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GENERATING FEDERAL CANNABIS TAX REVENUE IN A SENSIBLE AND EQUITABLE MANNER



BACKGROUND

Popular support for cannabis legalization has increased substantially over the last several decades. A strong majority (64%) of Americans now support cannabis legalization, compared to only 12% in 1970.¹ Americans are almost universally (93%) in support of legal medical cannabis for qualified patients with a valid physician's recommendation.² Many state legislatures and voters through ballot initiatives have enacted state-based reforms consistent with contemporary public opinion on medical and adult-use cannabis, but federal law has been static since 1970, with all aspects of cannabis-related activity, from possession to distribution, remaining illegal. (Notably, more than 70 percent of Americans believe the federal government should respect the state laws.) There is a dire need for re-evaluation of federal cannabis policy and the development of sensible alternatives. The road to comprehensive reform may be lengthy, but Congress can act now to minimize the detrimental effects of incompatible federal and state policy. This brief is a starting point for discussion of how a federal taxation model for cannabis could generate substantial new federal revenue, providing additional impetus for shifting cannabis production and sale from the criminal market to legitimate, state-regulated, tax-paying businesses.



**A strong majority
of Americans
(64%) believe that
marijuana use should
be legal for adults.**

The Legal Status of Cannabis

As of December 2017, 29 states, D.C., and the U.S. territories of Guam and Puerto Rico have legalized medical cannabis. Eight of those states and the District of Columbia allow cannabis use by all adults who are 21 years of age or older. Most of the jurisdictions that legalized cannabis in some form have adopted comprehensive licensing and regulatory schemes for cannabis producers and retailers. Many states and localities have also imposed excise and sales taxes on cannabis, collectively generating hundreds of millions of dollars in tax revenue in 2016 alone.

Despite these state-based reforms, cannabis remains classified as a Schedule I controlled substance under the federal Controlled Substances Act (CSA). Cannabis production, distribution, and possession is therefore prohibited under federal law except for federally authorized research purposes. Consequently, cannabis businesses that operate in compliance with state law remain in violation of federal law and face a variety of difficulties.³

Section 280E of the Internal Revenue Code

One significant difficulty faced by cannabis entrepreneurs is the objectively greater federal tax burden imposed upon state-authorized cannabis businesses relative to other commercial entities. This is due to an obscure provision of the Internal Revenue Code (IRC). Section 280E of the IRC prohibits businesses engaged in the trafficking of Schedule I or Schedule II controlled substances in contravention of state or federal law from deducting normal business expenses, such as payroll and rent, from gross income. Section 280E was intended to penalize criminal market operators, but because cannabis remains a Schedule I controlled substance, it applies to licensed cannabis businesses that operate in compliance with state laws and regulations. In the interest of fairness and equitable policy, any legislative proposal to impose a federal excise tax on cannabis should include a provision to modify Section 280E so that it no longer applies to state-authorized cannabis businesses. In fact, because the imposition of a federal excise tax absent modification of 280E would cause prices to rise, putting state-legal businesses at a competitive disadvantage with the criminal market, **the National Cannabis Industry Association could not support any federal excise tax proposal that does not exempt state-legal cannabis businesses from Section 280E.**

State and Local Taxes on Cannabis

All states that have chosen to legalize and regulate cannabis for adult use levy special cannabis taxes and fees to cover the cost of regulation and provide new funding for a variety of programs and services. With few exceptions, these special taxes are levied on an ad valorem - or percentage of price - basis, though the point of taxation varies. As shown in **Table 1 below**, only Alaska and California have adopted a flat tax by weight sold at wholesale. Many localities that allow state-licensed entities to operate within their boundaries impose their own taxes on adult-use cannabis as well. States that authorize medical cannabis sometimes apply the general state sales tax at the point of sale but typically do not impose additional special medical cannabis taxes.

\$199M

In the 2016 calendar year, total cannabis tax receipts at the state level in Colorado reached \$199M

Cannabis taxes and fees have generated a substantial amount of revenue for state and local governments. In Fiscal Year 2015-2016, Colorado collected more than \$129M in adult-use cannabis taxes and Washington collected more than \$185M. In the 2016 calendar year, total cannabis tax receipts at the state level in Colorado reached \$199M. After covering the direct and indirect costs of regulation, state cannabis revenue is allocated to beneficial programs and services. For example, Colorado earmarks the first \$40,000,000 in annual revenue from an adult-use cannabis excise tax to public school construction and improvement and uses other cannabis funds to support substance use treatment and prevention, behavioral health services, public health initiatives, public education campaigns, research, and law enforcement training.⁴ Oregon dedicates the revenue that remains after regulatory costs to the state's Common School Fund, to local and state law enforcement, and to programs for the treatment, intervention, and prevention of alcoholism, drug use and abuse, and mental health issues.⁵ Local cannabis revenues have also been used for beneficial purposes. For example, Pueblo County, Colorado announced in June 2017 that it was using cannabis tax revenue to award \$420,000 in college scholarships to 210 local students and Aurora, Colorado dedicates a portion of cannabis tax revenues to addressing homelessness.

Table 1:

Summary of State Adult-Use Cannabis Taxes

	STATE SALES TAX	STATE WHOLESALE EXCISE TAX	STATE CANNABIS SALES TAX
Alaska	N/A	\$50.00/oz.	N/A
California	7.25%	\$9.25/oz. (flower) \$2.75/oz. (leaves)	15.00%
Colorado ^{6, 7}	N/A	15.00%	15.00%
Maine	5.50%	N/A	10.00%
Massachusetts	6.25%	10.75%	N/A
Nevada	4.60%	15.00%	10.00%
Oregon	N/A	N/A	17.00%
Washington	6.50%	N/A	37.00%

Federal Cannabis Excise Tax

It is surely unusual for a trade association to support increased taxation on its products or services. But the circumstances surrounding cannabis in the U.S. today are clearly atypical. As the federal government determines and establishes its law enforcement priorities related to cannabis, it is possible that a federal excise tax will comprise a portion of an overall approach that treats cannabis as a legitimate product in commerce, perhaps even prior to comprehensive reform of the Controlled Substances Act. In addition, as noted above, a federal excise tax on cannabis could be part of a legislative package that includes an exemption from Section 280E of the IRC. Given these possibilities, it is reasonable – and, in fact, necessary – for the National Cannabis Industry Association to put forth its own vision of an appropriate federal excise tax on cannabis.

Precedent for Federal Taxation of Illicit Activities

In contemplating the possibility of a federal excise tax prior to comprehensive reform of the CSA, it is necessary to examine whether it is possible to tax activity that is considered illegal under federal law. Over the last two centuries, Congress has exercised its broad taxation power granted by the U.S. Constitution to impose and collect taxes on partially or wholly illicit activities and resultant income. Some of these taxes have been successfully challenged for violating a potential taxpayer's Fifth Amendment privilege against self-incrimination.⁸ The successful challenges generally centered on the real risk of incrimination associated with compliance; specifically, that the information required in registration or filing and payment of the tax constitute incriminating evidence that could be reasonably expected to be used in prosecution. It should be noted that these cases do not challenge the government's ability to impose taxes on prohibited activity as doing so is recognized to be well within the broad taxation powers conferred by the Constitution. Furthermore, the intent to "curtail and hinder" specific deeds through taxation was evident in several cases in which federal taxes on prohibited activity were upheld.⁹ Thus, federal taxation of illicit activity is considered to be congruous with the Constitution and public policy.¹⁰

The existing body of case law does not directly address whether a state-licensed entity conducting business in contravention of federal law has the same standing to assert the Fifth Amendment privilege against self-incrimination. The successful challenges referenced above hinged on the required provision of information that could be reasonably expected to be used in future prosecution. In the case of a state-authorized cannabis business, a state license to conduct commercial cannabis activity plainly evidences the licensee's engagement in federally prohibited activity and therefore additional filings associated with a federal cannabis excise tax levied on state-licensed cannabis businesses would arguably (and ironically) not reach the same level of self-incrimination that might exist for an individual or entity operating underground. This suggests the constitutional privilege against self-incrimination may not be a defensible basis for a state-licensed cannabis business's failure to pay a federal cannabis excise tax.

Federal Excise Tax Structures

A federal excise tax may take the form of an ad valorem tax or a unit tax (also referred to as "specific tax"), in which a fixed dollar amount is collected for a specified quantity of a product, regardless of price.¹¹ Unit taxes are more common in part because they are often easier to administer and less susceptible to certain

forms of tax avoidance, but both models have advantages and disadvantages. Federal excise taxes are typically levied early in the supply chain, such as at the production or wholesale level, to minimize the number of collection points and opportunities for evasion. Regardless, some or all of the tax is ultimately passed on to consumers in retail pricing.

Gasoline and most alcohol and tobacco products are subject to per-unit excise taxes. Tobacco product manufacturers pay a certain dollar amount per thousand units (cigarettes and small cigars) or per pound (chewing tobacco, snuff, roll-your-own, and pipe tobacco). Alcoholic beverage manufacturers must also pay a set dollar amount per barrel of beer, per wine gallon, or per proof gallon of distilled spirits, but within these major categories there are tiered or adjusted rates based on alcohol content.¹² Motor fuels intended for highway use are taxed at a fixed rate per gallon upon removal from the refinery for use other than for production.¹³ These taxes are in place primarily to offset the externalities associated with consumption of these products, but arguably also to generate revenue and control consumption.^{14, 15, 16} Domestic air travel, indoor tanning services, heavy vehicles, firearms, and ammunition are all subject to ad valorem taxation, in which the tax rate is equal to a fixed percentage of the product's sales price.

The federal excise tax on large cigars is notable as it is a hybrid of both ad valorem and unit tax models. Under current federal law, if the wholesale price of a thousand cigars is less than or equal to \$763,222, the cigars are subject to an ad valorem tax, but if the sales price is greater, a fixed unit tax per cigar applies.¹⁷ Thus, a cigar manufacturer pays a percentage of the wholesale price but there is a backstop tax ceiling to prevent the tax from raising above a certain maximum dollar amount per 1,000 units.

Policy Considerations in Cannabis Excise Tax Design

A legislative proposal for a federal excise tax should be clear and straightforward, but there are many factors for regulators to consider when determining how to implement such a tax. The following factors should be taken into consideration when designing and administering a cannabis excise tax:

Diversity of Product Types

Excise taxes are typically levied on a weight or quantity basis regardless of per unit price, but this methodology is complicated by the diversity of product types available in the legal cannabis industry and likelihood of future innovation.¹⁸ There are three major consumer product categories currently present in legal cannabis markets: cannabis flower, concentrates, and infused products. Each major category has sub-categories that vary in price, cannabinoid concentration, psychoactive potential, and method of consumption. State cannabis laws and regulations categorize product categories differently. Such multiplicity makes it difficult to define taxable product categories and appropriate rates. For these reasons, an ad valorem tax imposed early in the supply chain may offer greater administrative simplicity and reduce the need for legislative amendments over time.

The number of potential distinct taxable product categories increases once raw cannabis undergoes extraction and again when resultant extracts are used to manufacture infused products like edibles and topicals. Consequently, imposing a federal excise tax on unprocessed, raw cannabis is simplest from a product categorization standpoint. In determining the appropriate taxable product categories for unprocessed cannabis, regulators may consider the unprocessed plant material categories already in use in regulated states like

Colorado. For example, there are five categories of cannabis subject to state excise tax imposed after cultivation: cannabis flower (smoke-able finished product), trim (used primarily for extraction), immature plants (i.e., clones or vegetative plants), wet whole plants (whole plant weight within two hours of harvest), and seeds.¹⁹ The moisture content of different product categories sold at wholesale should also be considered, especially if there is any weight-based component to taxation. Cannabis plant material may be sold fresh (i.e., wet weight), dried, or fresh frozen. It will be critical to develop precise definitions of taxable product categories because terminology varies across and even within states.

Point of Taxation and State Market Design

Most federal excise taxes are imposed when a regulated product leaves a federally registered production site for distribution. In the absence of federal registration or regulation of cannabis businesses, legal cannabis states developed their own distinctive licensing and regulatory structures that have certain aspects that must be considered when determining the appropriate point of taxation. First, a number of states offer only one license type, which authorizes a licensee to conduct all commercial activities from cultivation to retail sale, while others offer multiple distinct licenses that each authorize a limited range of activities. Second, among the states that issue more than one license type, some require vertical integration while others prohibit, limit, or permit it.

Since some states permit vertical integration or otherwise do not separately license cultivation and manufacturing, there may not be an arm's length transaction between two licensees after cannabis is harvested. Though it's possible to impose a federal cannabis excise tax at the point of retail sale, it is not a common practice at the federal level and is unlikely to be the approach taken with cannabis. Imposing a federal cannabis tax early in the supply chain – such as upon first transfer, sale, or removal of unprocessed cannabis from the licensed cultivation site – is preferable in terms of consistency with federal tax administration practices, limiting the number of taxable product categories, and reducing the number of collection points. However, it may be necessary to include special provisions to ensure fair taxation of vertically integrated and affiliated entities.²⁰

Market Maturity and Wholesale Pricing

Though personal use of medical cannabis has been legal in several states since the late 1990s, state-licensed commercial cannabis businesses have been in existence for less than a decade. The infancy of the legal cannabis market must be taken into account in the design of a federal cannabis excise tax because the impacts of market maturation will determine if the tax is practical, reasonable, and effective in the long term.

Although cannabis sales are expected to increase over time as new states legalize for medical and adult-use and existing state markets mature, the wholesale – and, eventually, retail – price of cannabis will decline as businesses reach economies of scale and supply increases to meet consumer demand. The tendency for wholesale prices to drop over time has been observed in states like Colorado that have had licensed business's producing and distributing cannabis to patients and adult consumers for several years. Though features of a state's cannabis licensing and regulatory program, such as production control mechanisms and license caps, influence cannabis pricing, the age and maturity of a state legal cannabis market will have an outsized impact on wholesale and retail prices.

As such, a long-term drop in average cannabis price and substantial price variation across states must be anticipated in federal cannabis tax design. Relatedly, policymakers must always be cognizant of the need to keep legal market prices below underground market prices. A proposal that seems reasonable for products in one state could lead to a shift toward the underground market in another state.

The Marijuana Revenue and Regulation Act

The Marijuana Revenue and Regulation Act (S. 776 and companion bills H.R. 1823 and 1841), currently under consideration in Congress, proposes a federal cannabis taxation and regulation structure that is sensible in some regards and suboptimal in others. In brief, the bill would levy a percentage-of-price tax on cannabis that increases from 10% to 25% over five years and an annual occupational tax of \$1,000 for each premises used to conduct business. After the initial five-year period, cannabis flower would be taxed on a per ounce basis at a rate that is equal to 25% of the "prevailing sales price" of cannabis sold during the previous calendar year and products containing cannabis derivatives (i.e., concentrates and infused products) would be taxed based on tetrahydrocannabinol (THC) content. Per a formula included in the bill, the applicable tax rate per gram of THC would be equal to the applicable rate per ounce of cannabis flower (i.e., 25% of the "prevailing sales price" per ounce) divided by 2.83495. The tax proposed under the MRRRA carries a number of design flaws:

- An ultimate federal tax rate of 25%, based on some kind of national average, is excessive and likely to have counterproductive effects on legal cannabis markets. Excessive taxation sustains the criminal market by increasing the price of cannabis sold in state-licensed dispensaries relative to cannabis obtained from unregulated sources. Research indicates that states that tax adult-use cannabis at lower rates are more effective at stamping out the criminal market than states that impose higher rates.²¹ Accordingly, two of the states with more mature medical and adult-use cannabis markets – Washington and Oregon – have reduced their cannabis tax rates over time.²² (Colorado was moving toward reducing the sales tax on adult-use cannabis in 2017, but ended up increasing the tax on these products slightly to pay for non-cannabis related expenditures.) There is federal precedent for minimizing the tax burden on a formerly illicit product: in the post-prohibition period, the federal tax burden on beverage alcohol was kept relatively low to ensure legal operators could compete with bootleggers.²³
- The proposed percentage-of-price tax is also likely to negatively impact small cannabis businesses and producers of high-end products. A tax rate at 25% may very well force these businesses out of the market as other operators reach economies of scale and can produce at a substantially lower cost. Reducing the tax rate and adding a reasonable ceiling to limit the maximum dollar amount owed under an ad valorem taxation model could help reduce potential impacts on producers of more expensive cannabis products.
- A tax rate based on a percentage of the prevailing (national) sales price per ounce does not take into account the substantial state-level price variation resulting from differences in state regulatory system design and market maturity. If an average market rate is to be incorporated into a federal cannabis tax structure, it must be calculated on a state-by-state basis at least until cannabis can lawfully enter interstate commerce.

Proposal for Federal Excise Tax on Cannabis

The National Cannabis Industry Association supports a federal excise tax on cannabis produced and sold by state-licensed businesses that is loosely modeled after the federal excise tax on large cigars. In brief, NCIA recommends taxation of unprocessed cannabis upon first sale or transfer from the cultivation site at a percentage of the wholesale price up to a certain dollar amount per pound, or if the price per pound is greater than the specified dollar amount, at a specific fixed dollar amount per pound. This type of structure is preferred because it carries the benefits of an ad valorem tax but attempts to limit the tax burden for craft cannabis businesses and producers of high-quality cannabis products. The tax burden placed on small-scale producers and those that choose more costly inputs or methods in the interest of quality must be limited for these businesses to remain competitive as state-legal cannabis markets mature and economies of scale arise. It will also ensure that the federal excise tax does not push prices for state-legal cannabis above the cost of cannabis in the illicit market in recently legalized states.

NCIA also believes that the rate for a federal excise tax on cannabis should have a rational basis. One common practice with so-called “sin” taxes is to base them upon external costs associated with the use of the product. In a report produced by the Congressional Research Service in 2014, the authors considered the external costs associated with alcohol, divided that figure based on the relatively less harmful nature of cannabis, and further reduced the figure based on the fact that there are fewer cannabis users in society. They ultimately concluded that a federal excise tax on cannabis based on external costs should be designed to generate between \$0.5 billion and \$1.6 billion annually.²⁴

Given the desired tax structure and the proposed revenue target, above, the following may be used as a starting point for legislative proposal development, with the assumption that additional taxable unprocessed cannabis categories will be included, as well, either during the legislative process or through rulemaking. We recommend establishing distinct wholesale price ceilings and per pound rates for flower, trim, whole wet plants, seeds, and immature plants.

- When cannabis flower is first sold by a cultivator to another licensee, we propose a federal excise tax that is equal to:
 - 5% of the price when the wholesale price is \$1,000 per pound or less; or
 - \$50 per pound when the wholesale price exceeds \$1,000 per pound.

Based on an analysis commissioned by NCIA, a federal excise tax based on the rates above would be expected to generate in excess of \$1 billion annually from a national cannabis market.



Alternative Models

While NCIA’s Policy Council settled on the “cigar model” as an optimal means of taxing cannabis at the federal level, there was significant support for other possible tax structures. We believe the following four models deserve consideration if and when Congress debates how to tax cannabis.

Alternative #1: Tax by weight at the first transfer from a cultivation facility

In the proposed “cigar model,” raw cannabis would be taxed as a percent of the wholesale price coming out of the cultivation facility up to a certain price, at which point it would become essentially a weight-based tax. As an alternative, the federal government could impose a flat weight-based tax across the board. Using the example given above, the 5% rate would no longer apply to less expensive cannabis. Instead, all cannabis would be taxed at \$50 per pound. This would have the effect of imposing a higher tax, as a percentage of the wholesale price, on less expensive cannabis. But it would be more consistent with weight- and volume-based excise taxes currently imposed by the federal government on beer, wine, spirits, and cigarettes.

Alternative #2: A retail tax

While most federal excise taxes, including all forms of alcohol and tobacco, are imposed at the wholesale level, there are some examples of federal excise taxes at the retail level (e.g., a tax on airline tickets). Moreover, many states have demonstrated that taxing cannabis at the retail level can effectively generate significant tax revenue. Thus, a relatively simple means of taxing cannabis at the federal level would be to impose an ad valorem tax on all cannabis products at the retail level. This would eliminate the challenge of distinguishing between the various forms of cannabis post-harvest as well as the challenge of determining an appropriate wholesale price in vertically-integrated businesses that cultivate, process, package, and sell to consumers.

Alternative #3: A tax on packaged products upon transfer to retail stores

The federal excise tax on cigarettes is not imposed on raw tobacco. Rather, it is applied to packages of cigarettes coming out of the processing/production facility. This is another possible model for taxing cannabis products. Instead of taxing cannabis as it leaves the cultivation facility, it would be applied at the transfer out of the entity that produces a final packaged product. One possible approach to this model would be to tax packaged flower products (and concentrates) with a flat weight-based tax. Infused products, from topicals to edibles to vape pen cartridges, could be taxed based on THC content (e.g., 0.5 cents per milligram of THC).

Alternative #4: A “cigar model” tax on packaged products upon transfer to retail stores

A variation on Alternative #3 would be to tax packaged flower products in a manner similar to the “cigar model.” Accordingly, packaged flower products would be subject to an ad valorem (percentage) tax based on the price per pound. But once the per pound price reaches a certain level, the tax would become a flat amount per pound.



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FOOTNOTES

1. Justin McCarthy, "Record-High Support for Legalizing Marijuana Use in the U.S.," Gallup, October 25, 2017.
2. Tim Malloy & Pat Smith, "Republicans Out Of Step With U.S. Voters On Key Issues, Quinnipiac University National Poll Finds; Most Voters Support Legalized Marijuana," Quinnipiac University Poll, February 23, 2017.
3. See The Marijuana Policy Gap and the Path Forward (Congressional Research Service Report 44782) for a summary of complications resulting from the conflict in federal and state laws regarding cannabis.
4. Joint Budget Committee, State of Colorado. Staff Budget Briefing FY 2017-18: Marijuana Policy Overview (JBC Working Document), 2016. http://leg.colorado.gov/sites/default/files/fy2017-18_marbrf.pdf. See also 39-28.8-501(2)(b)(IV), Colorado Revised Statutes (C.R.S.).
5. Oregon Department of Revenue, Marijuana Tax Fact Sheet. Retrieved from: https://www.oregon.gov/DOR/press/Documents/marijuana_fact_sheet.pdf
6. During the 2017 legislative session, Colorado increased the special sales tax on adult-use cannabis from 10% to 15%, but exempted adult-use cannabis from the general state 2.9% sales tax.
7. Colorado's cultivation tax is 15% of the average wholesale market rate, as determined by the Dept. of Revenue on a quarterly basis, and is levied at the point of first sale or transfer of unprocessed cannabis from a licensed cultivator to a retailer or manufacturer. The amount of the excise tax paid is equal to 15% of the actual wholesale price if the transaction occurs between unaffiliated licensees, but in transactions between affiliated licensees, the tax paid is 15% of the average wholesale market rate.
8. For example, see *Marchetti v. United States*, 390 U.S. 39 (1968); *Grosso v. United States* 390 U.S. 62 (1968); *Leary v. United States*, 395 U.S. 6 (1969).
9. *United States v. Kahringer* 345 U.S. 22 (1953). Cases cited include *Veazie Bank v. Fenno*, 8 Wall 533; *McCray v. United States*, 195 U.S. 27, 59; *United States v. Doremus*, 249 U.S. 86; *Nigro v. United States*, 276 U.S. 332; *United States v. Sanchez*, 340 U.S. 42.
10. For example, see *License Tax Cases*, 5 Wall 462 (1866).
11. Lowry, S. 2013. Federal Excise Taxes: An Introduction and General Analysis. Congressional Research Service Report R43189.
12. Ibid.
13. 26 U.S.C. § 4041
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15. National Academy of Medicine (formerly called Institute of Medicine). 1994. Growing Up Tobacco Free: Preventing Nicotine Addiction in Children and Youths. Chapter 6: Tobacco Taxation in the United States.
16. Priog, R. 2011. The Role of Federal Gasoline Excise Taxes in Public Policy. Congressional Research Service Report R40808.
17. 27 CFR §40.21(a). See, <https://www.law.cornell.edu/cfr/text/27/40.21>
18. <https://taxfoundation.org/marijuana-taxes-lessons-colorado-washington/>
19. <https://www.colorado.gov/pacific/sites/default/files/AverageMarketRate.pdf>
20. For example, see 27 CFR 40.22 for federal regulations concerning constructive sale price for tax purposes when large cigars are sold between affiliated corporations and other special cases.
21. Rachel Estabrook, Colorado Public Radio, March 8, 2016, Report: Colorado Better Than Washington At Tamping Down Pot Black Market. Retrieved from: <http://www.cpr.org/news/story/report-colorado-better-washington-tamping-down-pot-black-market>.
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