Considering Cannabis Legalization in Canada

Prices, Taxes, and International Implications

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Testimony of Beau Kilmer[1]
The RAND Corporation[2]

Before the Standing Committee on Health
House of Commons of Canada

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Chairperson Casey, Vice Chairperson Davies, Vice Chairperson Webber, and other distinguished members of the Standing Committee on Health, thank you very much for the opportunity to testify before you today. I am a senior policy researcher at the RAND Corporation, where I co-direct RAND's Drug Policy Research Center. I have studied cannabis policy for more than 15 years, and my research has been published in leading journals, such as *Addiction*, *American Journal of Public Health*, and *New England Journal of Medicine*. In 2016, I co-authored a book on cannabis legalization that was published by Oxford University Press.

Over the past two years, I have been fortunate enough to travel to Canada multiple times to meet with researchers and policymakers about cannabis policy and provide an objective assessment of cannabis legalization in the United States. I was invited to testify about my general thoughts on Bill C-45 and on some of the international implications if it passes. RAND does not have a formal position on cannabis policy, and it does not advocate for or against legislative bills or ballot initiatives. My goal for today is to help inform cannabis policy debates at the federal, provincial, and local levels. I will divide my comments into three sections: prices, taxes, and international implications.

Prices

Many of the outcomes featured in debates about legalizing cannabis will be shaped by its retail price. For example, those seeking to reduce the size of the illicit cannabis market will want the retail price to be competitive enough to move users to the new legal market. On the other

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hand, those concerned about an increase in problem cannabis use and disorders will want to prevent retail prices from significantly declining, because cannabis users are price-sensitive.[3]

Over time, legalization is expected to dramatically reduce the production and distribution costs of cannabis for many reasons:

- Suppliers will no longer need to be compensated for the risk of arrest, incarceration, and violence.
- Firms can take advantage of economies of scale as production moves to larger farms and facilities.
- It can be easier to benefit from advances in technology (e.g., for flower trimming or cannabinoid extraction) when an activity is legal.[4]

For those concerned about an increase in cannabis consumption and use disorder related to a price drop, there are several options to consider. I will briefly highlight six of them.

1. **Implement a government-run monopoly**. Markets that allow for-profit companies to produce and sell cannabis enable and encourage competition between sellers, which causes prices to fall. Instead of allowing for-profit companies to supply cannabis, other strategies exist, as shown in Figure 1. Allowing the government to control production, retail sales, or both would not only make it easy to set the retail price but could also limit diversion, marketing, and the proliferation of new cannabis products.[5]
2. **Minimize competition**. If nongovernmental agencies are allowed to produce and sell cannabis, another option is for the government to limit the number of market participants, which reduces competition (Figure 1).
3. **Cap production**. Limiting the total amount of cannabis that can be supplied can also help avoid a large drop in legal retail price.
4. **Impose costly licensing fees and/or regulations**, such as accurate testing protocols. For example, requiring cannabis producers and/or processors to submit to rigorous product testing for potency and adulterants drives up the costs to the firm, which are then passed on to the consumer in the form of higher prices. This can also help protect public health.
5. **Require minimum pricing.** Another approach for keeping retail prices from dropping precipitously is to simply impose a minimum price.[6]
6. **Levy cannabis taxes.** There are several approaches to taxing cannabis, and they are discussed in the next section.

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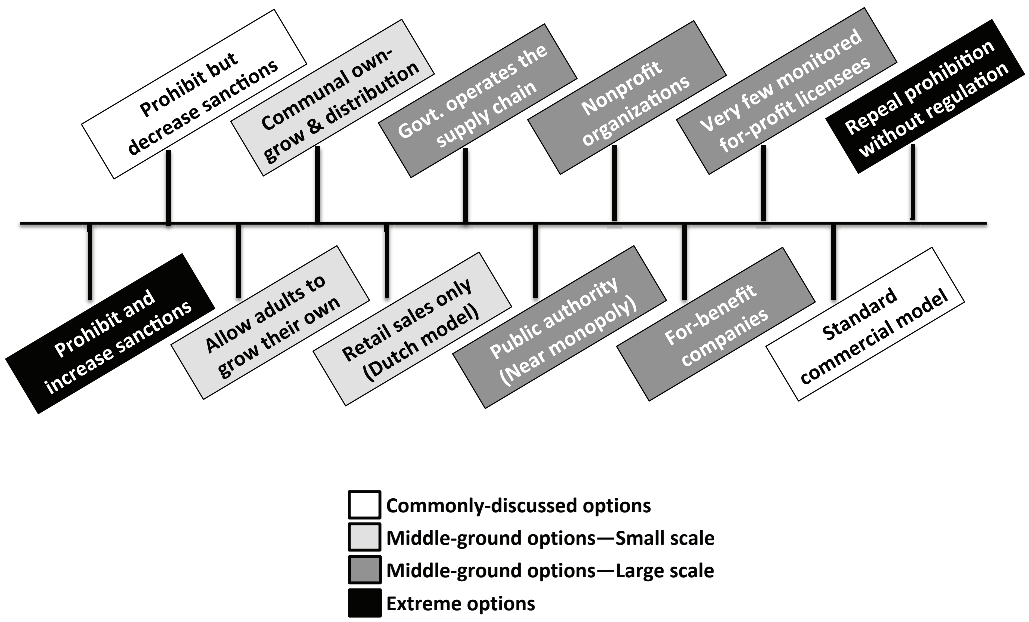
[3] See review and analysis in M. Ouellet, M. Macdonald, M. Bouchard, C. Morselli, and R. Frank, *The Price of Cannabis in Canada*, Ottawa, Canada: Public Safety Canada, 2017.

[4] B. Kilmer, J. P. Caulkins, R. L. Pacula, R. J. MacCoun, and P. H. Reuter, *Altered State? Assessing How Marijuana Legalization in California Could Influence Marijuana Consumption and Public Budgets*, Santa Monica, Calif.: RAND Corporation, OP-315-RC, 2010 (www.rand.org/t/OP315); and J. Caulkins, B. Kilmer, and M. Kleiman, *Marijuana Legalization: What Everyone Needs to Know*, 2nd ed., New York: Oxford University Press, 2016.

[5] J. Caulkins, B. Kilmer, M. A. R. Kleiman, R. J. MacCoun, G. Midgette, P. Oglesby, R. L. Pacula, and P. H. Reuter, *Considering Marijuana Legalization: Insights for Vermont and Other Jurisdictions*, Santa Monica, Calif.: RAND Corporation, RR-864, 2015 (www.rand.org/t/RR864).

[6] Some studies show that this approach has been effective at reducing alcohol consumption in Canada. I believe it was first suggested as an approach for cannabis in S. Rolles and G. Murkin, *How to Regulate Cannabis: A Practical Guide*, Bristol: Transform Drug Policy Foundation, 2013.

Figure 1. Twelve Alternatives to Status Quo Cannabis Supply Prohibition



SOURCE: Caulkins et al., 2015.

Preventing retail cannabis prices from plummeting may be good for public health,[7] but it can slow the shrinkage of the illicit market. Acknowledging that this is a trade-off and that some people have different goals for cannabis policy can lead to much more-productive discussions about legalization.

Taxes

No one knows the best way to tax cannabis, and there are trade-offs with all options.[8] Taxing as a function of price is attractive because it is easy to apply (e.g., Washington state levies a 37-percent tax at the retail level), but its main drawback is that the tax revenue per transaction will fall as the price falls. Taxing as a function of weight (e.g., Alaska applies a $50-per-ounce tax at the wholesale level) is also easy to apply, but some are concerned that it creates incentives for

[7] The overall public health effects of cannabis legalization will also depend on how the policy change influences the use of alcohol, opiates, tobacco, and other substances. See Caulkins et al., 2015.

[8] J. P. Caulkins, A. Hawken, B. Kilmer, M. A. Kleiman, K. Pfrommer, J. Pruess, and T Shaw, "High Tax States: Options for Gleaning Revenue from Legal Cannabis," *Oregon Law Review*, Vol. 91, No. 4, 2013, pp. 1041–1068; Caulkins et al., 2015; and P. Oglesby, "Marijuana Taxes—Present and Future Traps," *Tax Notes*, Vol. 83, No. 4, January 2017, pp. 391–399.

producers to sell more-potent cannabis. We know little about the health consequences—risks and benefits—of high-potency cannabis products.[9]

Another option is to tax cannabis as a function of cannabinoid levels (e.g., tetrahydrocannabinol, or THC), which would allow the government to nudge cannabis users to lower-potency products. Such an approach is similar to how many countries typically tax alcohol, with higher taxes imposed on products with higher ethanol content. The final report of the Task Force on Cannabis Legalization and Regulation recommended that Canada "Develop strategies to encourage consumption of less potent cannabis, including a price and tax scheme based on potency to discourage purchase of high-potency products," but Bill C-45 is largely silent on this issue.[10]

If a jurisdiction has a robust testing and labeling system in place, taxing as a function of THC (or any other combination of cannabinoids) is straightforward. When testing yields inconsistent results or the system can be corrupted, this creates challenges for labeling and levying THC taxes. Jurisdictions without a rigorous testing regime could consider using the company-stated THC level as the base for an alternative minimum tax. As I have noted in previous testimony,

> Until rigorous methods are developed to test the heterogeneous plant material, the company-stated THC content could be used as a tax. Of course, sellers may try to dodge the tax by falsely understating the THC content. To help reduce gaming, the reported THC could be used as an alternative minimum tax base; that is, it could only apply when the primary tax base (e.g., price or weight) yielded a low tax that was inconsistent with high-stated THC. The tax that would be paid would be the larger of (1) the tax computed using the primary base and (2) the tax computed using the stated THC.[11]

International Implications

I focus this final section on the movement of people and cannabis across international borders and on the banking situation in Uruguay. I will not speak much about Canada's international drug treaty obligations and the various options Canada could pursue if it legalizes cannabis for nonmedical purposes (including doing nothing). I will note, however, that what Canada does—and, perhaps more importantly, how other countries respond to those actions—could send a signal to other countries about their drug treaty obligations. Given Canada's size, proximity to the United States, and status as a member of the G-7, national legalization in

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[9] A. Englund, T. P. Freeman, R. M. Murray, and P. McGuire, "Can We Make Cannabis Safer?" *Lancet Psychiatry*, Vol. 4, No. 8, 2017, pp. 643–648; and B. Kilmer, "Recreational Cannabis—Minimizing the Health Risks from Legalization," *New England Journal of Medicine*, Vol. 376, No. 8, 2017, pp. 705–707.

[10] Bill C-45 states, "The Governor in Council may make regulations for carrying out the purposes and provisions of this Act, including for the administration and enforcement of this Act, and regulations . . . respecting the composition, strength, concentration, potency, purity or quality or any other property of cannabis or any class of cannabis."

[11] B. Kilmer, Marijuana Legalization, Government Revenues, and Public Budgets*: Ten Factors to Consider*, Santa Monica, Calif.: RAND Corporation, CT-449, 2016 (www.rand.org/t/CT449). My colleague Mark Kleiman notes that using stated THC as a tax base sets up usefully opposed incentives; for example, a producer who wants to dodge taxes cannot claim high potency in its marketing.

Canada could have a much larger international impact than the legalization of cannabis in Uruguay in 2013.

With respect to the movement of people across international borders, drug tourism will happen if provinces and territories do not limit sales to Canadian residents. There will be competition from some of the U.S. states that have legalized, but some people will choose to travel to Canada if they can legally consume cannabis there. If provinces and territories allow public consumption in cannabis cafés or lounges, this will make tourism even more attractive.

There is also the issue of Canadians being denied entry to the United States because of cannabis consumption.[12] It is unclear whether the United States will change its approach if Canada legalizes cannabis, and if so, whether that approach will become more or less strict. If U.S. customs officials at the Canadian border spend more time interrogating visitors about their experiences with cannabis, this could slow border crossings.

With respect to the movement of cannabis across borders, we must acknowledge that this is already happening via legal and illegal channels. Currently, Canada legally exports cannabis products to some countries for medical or research purposes.[13] If Canada exported cannabis for recreational purposes, it would be a violation of its current international treaty obligations. As for smuggling cannabis and money across the U.S. border, the amount—and direction—will depend on cannabis production costs, retail prices, risk of arrest, and oversight on both sides of the border.

Finally, Canada should pay attention to the cannabis banking issue in Uruguay. While Uruguay legalized cannabis for nonmedical purposes in December 2013, residents could not purchase it at pharmacies until July 2017. In August 2017, it was reported that some U.S. banks would stop doing business with banks in Uruguay that provided banking services to pharmacies selling cannabis. In response, the *New York Times* reported that "Uruguayan banks warned some of the pharmacies over the last couple of weeks that their accounts would be shut down."[14] It is unknown whether U.S. banks would apply the same pressure to Canadian financial institutions doing business with Canadian entities supplying cannabis for nonmedical purposes, but if Bill C-45 passes, this possibility should not be ignored.

In sum, the federal and provincial governments will confront complex decisions if Bill C-45 passes. Because it is hard to predict the international and domestic consequences of these choices, jurisdictions considering alternatives to prohibiting cannabis supply should proceed cautiously and build flexibility—especially with respect to prices—into proposed regulations.

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[12] U.S. Customs and Border Protection, "Waiver of Inadmissibility—Applying for Advance Permission to Enter the U.S. as a Non-Immigrant," web page, Washington, D.C.: U.S. Department of Homeland Security, undated. Also see P. Zimonjic and J. Van Dusen, "Banning Canadians from U.S. for Life for Smoking Pot 'Ludicrous,' Says Goodale," CBC News, September 8, 2016; P. Zimonjic and J. Van Dusen, "Have You Ever Smoked Weed? Answer This Question and You Could Be Banned from the U.S.," CBC News, September 8, 2016; and R. Hotakainen, "Ever Smoked Pot? 'Yes' Can Get Foreigners Barred for Life at U.S.-Canada Border," *Seattle Times*, May 5, 2017.

[13] Health Canada, "Import and Export of Marijuana by Licensed Producers—Information Bulletin," August 24, 2016; and J. Wingrove and J. Skerritt, "Canadian Pot Firms See Medical Exports Growing Under Trudeau Law," Bloomberg, April 20, 2017.

[14] E. Londrño, "Pot Was Flying Off the Shelves in Uruguay. Then U.S. Banks Weighed In," *New York Times*, August 25, 2017.