Recreation Tax Policy Analysis and Recommendations

Joint Committee on Implementing Measure 91

Beau R Whitney – May 2015
Chief Operating Officer: Greenpoint Oregon, Inc.
Economist: WhitneyEconomics, LLC

Honorable Members of the Committee:

My name is Beau Whitney. I am the Chief Operating Officer at Greenpoint Oregon, Inc. I am also an economist, an economics instructor at the university level and I have previously submitted testimony to the Secretary of State's office regarding the tax revenue forecast associated with Measure 91.

The company I work for, Greenpoint Oregon, Inc is an Oregon based, vertically integrated Medical Cannabis Company that serves the medical community and provides patients with high quality, high value user experiences.

As an industry leader committed to transparency and controls, Greenpoint dedicated to partnering with industry leaders, communities and regulators. Greenpoint is a solutions provider that leverages a strong management team and advanced research techniques to introduce innovative products and services into the cannabis marketplace.

Introduction:

As Oregon enters into the uncharted territory that recreational adult use marijuana markets represents, there are several significant factors that will determine the success or failure of the market structure. Two of those factors are taxation and conversion from black market to open market consumption. If taxes are too high, demand will remain on the black market and tax revenues will be minimal, however if taxes can strike a balance between maximizing revenue for the States and minimizing the delta between the market (black market) prices and open market prices then the State can also achieve its objective of limiting black market activities. The closer those prices are, the more taxes will be collected. In fact, there is a price point in which taxes revenues can be maximized, conversion will be maximized and price will be the lowest possible level.

The objective of this analysis is to compare the current tax structure that is proposed by Measure 91, assess the impact of the price floor on demand and propose a new level of taxation that will minimize the price delta between black market and open market, maximize conversion to the open market while maximizing Oregon state tax revenue.

Current state

The taxation model proposed by Measure 91 is a weight based tax. It imposes a $560 per pound tax on flower regardless of the quality or value of the product. It also imposes a $160 per pound tax on leaves or "trim". The advantage of this structure is that it is simple to understand and straight forward to track and manage. The effect of the structure though is that it creates are price floor which limits the conversion from black market to open market since it creates a permanent delta between black market and open market prices that cannot be overcome by a market price change. This creates externalities in the market which will limit that maximum amount of taxes that the state of Oregon will be able to collect.

Why would this limit the tax revenues?

By creating a price floor (**a government imposed limit on how low a price can be charged**), there is a competitive advantage given to black market suppliers. If the delta between the market price and the price floor is significant enough, there is no incentive for the cannabis consumer to convert over from the black market to the open market. Currently the tax rate for flowers is $560 per pound. Based on a sales price of $1,800 per pound, this equates to a 31.1% tax. As a basis of comparison, Colorado originally imposed a blended tax rate of 22% on recreational sales and the conversion rate came in lower that their original forecast. As a result the Colorado tax revenues came in lower than expected. The premium that a consumer would pay to purchase on the open market was much lower than the price associated with a 22% tax. Washington faced a similar issue by imposing a blended tax of 44%, which nearly crippled the industry before it got out of the gate. Oregon must try to avoid these mistakes by lowering the effective tax rate to below the levels of both Colorado and Washington.

What influences the conversion rate from black market to open market?

Like any other product, demand is a function of price. If consumers have options, then they will be much more sensitive to changes in price. This concept is called elasticity. Originally economists assumed that since there are no other alternatives to cannabis, then demand would be inelastic (little change in demand based on changes in price). However in my opinion and based on empirical data, the elasticity of demand is actually quite high. Therefore if there is a significant drop in the Measure 91 tax rate, there will be a corresponding significant shift from black market to open market consumption.

Price elasticity of demand and conversion to the open market.

In a recent empirical study on price elasticity at a Greenpoint dispensary, the price of flower was reduced by 21% which resulted in an increase in sales of that product by 156%. This is a price elasticity of 7.4, which implies that demand is highly sensitive to price changes. We have seen similar results on our oil based products as well. I am currently in the process of expanding this analysis to other products and reaching out to other dispensaries in order to develop a larger data set for further review, but the bottom line is that if Oregon lowers the tax rate from the current 31% tax rate, demand will follow. The key is to strike a balance between lowering tax to a point where tax revenues are maximized and black market consumption is minimized.

What should the tax rate be?

Based upon the initial data analysis, I am proposing that the Legislature adjust the Measure 91 tax structure from a weigh based tax to a point of sales tax and that the point of sales tax rate should be 12.5%, (or no more than 17.5%). At this rate, the conversion volumes are great enough to offset the decrease in taxation per ounce. Using the baseline tax revenue forecast that I submitted to the Secretary of State's Office on July 30, 2014, by decreasing the tax to 17.5%, there would be a conversion rate from 50% of the market to 79% of the market. This does not include any increase in demand due to Canna-tourism. This will be a significant step forward in minimizing black market consumption while still allowing the market to adjust for price.

Conclusion:

While a weight based tax has its merits and is easy to manage, this tax structure limits the ability of the market to adjust for price and limits conversion to the open market. By implementing a point of sales tax system, the market can operate normally by allowing for pricing adjustments and by lowering the tax levels to between 12.5% and 17.5%, the State of Oregon can achieve its goal of minimizing the influence of black market activities while maximizing tax revenues.