The State of California's Legal Cannabis Industry

Eight years after the historic passage of Proposition 64, which legalized adult-use cannabis in California, the legal cannabis industry continues to grapple with enduring challenges. Despite the initial optimism surrounding legalization, the industry faces significant systemic issues.

Foremost among these challenges is the burden of excessively high taxes, compounded by regulatory hurdles. These factors, combined with limited legal retail access, a thriving illicit market, the influx of potentially harmful intoxicating hemp products, and financial obstacles unique to cannabis businesses, collectively strain the legal industry. Consequently, many businesses within the sector have been forced to take difficult measures, including scaling down operations, reducing their workforce, or even closing their doors. This grim reality is further underscored by the consistent decline in state cannabis tax revenue, a trend discussed further in the following section.

As CCIA examines our legislative and regulatory work program for 2024, we believe it is crucial to highlight the ongoing systemic issues affecting the legal industry. While there are no easy solutions, we urge the governor, the legislature, and regulators to consider these challenges and collaborate with us to identify meaningful solutions.

Taxes: The Impact of Cannabis Taxes on the Legal Industry

The cannabis tax landscape in California reveals a concerning and challenging reality for the legal cannabis industry. In the first quarter of 2023, only $128.8 million in cannabis excise taxes were collected, marking a distressing decline of more than 40% since the peak observed in the second quarter of 2021 when the state collected $180.4 million (California Department of Tax and Fee Administration). While the state did experience a slight uptick in revenue collections in the second quarter (Q2) of 2023, most attribute that spike to an increase in consumer sales associated with the cannabis holiday 420. In fact, the succeeding quarter (Q3) of 2023, saw a continuation of this downward trend, with an almost $8 million decline in cannabis excise tax collections from the prior quarter (Q2).

Moreover, more than 260 of California's 1,216 cannabis retail licenses failed to pay their state excise taxes by the May 1 deadline earlier this year, according to the California Department of Tax and Fee Administration and as reported by SFGATE in August 2023. These figures illustrate the urgent need for additional measures to stabilize the legal cannabis market in California.

The original vision of Proposition 64, which aimed to transition cannabis away from the illicit market and establish a safe, regulated framework for tested cannabis products within a legitimate marketplace, is under threat due to the compounding impact of excessive taxation. High taxes have artificially inflated prices for consumers, inadvertently driving them towards cheaper alternatives in the unlicensed, untested, and untaxed cannabis marketplace.

While the industry celebrated the elimination of the cultivation tax in July 2022, another significant challenge remains in the form of a 15% retail excise tax imposed on cannabis businesses. Additionally, commercial cannabis sales are subject to sales and use tax, varying across jurisdictions but averaging 8.82% in 2023 according to the Tax Foundation.

Moreover, licensed cannabis businesses bear the burden of locally imposed cannabis taxes that vary by jurisdiction, including taxes based on cultivation square footage and a percentage of gross receipts at various stages of the supply chain. These local taxes compound, resulting in higher tax rates for the end consumer product.

Furthermore, cannabis businesses face federal income tax penalties under Internal Revenue Code 280E, which prevents them from claiming deductions under the "ordinary and necessary" standard applied to most businesses. This leads to significantly higher federal income tax rates for cannabis businesses compared to those in other industries.

Considering these challenges, it is imperative that we recalibrate our approach to taxation in a manner that ensures that the legal cannabis industry survives and thrives. Addressing excessive taxation is a critical step towards creating a robust, compliant, and flourishing cannabis marketplace that aligns with the original vision of Proposition 64.

A Lack of Retail Access

While high taxes continue to undermine the success of the legal cannabis industry, limited access to legal cannabis retail exacerbates the issue. Currently, 621% of cities and counties in California prohibit cannabis retail operations, as reported by the Department of Cannabis Control. Additionally, as of September 1, 2023, only 1,216 dispensary licenses are active, resulting in a meager 3.1 retail locations per 100,000 people, representing the lowest rate among mature cannabis markets in the nation. This number tracks with earlier reports published by Politico in October 2021 and the Reason Foundation in May 2022, which both identified a dramatic undersupply of legal retail in California compared to Colorado which has approximately one legal retailer per 13,838 residents while Oregon boasts one retailer per 6,145 residents.

The Reason Foundation report also evaluated consumer spending on legal cannabis. Findings suggested that a retailer's proximity to an individual's place of residence affects their propensity to purchase cannabis from a legal versus illegal seller. In this respect, both the overall number and geographic distribution of legal retailers are likely to strongly influence the volume of legal sales.

Moreover, because the concentration of retailers is heavily skewed by jurisdiction in California, this undersupply is unevenly distributed. In a summary of California licensee data by jurisdiction the report found more than half of the 929 storefront dispensaries in February 2022 were in just 18 cities. An additional 402 delivery-only licensees made deliveries to customers beyond their home jurisdiction, but most delivered only within regional metropolitan areas, and none delivered to all locations in California.

The report confirmed that this discrepancy led to large geographic "cannabis deserts" wherein residents did not have access to a legal retailer within a reasonable distance of their homes forcing consumers to turn to unlicensed retailers to fulfill local demand.

While taxation is a key reason why California has been relatively ineffective at transitioning cannabis sales from the illegal to the legal market, lack of access to legal retailers is an additional hurdle for market participants that cannot be ignored.

The root of this issue can be traced back to Proposition 64's dual licensing structure, where cannabis businesses must secure licenses from both the State and their respective local jurisdictions to operate legally. Consequently, local governments hold the final say in permitting commercial cannabis activity, sales, and additional local taxes. Unfortunately, this has resulted in a landscape where only 44% of California's 540 cities and counties allow any form of commercial cannabis retail, creating a vacuum that illicit cannabis operations are quick to fill, exposing consumers to untested and untaxed products.

To address this problem effectively, local jurisdictions need incentives to permit legal retail cannabis activities and expand access to legal products through fair and equitable cannabis ordinances that transition consumers into the legal market.

A Thriving Illicit Market

In the first half of 2023, California's adult-use cannabis retailers reported nearly $2.2 billion in sales subject to the state's 15% cannabis excise tax, averaging roughly $361.6 million per month. In comparison, Michigan, with a population of 10 million, averaged nearly $235 million in monthly adult-use cannabis sales during the same period. This per capita comparison reveals a significant disparity: Michigan sold approximately $23 of legal adult-use cannabis per state resident each month in 2023, whereas California, with around 39 million residents, only managed to sell about $9 per state resident per month. (Source: Cannabis Business Times)

This per capita sales disparity extends beyond Michigan, as seen below, and highlights a consistent trend in California's cannabis market. Much of this discrepancy can be attributed to California's thriving illicit cannabis market, which continues to flourish due to limited access to legal retail establishments.

2023 Monthly Adult-Use Cannabis Sales Per Capita

State	2023 Population Estimate	2023 Monthly Sales Average	Monthly Sales Per Capita
Michigan	10,030,000	$234,868,524	$23.42
*Nevada	3,210,000	$66,239,994	$20.64
Colorado	5,870,000	$114,589,345	$19.52
Massachusetts	6,970,000	$126,747,641	$18.18
Montana	1,140,000	$20,888,575	$18.32
Oregon	4,220,000	$74,880,734	$17.74
*Washington	7,830,000	$101,625,437	$12.98
Maine	1,390,000	$16,906,305	$12.16
Arizona	7,450,000	$83,489,639	$11.21
Illinois	12,480,000	$132,062,987	$10.58
California	38,920,000	$361,600,731	$9.29

Source: Cannabis Business Times research and analytics

*Washington and Nevada's monthly adult-use sales figures are estimates based on 2023 total sales (adult-use + medical) and 2022 percentages attributed to adult-use market share.

The Reason Foundation report on California's cannabis tax structure and its impact on consumer participation in the legal marketplace reaffirms this analyses suggesting that California lags other legal states in licensed cannabis sales, with the illicit market still accounting for about two-thirds of cannabis sales in the state.

While it was assumed that legalizing cannabis would ultimately eliminate or severely constrain the illicit market, the promise of Proposition 64 has yet to materialize. From a state perspective, enforcement is spread across multiple state agencies with insufficient resources and competing priorities. While some grant funding is available to bolster local enforcement efforts, it is limited only to local jurisdictions that allow commercial cannabis cultivation and retail, barring a significant majority of cities and counties from any state support.

The Reason Foundation report examined the effect of the state's tax regime on legal cannabis and how it affects individuals' decisions to participate in the legal or illicit market. Research concluded that the cumulative effect of state and local taxes creates a price disparity between otherwise comparable cannabis products available in the legal and illicit markets.

More recent surveys indicate consumers prefer legal cannabis products if they are available at comparable prices to competing products on the illicit market but will prefer illegal products as those prices diverge. In fact, price, and sale data, obtained by the Reason Foundation, for legal cannabis transactions in California determined that consumers purchase about 0.77 percent fewer legal products for every 1 percent rise in their price.

Unfortunately, illicit cannabis is not the only product that is undermining legal cannabis.

Intoxicating Hemp

In October 2022, CCIA released a white paper detailing the dangers associated with the growing number of increasingly intoxicating products currently being sold as "hemp" and called for urgent action by both state and federal governments.

Titled "Pandora's Box: The Dangers of a National, Unregulated, Hemp-Derived Intoxicating Cannabinoid Market," the white paper reveals how cannabinoid compounds derived from hemp, including the well-known delta-8 THC and other more potent THC-like substances, are being sold by hemp manufacturers exploiting flaws in the 2018 Farm Bill. These synthetic and derivative cannabinoids are often many times stronger than traditional delta-9 THC.

According to the paper, products containing this new generation of intoxicants are often brazenly marketed to children, are rife with contaminants, and sold without age-gates, testing standards, or other oversight in gas stations, convenience stores, smoke shops, and online nationwide.

To address this alarming issue, CCIA sponsored AB 420 (Aguiar-Curry) last year. The bill aimed to bolster enforcement provisions in existing state law. It also sought to establish a regulatory framework to allow hemp cannabinoids to be legally manufactured and sold in food, beverages, cosmetics, and dietary supplements across the state *if* incorporated into legal cannabis products, which are subject to rigorous health and safety protocols. While AB 420 stalled in the Senate Appropriations Committee, the author and CCIA remain committed to reintroducing legislation in 2024, as further detailed in Legislative Priorities (Section 1) of this document.

The Ripple Effect of Uncollected Debts and Tax Liabilities

California's legal cannabis businesses contend with a distinct set of financial hurdles, primarily stemming from the industry's heavy reliance on cash transactions and limited access to traditional financial services. These challenges are further exacerbated by the intricate web of municipal regulations that have confined legal sales to a mere fraction of the state. As a result, many transactions between cannabis licensees, or ancillary businesses that serve them, are made on terms of credit. Unfortunately, a concerning "culture of nonpayment" has arisen, with many businesses neglecting payment terms, leaving suppliers and service providers in precarious positions.

The consequences of this burgeoning debt crisis are already reverberating across California's cannabis market. Recent developments, such as the receivership of the state's largest cannabis distributor, Herbl, and the abrupt closure of major retail delivery company Grassdoor, underscore the pressing need for a comprehensive approach to debt resolution. Parties owed outstanding payments, including fellow licensees and the state itself, are grappling with unclear avenues for recovering these funds due to the industry's unique legal status, which prevents it from seeking traditional bankruptcy protection.

Compounding this financial strain is a long-standing industry trend, as documented in a Green Market report, of licensed cannabis businesses offering credit terms to compensate for a lack of access to traditional banking and financing options. This practice has contributed to a significant cannabis debt bubble, with repercussions rippling throughout the supply chain. Cultivators extend credit to manufacturers or distributors, who, in turn, extend it to retailers. This chain reaction is already affecting cash flow throughout the supply chain, placing ancillary businesses at risk and further jeopardizing cannabis tax revenues.

The financial landscape of California's cannabis industry is at a crossroads, with uncollected debts and outstanding tax liabilities casting a shadow over its growth. However, proactive measures, greater oversight and regulatory adjustments can empower the industry to navigate these challenges and pave the way for a more stable and prosperous future.

Cannabis Industry by the Numbers

- **24 states, two territories, and the District of Columbia** have enacted measures to regulate cannabis for non-medical adult (recreational) use as of November 8, 2023. *(National Conference of State Legislatures)*

- **70% of Americans** believe cannabis should be legal, marking the highest level of support, after holding steady at 68% for three years. This majority support extends across various demographic groups, including age, political party, and ideology. *(Gallup, October 2023).*

- The projected impact of the **cannabis industry on the U.S. economy** is estimated to reach **$170.7 billion** by 2028. *(MJBizDaily research)*

- The number of **plant-touching cannabis businesses** in the U.S. has grown to **66,000**, representing a **28% increase** since 2022. *(MJBizDaily research)*

- There are over 9,700 **active cannabis licensees** in California. *(Department of Cannabis Control)*

- The legal cannabis industry in the U.S. **supports 417,493 full-time equivalent (FTE) jobs**, which is a **2% decrease** compared to the previous year, marking the first drop in job count in the history of legal cannabis. California's legal cannabis industry supports **83,593 FTE jobs**, reflecting a **13% decrease** from the prior year. *(Vangst Jobs Report 2023)*

- Approximately **66% of cannabis sales in California** occur in the illicit marketplace. *(Reason Foundation, May 2022)*

- **62% of cities and counties** in California prohibit commercial cannabis retail. *(Department of Cannabis Control)*

- Since January 2018, **California's licensed cannabis industry** has contributed a total of **$5.5 billion** in cannabis tax revenue, including nearly **$2.8 billion** in cannabis excise tax and nearly **$2.2 billion** in sales tax. This figure also includes **$501 million** in cultivation tax, which was eliminated on July 1, 2022. *(California Department of Tax and Fee Administration)*