.

   As of March 5th, the Bureau of Cannabis Control has only granted 26 temporary licenses for testing laboratories Statewide. One of these is in the City of Salinas, but none are in the unincorporated County of Monterey. The low number of testing laboratories has produced a bottleneck that hinders the ability of producers to get their products onto retailers' shelves.

   Encouraging testing laboratories by reducing or eliminating taxes, consistent with other agricultural services, would strengthen the cultivation and manufacturing sectors in the County by giving them better access to retailers. Since there are none currently, this action would bring no associated reduction in revenue. However, it could indirectly bring an increase in revenue by creating a more supportive industry cluster for cultivators and manufacturers.

7. **The current 5% tax rate on gross receipts of cannabis businesses is higher than emerging Statewide norms.** HdL is currently working on cannabis tax measures for 25 local agencies around the State. The initial range of tax rates for cannabis businesses other than cultivation commonly runs from 2% of gross receipts for distributors, to 2.5% for manufacturers, and up to 4% for retailers. These rates may be adjusted up to a maximum of 3%, 4% and 6%, respectively.

   While the current rate of 5% is within the range for cannabis retailers, the County may wish to consider applying different rates for manufacturers and distributors. While retailers compete with other retailers locally (and thus are generally subject to the same local tax rates), manufacturers and distributors must compete with other businesses from around the State, many of which may be located in jurisdictions with lower taxes.

   While the cannabis cultivation industry appears to be overly saturated, HdL believes that manufacturing and distribution provide significant opportunities for growth. As such, the County may wish to consider changes to its tax rates that support and encourage these sectors.

8. **Develop administrative procedures to avoid double taxation of vertically-integrated businesses.** Vertical integration allows a single entity to hold multiple license types, raising the concern that a business may be taxed both on its cultivation area and on the gross receipts of other activities. We recommend that the County develop administrative procedures that will appropriately apportion taxes between cultivation and other activities.

   HdL has worked with numerous local agencies to develop procedures for improved administration of their cannabis taxes. Many jurisdictions provide a reduction in the tax rate for each additional license type held, so as to not penalize vertically integrated businesses. For example, a cultivator that also holds a distribution license may see a reduction in their gross receipts rate. A cultivator that is also a manufacturer and a distributor would see rate reductions for both of these "secondary" license types.

   HdL can provide further assistance to the County in development of such administrative procedures, if desired.

9. **Dual State cannabis taxes leave little room for local taxes.** The State of California applies two separate taxes to cannabis: a cultivation tax of $9.25 per ounce of dried flower ($2.75 per ounce of dried leaf or trim and an excise tax of 15% on the purchase of cannabis and cannabis products. These two separate State taxes can add up to 26% to consumer cannabis prices, even before any local taxes are contemplated. This leaves very little room for local jurisdictions to work within if they wish to remain under the total cumulative tax rate of 30%. This is an important benchmark to allow the local industry to compete against the black market and against other regulated cannabis businesses from around the State.

   Reducing these State tax rates would allow local governments to generate more revenue from this industry. On February 20, 2018, HdL provided testimony to the California State Legislature on behalf of our clients and the League of Cities, supporting a reduction in the State's cannabis tax rates to allow an opportunity for the industry to stabilize and for local governments to evaluate more reasonable tax rates.

   Following upon this testimony, HdL collaborated with Assemblymember Tom Lackey to introduce a bill (AB 3157) that would reduce the excise tax on cannabis to 11% through June 30th, 2021, and suspend the cultivation tax for the same period. The County may wish to consider supporting this bill.

10. **Support a regional approach to cannabis taxes and regulation.** The County coordinated with the cities of Gonzales, Greenfield, King City, and Salinas in its developing Measure Y. These cities all adopted tax rates and structures which are consistent with Measure Y, either in whole or in part. In addition, the cities of Del Rey Oaks, Seaside, and Soledad have adopted, or are contemplating adoption of cannabis regulations and cannabis business taxes. HdL supports this regional collaboration.

    The County may wish to share this report with the local cities and advise them of any changes the County may be considering. Doing so would allow the cities to consider whether they may wish to make similar adjustments, so as to preserve this consistent regional approach.

## III. Revenue Projections

We have provided a range of revenue projections by applying a number of assumptions to the current number of cannabis businesses in the County. For cultivators we assume that 75% of the permitted cultivation area will contain taxable canopy, on average. For nurseries we assume that the percentage of canopy will average 50%.

Our estimates of gross receipts for other cannabis businesses are based upon HdL's review of over 1,200 applications, business plans, pro formas and financial audits of cannabis businesses. Additionally, HdL has access to confidential sales tax data for all cannabis retailers in California. While there is a range of sizes for each of these types of businesses, HdL believes that the averages used here are reliable.

Under the current tax rates, the County could expect to generate up to $14.7 million annually. We stress that this figure is "up to", as higher tax rates can be expected to create attrition within the industry, as businesses either fail due to their inability to compete or choose to move to other locations with a "friendlier" tax and regulatory climate. We would anticipate that actual revenues would be somewhat less due to this effect.

Alternate Rate A applies the lower rates that we are commonly seeing among the 25 local agencies we are currently working with. Applying these rates to the current number of cannabis businesses in the County would generate an estimated $5.5 million.

Alternate Rate B applies the higher rates from the current tax measures. Under this scenario, we estimate that the current cannabis businesses in the County would generate $9.17 million.

**Figure 2:**

| Revenue Projections | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| **License Type** | **# of Businesses** | **Size (square feet or gross receipts)** | **Current Tax Rate** | **Annual Revenue** | **Alternate Rate A** | **Annual Revenue** | **Alternate Rate B** | **Annual Revenue** |
| **Cultivators** | 106 | 889,726 | $15/sf | $10,009,420 | $4/sf | $2,669,179 | $7/sf | $4,671,063 |
| **Nurseries** | 48 | 352,739 | $2/sf | $352,739 | $1 | $176,370 | $2/sf | $352,739 |
| **Manufacturers** | 20 | $2,000,000 | 5.00% | $2,000,000 | 2.50% | $1,000,000 | 4.00% | $1,600,000 |
| **Distributors** | 4 | $2,500,000 | 5.00% | $500,000 | 2.00% | $200,000 | 3.00% | $300,000 |
| **Testing** | 0 | $1,500,000 | 5.00% | $0 | 1.00% | $0 | 2.50% | $0 |
| **Retailers** | 15 | $2,500,000 | 5.00% | $1,875,000 | 4.00% | $1,500,000 | 6.00% | $2,250,000 |
| **Total** | | | | **$14,737,159** | | **$5,545,548** | | **$9,173,802** |

When the County's current tax rates are applied at their appropriate price points in the cannabis product chain and combined with the multiple State taxes established by Proposition 64, the total cumulative tax rate on a hypothetical cannabis product that is grown, distributed and sold entirely within Monterey County would be around 32%, or $300 per pound. Applying the rates under Alternative A would reduce the cumulative tax rate down to 29.5%, or $187 per pound. Applying the rates under Alternative B would push the cumulative tax rate to 31%, or $265 per pound.