

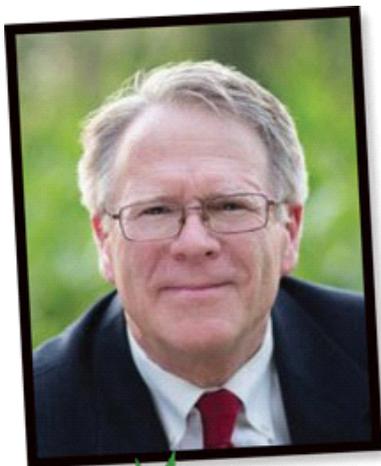
GROWERTALKS

Corr on Cannabis

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Of Mice and Men ... and Competing with the Black Market

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Maybe Robert Burns was on to something when he philosophized a couple of hundred years ago: “The best laid schemes o’ mice an’ men gang aft a-gley.” Or for those who don’t speak Outlander, “The best-laid plans of mice and men often go awry.”

One of the selling points for legalization of cannabis for general adult use (“recreational” use) was to reduce black-market sales. Proposition 19 was an attempt in 2010 to legalize adult use of cannabis in California (although Prop 19 failed, the Adult Use of Marijuana Act passed in 2016).

One of the advertisements for the passage of Prop 19 used this argument: “Al Capone and his bootleg gangsters were shooting up the streets not because they were drunk on booze. It was for the vast underworld profits. And once alcohol was legalized, it put them out of business as bootleggers.

And that’s the goal of Prop 19 that would be achieved very quickly.”

That argument hasn’t held up well for cannabis. Last year, three years after the passage of the Adult Use of Marijuana Act, black-market cannabis sales in California were estimated to be \$8.7 billion in comparison to legal sales of \$3.1 billion. Clearly, modern-day cannabis bootleggers are doing just fine.

There’s no single explanation for the continued success of black-market sales. Inertia certainly is one reason. Once an industry is set in motion it will tend to stay in motion. The black-market cannabis industry has an entrenched production, distribution and sales network. That doesn’t disappear overnight.

In physics, inertia is overcome by external forces, and one would think the introduction of legal production, distribution and sales would be a strong external force. However, passage of the Adult Use of Marijuana Act in California, and similar regulations in other states, didn’t just allow for state-legal marijuana production and sales. These regulations also established rules regarding how that production would take place and for taxation of the sales.

Black-market rules didn’t change—production could be done wherever and however it could be done without detection, and without taxes.

How significant are the costs related to rules and taxation of legal marijuana?

The first significant cost differential between state-legal and black-market cannabis production is the cost of establishing the business. State-legal production requires applying for a license, which by definition isn't done by the black market. The cost of acquiring a license varies by the type of license (cultivation, distribution, dispensary, etc.) and the location (each state or province has different rules).

As an example, when my home state of Illinois legalized medical marijuana, the fee for a cultivation license was set at \$100,000 each year. But that's just the fee—most companies applying for the license spent much, much more than that to prepare their application for the license. The black-market producers didn't need to do that.

Testing of products is another significant cost borne by state-legal marijuana producers that the black market doesn't worry about. Regulations established testing that marijuana must pass before it can be sold. The exact testing and specifications vary by jurisdiction, but usually there's a requirement to test for cannabinoid content (typically at least THC and CBD), pesticides, microbial contaminants, heavy metals and residual solvents (for products that are extracted).

A simple test for just cannabinoids might run little more than \$100; it's everything else that gets expensive. A full-range test for all the items required by most states might run \$1,000—and that's just the testing cost. The material sampled for testing could otherwise have been sold. With the value of cannabis as high as it is, that material is a significant additional cost.

If a batch fails for any of the tests run (for example, too high a microbial count or a trace of pesticide) that batch must be destroyed (re-testing is allowed in some jurisdictions and in some cases). Loss of a batch can result in a loss of tens of thousands of dollars.

Marijuana sold on the black market has none of these testing costs. The quality of marijuana purchased on the black market isn't assured by anything more than the word of the person selling it.

Finally, state-legal marijuana is heavily taxed. To start, most states tax marijuana with the usual retail sales taxes; it's the additional taxes that really add up. For example, in Illinois, retail marijuana taxes range from 10% to 25% based on type of product and potency. This is in addition to the usual sales tax that starts at 6.25% at the state level, plus whatever local sales tax has been imposed. Besides usual sales taxes, municipalities are allowed to add up to 3.75% in an additional special tax on marijuana. These retail taxes are in addition to a 7% tax on wholesale production. When all is added in, Illinois taxes can be well over 40%. California and other states have a similar tax burden. Black-market dealers don't collect taxes.

When all of these costs are combined, it's no surprise state-legal cannabis production cannot compete with the black market on price.

Best-laid plans have resulted in economic disincentive for legal production of marijuana in many locations. Not as wise perhaps as Robert Burns, but I've often said it doesn't matter if you shoot yourself in the foot; it matters how fast you reload and do it again. Locations that have made legal marijuana uncompetitive against the black market have the opportunity to get it right when regulations are revised, unless they reload and shoot again. **GT**

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