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State Taxation of Marijuana Distribution and Other Federal Crimes

Robert A. Mikos†

ABSTRACT

The financial crisis has breathed new life into proposals to reform marijuana law. Commentators suggest that legalizing and taxing marijuana could generate substantial revenues for beleaguered state governments—as much as $1.4 billion for California alone. This Article, however, suggests that commentators have grossly underestimated the difficulty of collecting a tax on a drug that remains illegal under federal law. The federal ban on marijuana will impair state tax collections for two reasons. First, by giving marijuana distributors powerful incentives to stay small and operate underground, the federal ban will make it difficult for states to monitor marijuana distribution and, consequently, to detect and deter tax evasion. In theory, states could bolster deterrence by increasing sanctions for tax evasion, but doing so seems politically infeasible and may not even work. Second, even if states could find a way to monitor marijuana distribution effectively (for example, by licensing distributors) such monitoring could backfire. Any information the states gather on marijuana distribution could be seized by federal authorities and used to impose federal sanctions on distributors, giving them added incentive to evade state tax authorities. For both reasons, a marijuana tax may not be the budget panacea proponents claim it would be. To be sure, there are reasonable arguments favoring legaliz-
tion; rescuing states from dire fiscal straits, however, is not one of them.

INTRODUCTION

Fighting crime is enormously expensive. Federal and state governments together spend more than $200 billion annually on criminal justice.¹ Over the past few decades, these expenditures have ballooned due to the adoption of aggressive new anti-crime policies, including “three-strikes” sentencing laws and expanded criminal liability.² Some prominent legal scholars have suggested that the expansion in the scope and severity of the criminal law might never end—or at least, might never reverse itself—given the public’s seemingly insatiable demand for retribution and safety.³

Now, however, fiscal reality is casting doubt on that received wisdom. With some states teetering on the brink of financial ruin, lawmakers are starting to question whether tough crime-fighting measures are really worth their costs. Searching for ways to cut criminal justice expenditures, state lawmakers have proposed furloughing prisoners, switching to less costly forms of punishment, and trimming the ranks of police forces.⁴

Even more interestingly, a few states have seriously contemplated legalizing activities long considered criminal, including the possession, cultivation, and distribution of marijuana. Though marijuana has long been a drain on state budgets—California alone reportedly spends $156 million annually combating the drug⁵—some state lawmakers are beginning to see it as a panacea for state budget woes. They hope to ease the strain


² Criminal justice expenditures jumped from $36 billion to $204 billion from 1982–2005. Id.


⁴ See, for example, Christine S. Scott-Hayward, Center on Sentencing and Corrections, The Fiscal Crisis in Corrections: Rethinking Policies and Practices 4–11 (2009), online at http://www.pewcenteronthestates.org/uploadedFiles/Vera_state_budgets.pdf?h=5515 (visited Sept 30, 2010) (reporting that at least twenty-six states have cut FY 2010 corrections budgets by, inter alia, releasing prisoners early).

⁵ California NORML, CA NORML Analysis Finds Marijuana Legalization Could Yield California $1.5–$2.5 Billion Per Year, online at http://www.canorml.org/ background/CA_legalization.html (visited Sept 30, 2010).
on their criminal justice budgets—and create a new stream of tax revenue—by legalizing and taxing distribution of the drug.\textsuperscript{6}

California, perhaps the most financially distraught of the states, has been leading the charge to legalize and tax marijuana.\textsuperscript{7} Several proposals now under consideration would make the cultivation, distribution, and possession of marijuana legal for adults.\textsuperscript{8} Proponents suggest the groundbreaking reforms could save California the estimated $156 million it currently spends investigating, arresting, prosecuting, and imprisoning recreational marijuana dealers and users.\textsuperscript{9} Even more impressively, by subjecting the drug to a special tax—a $50 levy for every ounce of marijuana sold—along with the sales tax that applies to all commodities, the proposal would generate an estimated $1.382 billion in new tax revenue for the beleaguered state.\textsuperscript{10} Given that Californians reportedly produce nearly $14 billion in marijuana each year\textsuperscript{11}—and consume much of that in-state—one can hardly blame lawmakers’ enthusiasm for getting a cut of the action.

Indeed, lured by the promise of substantial tax revenues, nearly 700,000 Californians have signed petitions assuring that at least one proposal to legalize and tax marijuana (Proposition

\begin{footnotesize}

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  \item[\textsuperscript{7}] See, for example, Michael B. Farrell, A Marijuana Tax as the Next New Revenue Stream?, Christian Science Monitor 2 (May 8, 2009) (discussing Governor Schwarzenegger’s openness to a debate on legalizing and taxing marijuana); Rebecca Cathcart, Schwarzenegger Urges a Study on Legalizing Marijuana Use, NY Times A21 (May 7, 2009) (same); Peter W. Brown, Legalize Marijuana—and Tax It, SF Chron A12 (May 7, 2009) (urging California to control and tax the sale of marijuana).
  \item[\textsuperscript{8}] See, for example, AB 390, Cal Legislature, at 1 (Feb 23, 2009), online at http://www.leginfo.ca.gov/pub/09-10/bill/asm_ab_0351-0400_ab_390_bill_20090223_introduced.html (visited July 28, 2009) (detailing legislative proposal introduced in February 2009); California Secretary of State, November 2010 Statewide Ballot Measures, online at http://www.sos.ca.gov/elections/ballot-measures/qualified-ballot-measures.htm (visited Aug 20, 2010) (describing Proposition 19, a November 2010 ballot initiative that would legalize marijuana and enable state or local taxation of the drug).
  \item[\textsuperscript{9}] California NORML, CA NORML Analysis at 1 (cited in note 5) (summarizing a study describing the financial benefits of taxing marijuana).
  \item[\textsuperscript{10}] California Board of Equalization (BOE), Staff Legislative Bill Analysis, Bill No AB 390, 6 (released July 23, 2009), online at http://www.boe.ca.gov/legdiv/pdf/ab0390-ldw.pdf (visited July 29, 2009) (estimating the potential tax revenues that would be generated by AB 390).
  \item[\textsuperscript{11}] Id (reporting how much marijuana California produces each year). See also Jon Gettman, Marijuana Production in the United States, The Bulletin of Cannabis Reform 11 (Dec 2006) (providing state-by-state production estimates).
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19) will appear on the California ballot in 2010. The question is whether legislators and voters are buying a pig in a poke.

This Article suggests that proponents have grossly overestimated the marijuana tax's revenue potential by downplaying, or simply ignoring, the complexities of enforcing it. In general, tax proponents and many commentators have assumed the states could collect a marijuana tax as easily as they collect taxes on other "sins," such as cigarettes, without grappling with the unique issues posed by the federal ban. Opponents, by contrast, have assumed that distributors would necessarily evade the marijuana tax, without explaining why marijuana tax collections would fare worse than taxes imposed on other sins—a particularly egregious omission given that many extant sin taxes exceed the proposed marijuana tax. On all sides of the debate, commentary largely ignores—or makes undeveloped assumptions about—the role that federal law would play in state tax collections. Those commentators who have paid heed to the federal ban seem to agree that federal law poses a barrier to a state marijuana tax, but no one has explained in any depth how or why this is the case.

This Article seeks to fill that analytical void by analyzing the incentives to evade a state marijuana tax, in light of the enforcement mechanisms proposed by the state and the ignored or misunderstood wrench thrown into the machine by federal law. It starts with the standard economic model of tax evasion employed in the tax compliance literature. According to that literature, collecting reliable information on taxable activity is essential to curbing tax evasion. In a nutshell, to stop distributors

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13 See, for example, George F. Will, Rocky Mountain Medical High, Pittsburgh Trib Rev (Nov 29, 2009) (arguing that "states attempting to use high taxes to keep marijuana prices artificially high would leave a large market for much cheaper illegal—unregulated and untaxed—marijuana," but neglecting to distinguish the states' success at collecting steep taxes on cigarettes and alcohol).

14 See, for example, Jeffrey A. Miron, The Budgetary Implications of Marijuana Legalization in Massachusetts 7 (2003) (estimating revenue potential of state marijuana tax under assumption of federal legalization, but briefly noting that "[i]f the federal government continues to enforce federal marijuana prohibition, the production and sale of marijuana in a legalized state would probably not move from the black market into the legal, taxed market").


Social norms also play an important role in tax compliance. See generally Eric Posner, Law and Social Norms: The Case of Tax Compliance, 86 Va L Rev 1781 (2000)
from evading the marijuana tax, states must gather detailed information on their sales; the more information the states gather, the stronger will be distributors’ incentives to pay. The fragmentation of the marijuana market, however, threatens to overwhelm state monitoring of distribution. Thousands of suppliers now compete in the marijuana market, and the continuing federal ban will thwart consolidation even if California (or any other state) legalizes marijuana.

What is more, measures that might otherwise facilitate monitoring of a fragmented marijuana distribution system (for example, a distributor licensing system) could easily backfire, since distribution remains a crime under federal law. States cannot necessarily block federal authorities from seizing the information they glean from drug distributors. In many cases, federal law enforcement officials could use this information to track down and sanction tax-abiding distributors. The risk that federal authorities could seize data collected by the states gives distributors added incentive, besides the tax, to evade state detection.

The Article proceeds as follows. Part I provides some necessary background on proposals to legalize and tax marijuana in California. It briefly reviews the purposes such a tax might serve: 1) to force drug users to internalize more of the social harms arguably caused by drug use and 2) to raise revenues (and save costs) for state government. Part II analyzes the incentives that state law alone gives distributors to pay (or not) the marijuana tax. Part III then examines how the federal ban changes these incentives. The Article concludes that a marijuana tax may not be the budget panacea many proponents claim. To be sure, there are reasonable arguments favoring legalization of marijuana; rescuing the states from dire fiscal straits, however, is not one of them.

(discussing the role of social norms in tax compliance). However, in order to keep my analyses manageable—and because norms might not bolster compliance with a state marijuana tax—I do not consider norms separately in this Article. Suffice it to say that the long-standing prohibition on marijuana under state law—and the ongoing prohibition under federal law—may have eroded the compliance norm for marijuana-related regulations. After all, the firms that would be first to distribute marijuana in a state-legalized regime would be accustomed to evading law enforcement.

16 I explain in more detail why states cannot bar federal access to state records in Robert A. Mikos, Commandeering States’ Secrets (unpublished manuscript, 2010) (on file with author).
I. BACKGROUND

This Part provides some background information on proposals to legalize and tax marijuana distribution at the state level. Section A briefly discusses the leading proposals under consideration in California. Section B reviews the rationale for imposing a tax on marijuana in lieu of criminal sanctions.

A. The Proposed Vice Tax

California is once again at the forefront of the marijuana law reform movement. Advocates have floated several proposals to legalize and tax marijuana in the state. The particulars vary, but as a general matter each proposal would legalize the production, distribution, and possession of marijuana by adults. The state would regulate distribution and production in much the same way it now regulates the distribution of alcohol and tobacco products. Namely, it would license distributors and growers and impose a range of safety-oriented restrictions on them. For example, licensed distributors would be required to take steps to thwart distribution to the underage market.

More interestingly, for present purposes, the state would impose a special excise tax on the distribution of marijuana. Most proposals demur on specifying the tax rate, delegating that decision to state and local agencies, but the leading legislative proposal calls for a statewide vice tax of $50 per ounce of marijuana in addition to the state's 9 percent retail sales tax. The combined tax would sum to nearly $70 per ounce, representing a 37% tax rate, based on a projected post-legalization price of around $180 per ounce.

B. The Virtues of a Vice Tax

The rationales behind imposing a vice tax—especially in lieu of criminal sanctions—are well known, so I will only briefly review them here. Imposing a tax on marijuana distribution is

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17 One legislative proposal (AB 390) is now in committee; one referendum (Proposition 19) will appear on the 2010 ballot. See note 8.
18 AB 390 § 25405 (cited in note 8).
19 AB 390 § 34011 (cited in note 8). The sales tax rate (9 percent) includes the basic state sales tax along with various local and special taxes. See BOE, Bill Analysis at 7 (cited in note 10) (detailing the components of a proposed marijuana tax).
20 I calculated the tax rate based on the figures used by the California BOE to estimate tax revenues. See BOE, Bill Analysis at 7 (cited in note 10). My calculation excludes some compliance costs, such as the cost of figuring out how much tax is owed.
thought to serve two primary purposes. First, like a criminal sanction, a tax would force marijuana users to internalize some of the societal costs of drug use: the accidents, crimes, and emergency-room visits that (arguably) stem from marijuana use.\textsuperscript{21} In the absence of a tax or criminal sanction, some of these costs would be borne by society at large rather than by users,\textsuperscript{22} suggesting that marijuana use would be excessive from a societal perspective. A tax would help to correct this market failure and bring marijuana use closer to the socially optimal level, namely, where private benefits most exceed total social costs.\textsuperscript{23}

To be sure, from a neoclassical economics perspective, criminal sanctions arguably perform the same function: namely, they raise the cost of marijuana use and thereby reduce its incidence. But unlike criminal sanctions, the goal of a tax generally is to \textit{moderate} behavior, not eliminate it altogether. More precisely, the goal of a tax is to ensure that people engage in marijuana use only when it is efficient to do so, that is, only when the private benefits exceed the social costs.\textsuperscript{24}

Second, the tax is supposed to generate substantial revenues for cash-strapped state governments. State governments already derive substantial revenues from vice taxes imposed on alcohol and tobacco products. Tobacco taxes generated more than $16.1 billion for state governments in 2008, and alcohol taxes contributed another $5.3 billion to state coffers.\textsuperscript{25} Some estimates suggest that imposing a tax on marijuana sales could dramatically

\textsuperscript{21} For a balanced review of marijuana's potential harms and medicinal benefits, see Janet E. Joy, Stanley J. Watson Jr., and John A. Benson, Jr., eds, Institute of Medicine, \textit{Marijuana and Medicine: Assessing the Science Base} 83–136 (National Academy 1999). Even staunch proponents of legalization acknowledge marijuana use has social costs. See, for example, Lester Grinspoon and James B. Bakalar, \textit{Marihuana: The Forbidden Medicine} 140 (Yale 1993) (acknowledging marijuana plays a role in a large number of accidents).

\textsuperscript{22} A portion of these harms would be externalized because some injurers would escape detection or would be uninsured/judgment proof.

\textsuperscript{23} In the lingo of economics, the optimal level of consumption is the point at which the marginal benefits of consumption (all inclusive) equal the marginal costs (all inclusive).

\textsuperscript{24} There are, of course, other differences between a tax and criminal sanctions. For a review, see Dan Kahan, \textit{Pecuniary Versus Non-Pecuniary Penalties}, in Steven N. Durlauf and Lawrence E. Blume, eds, 6 \textit{The New Palgrave Dictionary of Economics} 347–49 (Macmillan 2d ed 2008) (discussing the differences between criminal and civil sanctions).

\textsuperscript{25} Tax Policy Center, \textit{State Tax Collection Sources 2000–2008}, online at http://www.taxpolicycenter.org/taxfacts/Content/PDF/state_detailedsource.pdf (visited July 29, 2009) (breaking down tax revenues for the federal government and each state according to the type of tax). Vice taxes are especially appealing during economic recessions because receipts tend to vary less than those associated with income and general sales taxes.
increase state vice tax revenues. The California Board of Equalization (BOE), for example, suggests that legalizing and taxing marijuana would generate $1.382 billion in new revenue for California alone—more than the state now generates from alcohol and cigarette taxes combined ($327 million and $1.04 billion, respectively).

In a related vein, imposing a marijuana tax in lieu of criminal sanctions (like imprisonment) could also save states millions (if not billions) of dollars they currently spend on enforcing marijuana prohibition. The basic idea is that it is cheaper to impose taxes on drug distributors than it is to imprison them. For one thing, prisons cost upwards of $65,000 per bed to construct; a tax, by contrast, has no comparable start-up capital expenses. A prison also costs exorbitant sums to operate—roughly $40,000 per bed annually. To be sure, a tax costs something to enforce; the state must process tax filings, audit taxpayers, prosecute evaders, and so on. But on balance, the costs of administering a tax system are going to be less (possibly far less) than the costs of administering a criminal justice system. Many constitutional guarantees that drive up the cost of enforcing law—such as the right to a government-supplied attorney—apply only to criminal proceedings; and the burden of proof in establishing criminal liability (beyond a reasonable doubt) is much more onerous for government agents to satisfy than is the burden of proof in establishing tax liability (preponderance of the evidence).

The marginal cost-savings of replacing prohibition with a tax could be substantial. One estimate suggests that American governments (state and federal combined) spend $10 billion annual-
ly enforcing the marijuana prohibition. California alone is thought to spend roughly $156 million per year on law enforcement directed at marijuana prohibition. Some of that would need to be redeployed to collect marijuana taxes: for example, to process filings, and to detect, prosecute, and punish tax evaders. And California would still need to police other restrictions on marijuana, such as the continuing prohibition on sales to minors. The BOE has not yet projected these expenses, but California currently spends $36 million annually to enforce the state's tax on cigarettes. Assuming the state would need to spend a comparable sum enforcing the marijuana tax and related restrictions, the marginal cost savings of imposing a tax in lieu of criminal sanctions would be around $120 million.

It is this financial motive—the prospect of generating new revenue and shedding expensive criminal-justice costs—that has recently propelled marijuana law reform into the national spotlight. In the current economic climate, state lawmakers are desperately searching for a budget fix. Collectively, the states faced $143 billion in deficits in fiscal year 2009, and matters are bound to get worse; deficits are forecast to grow to $180 billion in 2010, in spite of all the cuts that states have already made to welfare, education, and other core programs. Hence, it is no surprise that a new proposal to legalize marijuana outright and impose a tax on all marijuana sales has generated so much genuine interest in California and elsewhere.

29 Miron, Budgetary Implications at 20 (cited in note 26).
30 California NORML, CA NORML Analysis (cited in note 5).
31 See Governor's Proposed Budget 2010–11, online at http://www.ebudget.ca.gov/StateAgencyBudgets/0010/0860/department.html (visited Aug 27, 2010) (listing proposed expenditures on cigarette tax and licensing program). For a comprehensive report on state expenditures on taxing and regulating alcohol and tobacco, see The National Center on Addiction and Substance Abuse at Columbia University, Shoveling Up II: The Impact of Substance Abuse on Federal, State and Local Budgets 54 (2009), online at http://www.casacolumbia.org/absoluteMM/articlefiles/380-ShovelingUpII.pdf (visited Aug 27, 2010) (“In 2005, states spent an estimated $5.0 billion to regulate the sale of alcohol and tobacco, issue alcohol and tobacco licenses, collect alcohol and tobacco taxes and for governing or regulatory bodies. They collected $4.7 billion in alcohol taxes and $13 billion in tobacco taxes for a total of $17.7 billion.”).
32 See discussion below in Part II.C for caveats concerning the comparison between cigarette and marijuana taxes.
33 Editorial, States in Distress, NY Times A22 (Aug 4, 2009) (estimating state budget deficit growth in 2010); see also Jennifer Steinhauer, New Year but No Relief for Strapped States, NY Times A1 (Jan 6, 2010) (reporting that state budget problems persist because of rapidly declining tax collections—10.7 percent drop in third-quarter 2009—and expiration of federal support; California faces $20 billion deficit in FY 2010).
34 Puzzlingly, even if we assume California could generate $1.4 billion in new tax revenues—a huge assumption, as I demonstrate below—it is not clear that the proposal
To summarize, California has proposed legalizing and taxing marijuana distribution. The proposal has two goals: 1) to compel drug users to internalize more of the harms caused by their drug use; and 2) to generate substantial revenues for the state government and spare it the criminal justice funds currently devoted to enforcing prohibition. One can gauge the success (or failure) of the tax proposal by the extent to which it serves these two goals.35 It is to that task that I now turn.

II. INCENTIVES UNDER STATE LAW

The proposed marijuana tax would serve its ambitious goals only if the states can collect it.36 If distributors can evade the tax, the societal harms of marijuana would not be fully incorporated into the drug's retail price and marijuana consumption would be excessive from a societal perspective. Likewise, the substantial revenues being promised by legalization proponents would not materialize.

Do the proposals give distributors adequate incentives to pay the tax? Surprisingly, this question has been somewhat neglected in debates over the tax proposal. The California agency that estimated the tax's revenue potential—in the process, stirring up so much interest in it—has simply assumed a 100 percent compliance rate when estimating that the tax would generate $1.4 billion in new revenues.37 Needless to say, perfect compliance is an optimistic target for any tax. Nonetheless, few lawmakers or commentators have bothered to question the assumption, focusing instead on other contested issues, such as the size of the tax

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35 It may not be possible to serve both goals optimally. A tax designed to maximize net tax revenues could be higher (or lower) than one designed to correct a market failure. See Joel Slemrod, Cheating Ourselves: The Economics of Tax Evasion, 21 J Econ Persp 25, 41-45 (2007) (discussing various criteria to consider when deciding upon optimal tax rates and enforcement policies).

36 Luigi A. Franzoni, Tax Evasion and Tax Compliance, in Boudewijn R.A. Bouckaert and Gerrit De Geest, Encyclopedia of Law & Economics 52, 55 (Edward Elgar 2008) ("When taxes can be evaded, taxation will prove to be an imperfect tool for pursuing government aims..."").

37 BOE, Bill Analysis at 6 (cited in note 10). For example, the BOE cursorily dismisses the notion that consumer production could diminish tax receipts. Id at 7 ("Substantial home production would clearly have an impact on the revenues generated. Available research indicates, however, that such production is likely to be minimal."). And the agency does not even mention possible evasion by commercial distributors.
base. And the few commentators who have raised compliance concerns generally have not analyzed them in any depth—especially when those concerns stem from the ongoing federal ban.

This Part begins to explore the neglected compliance issue by closely examining distributors' incentives to pay (or not) the proposed marijuana tax. In this Part, I focus exclusively on the incentives created by state law; in other words, I proceed as if the federal ban did not exist. In the next Part, I add an additional layer of complexity and realism and examine how the federal ban changes distributors' incentives.

Scholars have developed an economic model of tax evasion based on the seminal work of Gary Becker. In economic terms, a distributor's decision to pay or evade depends on the relative costs of each option—the costs of the tax itself (T) versus the expected legal sanctions for evasion (p * S), where p is the probability of detection and S the nominal sanction. A risk-neutral distributor would pay if and only if p * S > T. If the tax exceeds the expected sanctions (that is, p * S < T), the distributor would

38 See, for example, Michael Hiltzik, Marijuana Valuations in California are Hallucinations, LA Times B1 (Apr 20, 2009) (claiming "purveyors of statistics about illicit activity often inflate them—whether to claim legitimacy for the activity, or (if they are law-enforcement agencies) to frighten voters into supporting funding for more officers, guns and helicopters"); Rosalie Liccardo Pacula, Rand Corporation, Legalizing Marijuana: Issues to Consider before Reforming California State Law (2009) (testimony) (criticizing BOE's assumptions concerning, inter alia, size of the tax base), online at http://www.rand.org/pubs/testimonies/2009/RAND_CT334.pdf (visited Sept 30, 2010).

39 See, for example, Bates, Economic Implications in Alaska at 30 (cited in note 26) (suggesting home production is a potentially large problem; assuming federal legalization); Caputo and Ostrom, 53 Am J Econ & Soc at 486–87 (cited in note 26) (flagging possible evasion concerns; assuming federal legalization); Miron, Budgetary Implications (cited in note 26) (assuming federal legalization); Miron, Budgetary Implications in Massachusetts at 7–10 (cited in note 14) (assuming "minimal" home production and federal legalization; but briefly suggesting a black market would persist barring federal legalization); Schwer et al, Fiscal Impact (cited in note 26) (implicitly assuming federal legalization and 100 percent compliance); Will (cited in note 13) (assuming widespread noncompliance based on proposed level of marijuana tax, but failing to explain why a marijuana tax would fare worse than sin taxes of comparable or greater magnitude).


41 There are other costs involved as well. Paying the tax may require additional expenditures, such as figuring out one's tax liability; the same is true of evading the tax—distributors would have to incur expenses to avoid detection, for example, by accepting only cash transactions. To simplify my analysis, I have ignored these other costs; I doubt they would change any of my findings.
evade, thereby creating a tax gap—a discrepancy between taxes owed and taxes actually paid. The bigger this gap is, the less effective will be the tax at rationalizing marijuana consumption and raising revenues for the states.

A. Incentives to Evade

For distributors, the proposed tax represents a cost of doing business. In a competitive market, distributors would need to pass this cost on to their customers by raising prices. The tax being considered by California, for example, would add approximately $70 per ounce—or 37 percent—to the post-legalization retail price of marijuana.

Despite assurances to the contrary, distributors would be sorely tempted to evade the marijuana tax. A distributor who can do so gains a substantial competitive advantage vis-à-vis her tax-paying competitors (ignoring, for now, the potential sanctions). The distributor could exploit this substantial cost advantage by expanding her profit margins or by poaching customers from her tax-paying rivals.

B. Creating Incentives to Pay

The tax rate helps determine the tax gap—the bigger the tax, the bigger the incentive to evade—but it is only half of the


43 See note 20 for an explanation of how to calculate the total tax rate.

44 Interestingly, marijuana distributors and users (the ultimate bearers of the tax) have been among the most vocal and ardent supporters of taxing—and not just legalizing—marijuana. In California, for example, the Marijuana Policy Project (MPP), a pro-legalization group, has launched a pro-tax lobbying campaign organized around the theme “we want to pay our fair share” and claiming that “millions of Californians” who use marijuana actually want to pay the tax. Marijuana Policy Project, We Want to Pay Our Fair Share, online at http://www.mpp.org/states/california/we-want-to-pay-our-fair-share.html (visited Sept 30, 2010) (showing a video of a California marijuana smoker who wants to pay taxes on the marijuana she consumes). These unusual pleas to be taxed have seemingly deflected concerns over marijuana tax evasion, but one should always be skeptical of a professed desire to pay taxes. To be sure, rational marijuana distributors may genuinely prefer the proposed tax over extant criminal sanctions (assuming, of course, the tax is lower than the monetized cost of these sanctions), but that does not mean distributors would necessarily pay the tax if it were adopted.

45 In general, the higher the tax rate, the larger the tax gap will be. Charles T. Clotfelter, Tax Evasion and Tax Rates: An Analysis of Individual Returns, 65 Rev Econ Stat 363, 372 (1983) (concluding that cuts in tax rates can reduce tax evasion); id at 371–72 (estimating that reducing income tax would reduce evasion and increase net tax revenues).
story. Apart from the tax rate, a distributor deciding whether to pay or evade must also consider the expected sanction for evasion. If the expected sanction exceeds the tax burden, a distributor would opt to pay the tax and there would be no tax gap problem (at least among rational risk-averse or -neutral distributors). Under the leading California proposal, for example, a distributor would pay the tax if (but only if) the expected sanction for evasion exceeds $70 per ounce (the combined cost of the excise and sales tax).

The expected legal sanction for tax evasion is a function of the probability of detection (p) and the gross sanction (S) imposed on violators who are detected. In theory, the state government could manipulate either variable (p or S) to achieve optimal deterrence whereby \( p \cdot S > T \). In practice, however, the government's ability to achieve optimal deterrence by imposing legal sanctions is constrained. Section B.1 analyzes constraints on the state's ability to detect tax evasion; Section B.2 analyzes constraints on the state's ability to sanction tax evasion.

1. Detection.

The state's ability to deter tax evasion rests, in large part, on its powers of observation—namely, its ability to detect evasion. But detecting tax evasion is easier said than done. Among other things, it requires knowing the identity (location, and so on) of firms that sell marijuana and how much they sell. Without this information, the government cannot discern which firms have satisfied their tax obligations. Simply put, in order to detect tax evasion, the state needs to monitor the activity being taxed.

Since the government cannot monitor taxable activity directly—and since it cannot necessarily trust taxpayers' self-reports—it must rely upon knowledgeable and preferably disinterested third parties (for example, employers) to report taxable activity. The government commonly relies upon third-party reporting to obtain the information it needs to enforce tax codes. The federal

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46 The level of detection (p) or sanction (S) required for optimal deterrence is a function of the ratio \( T/S \) or \( T/p \).

47 I define the term "firm" expansively to include any individual or entity that distributes marijuana.

48 See, for example, Franzoni, Tax Evasion at 54 (cited in note 36) ("[E]vasion problems originate in the fact that the variables that define the tax base (incomes, sales, revenues, wealth, and so on) are often not 'observable.' That is, an external observer cannot usually see the actual magnitude of an individual's tax base and hence, cannot know his true tax liability.").
Internal Revenue Service, for example, requires employers to submit periodic reports detailing employees' wages (the W-2). These reports greatly enhance the ability of resource-constrained agencies to enforce taxes. Empirical studies have shown, for example, that targeted audits—that is, ones based on leads generated by third party reports—uncover nearly twenty times more evaded tax (in dollar terms), on average, than do random audits. Indeed, the tax compliance literature has demonstrated just how important observing taxable activity is to curbing tax evasion. In general, tax gaps shrink the more information government receives concerning taxable activity. Consider federal income taxes. The IRS estimates on average that 16 percent of federal income taxes go unpaid, but the gap varies considerably by source of income. In particular, the gap is estimated to be much larger for income sources the IRS cannot easily monitor, such as farm income (72 percent gap), self-employment income (52 percent), and income from royalties and rents (51 percent)—the IRS cannot rely upon third parties to report such income.

By contrast, the gap is estimated to be smaller for income the IRS can observe through third party reporting: the gap is only 1 percent for salary income (reported on W-2s) and 4 percent for dividend income (reported on form 1099).

50 Lederman, 60 Stan L Rev at 698 (cited in note 15) ("Information reporting and withholding extend to a variety of types of income in the U.S. and are highly successful at securing compliance."). See also Edward K. Cheng, Structural Laws and the Puzzle of Regulating Behavior, 100 Nw U L Rev 655, 675-78 (2006) (emphasizing the key role of structure—including information reporting programs—for tax compliance); Mark J. Mazur and Alan H. Plumley, Understanding the Tax Gap, 60 Natl Tax J 569, 570-76 (2007) (emphasizing the key role of third-party reporting in explaining tax compliance); Slemrod, 21 J Econ Persp at 44-45 (cited in note 35) (same).
52 Slemrod, 21 J Econ Persp at 28 (cited in note 35) (reporting IRS figures).
53 Id (reporting IRS figures); see also id at 39 (suggesting that third-party reporting enhances compliance).

State use taxes provide another telling example of the need to observe taxable activity. The use tax is a substitute for the state sales tax; it applies to purchases of goods to be consumed in-state, even though the goods were bought out-of-state (or online). States have failed (miserably) in collecting use taxes on online purchases of common consumer goods, like CDs; by some estimates, the tax gap for such online purchases is 90 percent, a staggering figure. See Donald Bruce and William F. Fox, E-Commerce in the Context of Declining State Sales Tax Bases, 53 Natl Tax J 1373, 1380, 1380 n 20 (2000) (assuming a 90 percent tax gap). A number of factors, including the massive volume of online transactions, the huge number of online vendors, and the states' limited authority over out-of-state vendors, severely constrain the states' ability to monitor online transactions. Id (also noting that ignorance of the tax contributes to noncompliance). By contrast, the states have succeeded at collecting use taxes on automobile purchases, online or oth-
To illustrate how third-party reports enhance governments' powers of observation, suppose a government agency is responsible for overseeing one hundred thousand individual taxpayers. One of them, Azure, submits a tax return reporting $50,000 in wage income for 2008. If the agency has no means of verifying Azure's income (for example, no W-2) it would have no way of knowing whether Azure has satisfied her obligations or even whether she should be scrutinized more closely than any other taxpayer (out of 99,999). The agency must allocate its scarce enforcement resources at random, for example, by auditing one out of every fifty taxpayers—a costly and unproductive approach. However, if the agency has credible information regarding taxpayer income, it can focus its limited resources investigating only those taxpayers who (likely) underreported their tax obligations, thereby enhancing the probability of detection. For example, suppose that Azure's employer, Acme Corporation, had submitted a W-2 to the agency indicating that it had paid Azure $100,000 in wages throughout 2008. The agency need only compare the income on the W-2 to the income Azure reported on her tax return to spot an obvious case of evasion worthy of further investigation.

Given how crucial monitoring is for enforcing other taxes, it seems reasonable to suppose California would likewise need to monitor marijuana distribution in order to deter evasion of the proposed marijuana tax. In particular, California would need to observe 1) who sells marijuana and 2) how much is sold. The former observation identifies who owes the marijuana tax; the latter observation establishes how much they owe. Holding all else constant, the more complete are California's data on these two matters, the smaller the marijuana tax gap will be.
This begs the question: is there any way for California to reliably monitor marijuana distribution? After all, marijuana prohibition has been so costly and (arguably) ineffective largely because of the difficulty of observing the production and distribution of this ubiquitous weed. Nonetheless, advocates have proposed a promising solution: a licensing system for the distribution and production of marijuana that would (arguably) enhance tax monitoring. Under this system, distributors would need a state-issued license to distribute marijuana legally. As a condition of holding such license, distributors would be required to maintain business records detailing sales (among other things) and periodically submit such records to the state’s licensing authority (also its taxing authority). Producers would be subject to similar licensing, recordkeeping, and reporting requirements. States commonly employ such licensing systems to assist collection of other vice taxes.

A licensing system could bolster evasion detection in two main ways. First, California could use the system to limit the number of firms distributing marijuana, and hence, the number of firms the state would need to monitor. By limiting the number of distribution licenses, California would ensure that its “administrative resources [would] not be swamped by the necessity of overseeing thousands of extremely minor operations.” Second, by compelling licensees to report sales (among other things), the system would help generate the data the state needs to review tax compliance—for example, a licensee’s sales records could be used to estimate its tax base.

To be sure, the licensing system is not a panacea. For one thing, the system could be circumvented. Consumers could bypass commercial distributors altogether and grow their own supplies. After all, compared to tobacco, marijuana is relatively

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55 See, for example, Kevin B. Zeese, Drug War Forever?, in Melvyn B. Krauss and Edward P. Lazear, eds, Searching for Alternatives: Drug-Control Policy in the United States 254 (1991) (suggesting government efforts to eradicate marijuana supplies have been futile).


57 Leitzel, Regulating Vice at 162 (cited in note 56). Interestingly, there is no indication California even aspires to limit the number of licensees, see AB 390 (not limiting the number of licenses issued) (cited in note 8), so this is giving the state the benefit of the doubt.

58 For starters, the tobacco plant itself is very large (six feet plus) and temperamental. John Hanna, Agricultural Cooperation in Tobacco, 1 L & Contemp Problems 292, 294 (1934) (describing the cultivation of tobacco). The seeds must be started in nursery beds and then transplanted to fields. Id. Once the crop is established, it requires “assiduous
easy to cultivate and process—it costs roughly $100 to get started and for the horticulturally challenged, there are even numerous “idiot’s guide”-type books to show the way. And California could not feasibly license or tax home-grown marijuana, any more than it could license or tax home-grown tomatoes. Alternatively, consumers could patronize black market (unlicensed) distributors. By evading the tax, such distributors could offer consumers a steep price discount. One illustrative survey of New York cigarette smokers found that 37 percent admitted to buying cigarettes from non-taxed sources. Of course, most consumers would presumably opt for the safety and convenience of licensed marijuana distributors. But even those licensed distributors could evade taxes by underreporting sales. The third parties best situated to detect tax evasion—customers—are highly unlikely to report it, since they usually gain by it (via lower prices). To be sure, rival distributors, suppliers, and undercover buyers could catch and report some evasion, keeping most licensees tolerably honest. In other words, the licensing system should help, but it is hardly foolproof; some portion of marijuana tax evasion would undoubtedly escape detection.

2. Sanctions.

In theory, even if California cannot observe marijuana distribution reliably and detect all instances of evasion, it could still achieve optimal deterrence by imposing harsh sanctions on the tax evaders it does apprehend. To illustrate, to compensate for a very low probability of detection (say, \( p = 10 \) percent), California

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59 Steve Fainaru and William Booth, Cartels Face an Economic Battle, Wash Post A1 (Oct 7, 2009) (“With a $100 investment in enriched soil and nutrients, almost anyone can cultivate a plant that will produce two pounds of marijuana that can sell for $9,000.”).

60 A search on Google.com on Jan 9, 2010 for “idiot’s guide to growing marijuana” reveals numerous guides to growing marijuana.

could impose a sanction multiplier \( \left( \frac{T}{p} \right) \), to boost expected sanctions to the level needed to deter evasion \( (p \times \left( \frac{T}{p} \right) = T) \). In this case, where \( p = 10 \) percent, sanctions would need to be 1,000 percent of the tax originally due. In fact, economists generally prefer this option—namely, a high sanction paired with a low rate of detection—because it is cheaper to impose more severe sanctions (especially monetary sanctions) than it is to catch more criminals.\(^{62}\)

As it stands, however, the sanctions for tax evasion are too low to compensate even for small gaps in detection. In California, the sanction for intentionally evading taxes is only 125 percent of the original tax burden (plus interest), that is, \( 1.25T \).\(^{63}\) The same is true in most jurisdictions; in fact, legal scholars have frequently called attention to the low level of sanctions imposed for tax evasion.\(^{64}\) In our example above, where \( p \) equals 10 percent, the expected legal sanction a distributor would face per dollar of tax evaded in California is only about a dime \( ($0.125) \)—not nearly enough to deter risk-neutral distributors from evading.

Assuming its capacity to detect evasion is limited, as I have already shown, California would need to raise its sanctions—perhaps dramatically—in order to curb evasion. Such a strategy, however, is fraught with shortcomings. First, adopting substantial sanctions multipliers might not be politically feasible.\(^{65}\) It seems politicians do not want to appear as though they are empowering tax enforcement agencies (even for the greater good). And as a legal matter, the Eighth Amendment and like-minded provisions found in state constitutions could bar imposition of the sort of draconian fines that might be needed to deter tax evasion.\(^{66}\) What is more, a substantial sanction multiplier is more

\(^{62}\) Gary S. Becker, Crime and Punishment: An Economic Approach, J Pol Econ 169, 184 (1968). The gross sanction \( (S) \) necessary to achieve optimal deterrence is simply the tax due divided by the probability of detection, \( T/p \).

\(^{63}\) West’s Ann Cal Rev & T Code § 30205.

\(^{64}\) See, for example, Leandra Lederman, Tax Compliance and the Reformed IRS, 51 Kansas L Rev 971, 973 (2003) (remarking that penalties for tax evasion are generally only 20–75 percent of unpaid tax); Posner, 86 Va L Rev at 1783 (cited in note 15) (same).

\(^{65}\) See, for example, Doran, 46 Harv J Legis at 130–31 (cited in note 40) (suggesting that raising the sanction for and/or probability of detection of tax evasion to the level required to achieve optimal deterrence is not politically feasible); Lederman, 64 Ohio St L J at 1466 (cited in note 40) (concluding that “it is not politically realistic for the government to impose extremely high monetary penalties for tax evasion and the government does not do so”)

Interestingly, AB 390 is mum on specifics when it comes to sanctions for evasion.

\(^{66}\) Though the protection afforded by the Eighth Amendment is considered weak, it does establish an outer limit on the severity of fines states may impose. United States v Bajakajian, 524 US 321, 344 (1998) (invalidating, on Excessive Fines grounds, forfeiture
likely to be deemed "punitive" for purposes of constitutional analysis, a determination that could raise the cost of imposing the sanction and collecting the tax, thereby detracting from its appeal.  

Second, even assuming high sanction multipliers could be adopted, the government's ability to impose them is constrained. Perhaps most importantly, offender wealth establishes a de facto ceiling on the maximal financial sanction. To the extent it exceeds offender wealth, a monetary fine contributes nothing to deterrence. And there is no reason to assume that marijuana distributors who evade taxes could necessarily afford to pay fines several times larger than the taxes evaded. Indeed, since a portion of the taxes they evaded presumably would have been passed onto their consumers (as price discounts), distributors would not even necessarily be able to pay their original tax burden if caught, much less several times (in our example, 10x) that burden. Thus, despite the sound theoretical argument suggesting that high sanctions should deter evasion, empirical studies generally have failed to demonstrate that raising sanctions actually deters evasion. In any event, it is worth noting

of $357,144 in cash, which the defendant had attempted to remove from the United States without filing appropriate reports).

67 Once the Court determines that the sanction is punitive (versus civil), the constitutional guarantees of criminal procedure generally apply. See Kennedy v Mendoza-Martinez, 372 US 144, 168–69 (1963) (distinguishing criminal from civil sanctions).

68 For literature examining the limitations and drawbacks of maximal sanctions, see, for example, Lucian A. Bebchuck and Louis Kaplow, Optimal Sanctions When Individuals Are Imperfectly Informed about the Probability of Apprehension, 21 J Legal Stud 365, 365 n 2 (1992) (surveying justifications for use of non-maximal sanctions). For scholarship analyzing the limitations and drawbacks of maximal sanctions for tax evasion specifically, see, for example, Franzoni, Tax Evasion at 62–63 (cited in note 36) (suggesting that taxpayer wealth, fairness concerns, and the increasing costs of enforcing ever-harder sanctions counsel against imposing maximal sanctions for tax evasion).

69 See Franzoni, Tax Evasion at 18 (cited in note 36) ("From a practical point of view, the major impediment to infinite fines derives from taxpayers' limited wealth."). The analysis could be extended to other types of sanctions; for example, the offender's expected lifespan would establish an effective ceiling on the maximal incarceration sanction.

70 Even if the price reflects the expected sanction, the distributor who is caught would not necessarily be able to afford the gross sanction.

71 Franzoni, Tax Evasion at 60 (cited in note 36) ("Studies based on IRS data provide a picture of the compliance phenomenon in which many factors come into play: income source, socioeconomic grouping (age, sex, location), detection probability, marginal tax rate and income level. Notably, the severity of the sanction does not seem to play a significant role (partly because in the US sanctions are rarely inflicted."); Slemrod, 21 J Econ Persp at 38 (cited in note 35) ("There has been no compelling empirical evidence addressing how noncompliance is affected by the penalty for detected evasion, as distinct from the probability that a given act of noncompliance will be subject to punishment.") (emphasis omitted).
that the strategy has been employed for prohibition—that is, the very same regime California is now seeking to abandon. And if imposing severe sanctions has not bolstered compliance with prohibition, it seems reasonable to question whether it would bolster compliance with a tax regime either.

C. The Tax Gap (Version 1)

From the foregoing discussion, it should be clear that California (or any other state) would collect less than 100 percent of the marijuana tax due. The state cannot reliably observe marijuana distribution, suggesting the probability of detecting tax evasion (p) would be low. Moreover, the state cannot necessarily compensate for the gap in detection by raising sanctions for evasion. A marijuana tax gap will exist; the question is, how big would the gap be? There is no way to tell, precisely, because there are too many unknowns. At the same time, however, because it could alter the fate of proposed reforms, the gap should not be ignored. Hence, it seems prudent to hazard an estimate of the tax gap, even if it is necessarily rough.

To that end, this Section proposes to estimate the marijuana tax gap (roughly) by comparing that tax to the analogous cigarette tax. The cigarette tax provides a useful starting point for estimating the marijuana tax gap for at least two reasons. First, we have ample data and experience concerning the cigarette tax gap. Cigarette taxes have existed for decades and numerous quantitative studies have examined compliance with them. In other words, at least this starting point is on reasonably firm ground. Second, the cigarette tax compliance data should be informative because the systems used for enforcing that tax and the marijuana tax are so similar. In fact, the marijuana licensing system (discussed above) is modeled on the cigarette licensing system currently employed by California and other states, and

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the very same agency—the BOE—would administer both systems in California. Needless to say, this comparison is imperfect—the taxes and markets on which they are imposed differ in important respects, as I explain below; nonetheless, the two taxes and markets are similar enough such that the comparison should shed some light on the potential magnitude of the compliance problem California would face.

So what do the studies of cigarette tax compliance show? Not surprisingly, the findings vary from study to study, based on a number of crucial factors, including: 1) what counts as "evasion";\(^{73}\) 2) the methodology used to estimate black market sales;\(^{74}\) and 3) the time period studied.\(^{75}\) Nonetheless, despite their variations, one can glean from these studies a reasonable consensus concerning the range of possible cigarette tax gaps. According to national studies, the tax gap across all jurisdictions on average ranges between 7.2 percent and 12.7 percent—a small, but non-negligible level.\(^{76}\) Not surprisingly, the range among individual jurisdictions is much larger, due to the substantial variation in the tax rate across jurisdictions. (In 2009, for example, state tax rates varied from $.07 per pack in South Carolina to $3.46 per pack in Rhode Island.\(^{77}\) Studies report tax gaps ranging from 1 percent in the lowest tax states to more than 24 percent in the highest tax states, though studies that focus on smaller jurisdic-

\(^{73}\) Some studies define tax evasion expansively to include any purchase made without payment of a cigarette tax, see, for example, Stehr, 24 J Health Econ at 295 (cited in note 72) (examining all non-taxed sales), whereas other studies examine only certain forms of evasion, such as commercial smuggling, see, for example, Thursby and Thursby, 53 Natl Tax J at 69 (cited in note 72) (focusing on commercial smuggling).

\(^{74}\) Most studies estimate (in varying ways) actual consumption and compare that to taxed consumption, see, for example, Stehr, 24 J Health Econ 277 (cited in note 72), but some studies rely on other methods, such as direct surveys of smokers, see, for example, New York State Department of Health, Cigarette Purchasing Patterns (cited in note 61). For a brief review of some of the studies and methodologies used, see Smith and Huynh, Washington State Cigarette Consumption at 44–45 app. III (cited in note 72).


\(^{77}\) Tax Foundation, State Sales (cited in note 75).
tions (such as New York City) have reported even larger gaps.\textsuperscript{78} California's tax gap appears to fall in the mid-range—around 15 percent in FY 2005–06 (the most recent estimate available).\textsuperscript{79} It is worth noting that at the time of this estimate, California’s excise tax was 87 cents per pack and the federal excise tax was 37 cents per pack—together they added about 45 percent to the retail price of cigarettes, roughly in line with the proposed marijuana tax rate.

The studies generally attribute the cigarette tax gap to 1) sales made by black market (unlicensed) vendors, 2) sales made by licensed vendors that go unreported, and 3) cross-jurisdictional smuggling by consumers.\textsuperscript{80}

Using the cigarette tax gap to estimate the probable marijuana tax gap is, of course, subject to important caveats. On the one hand, the marijuana tax gap could be smaller than the cigarette tax gap. First, cigarette taxes are, on average, substantially higher than the proposed marijuana tax. On average, cigarette taxes currently add $2.35—or 84 percent—to the retail price of cigarettes;\textsuperscript{81} the leading marijuana tax proposal, by contrast, would add “only” 37 percent to the price of the drug. The higher tax burden presumably gives cigarette distributors and consumers a stronger incentive to cheat the system. It is worth noting, however, that many of the empirical studies discussed above ex-

\textsuperscript{78} Stehr, 24 J Health Econ at 295 (cited in note 72) (finding that tax gap varied from less than 1 percent in lowest tax states to nearly 19 percent in highest tax states). See also Smith and Huynh, Washington State Cigarette Consumption at 28 Table 11 (listing estimated non-taxed sales rates by state) (cited in note 72).

For studies of individual jurisdictions, see, for example, BOE, Revenue Estimate at 2 (cited in note 72) (estimating cigarette tax gap in California at 14.9 percent in FY 2005–06); Smith and Van Huynh, Washington State Cigarette Consumption at 12 (cited in note 72) (estimating Washington state tax gap at 24 percent); New York State Department of Health, Cigarette Purchasing Patterns at 15 (cited in note 61) (surveying New York smokers and finding that 37 percent buy cigarettes from non-taxed sources "some or all of the time," costing state estimated $419–$552 million annually).

\textsuperscript{79} BOE, Revenue Estimate at 2 (cited in note 72) (calculated as ratio of non-taxed sales—209 million packs—to total consumption—1,399 million packs).

\textsuperscript{80} BOE, Revenue Estimate at 2 (cited in note 72) (apportioning gap to casual smuggling by consumers and smuggling by retailers); Stehr, 24 J Health Econ at 295 (cited in note 72) (attributing tax gap to smuggling, internet sales, sales at reservations, and cross-border purchases by consumers). See also General Accounting Office, Cigarette Smuggling: Federal Law Enforcement Efforts and Seizures Increasing 5–6 (2004) (describing methods of evasion: 1) international smuggling; 2) cross-state smuggling; 3) using counterfeit tax stamps; and 4) falsifying distribution reports); Thursby and Thursby, 53 Natl Tax J at 60–61 (cited in note 72) (discussing types of evasion).

amined cigarette tax rates when they were more in line with the marijuana tax rate now under consideration.

Second, cross-jurisdictional smuggling arguably puts a bigger dent in cigarette tax collections than it would in marijuana tax collections, due to the enormous variance in cigarette tax rates across jurisdictions. As mentioned earlier, cigarette taxes vary from as little as $.07 per pack to $3.46 per pack across the United States—and the variation increases when local taxes are considered. Not surprisingly, jurisdictions that impose comparatively high taxes on cigarettes suffer comparatively large tax gaps due to smuggling.\textsuperscript{82} In New York City, for example, where cigarette taxes are among the highest in the nation—$4.25 per pack, including the state levy—an estimated 75 percent of cigarettes consumed by residents are bought somewhere else (that is, a lower-tax jurisdiction).\textsuperscript{83}

California is unlikely to experience smuggling from other states because its marijuana tax, though steep, is still (much) smaller than the criminal sanctions imposed elsewhere (at least for now). In fact, one might expect growers to migrate to California and then smuggle marijuana elsewhere, in order to take advantage of California’s comparatively hospitable laws.

On the other hand, the marijuana tax gap could be larger than the cigarette tax gap. First, the cigarette market is far more concentrated than the marijuana market is (or will be, anytime soon). As it stands, three firms manufacture more than 85 percent of all cigarettes consumed in the United States.\textsuperscript{84} As discussed above (and below), such market concentration greatly enhances government’s ability to monitor tax compliance—for example, it is easier to supervise a small number of large producers/distributors than a large number of small ones. The marijuana market, however, is highly fragmented—thousands of small distributors compete on the market in California alone.\textsuperscript{85} The fragmented structure of the marijuana market would pre-

\textsuperscript{82} See, for example, Daniel T. Brown, Economic Impact of Increasing the Delaware Cigarette Tax 2 (June 2009), online at http://128.175.63.72/projects/DOCUMENTS/HB211final_v4.pdf (visited Oct 3, 2010) (finding that nearly two-thirds of cigarettes purchased in Delaware are exported to neighboring states, where taxes can be as much as $3 higher per pack).

\textsuperscript{83} Cigarette Tax Burnout, Wall St J A14 (Aug 11, 2008) (discussing how high state cigarette taxes often cause cigarettes to be purchased out of state).


\textsuperscript{85} See below Part III.B.
sumably exacerbate the marijuana tax gap in comparison to the cigarette tax gap.

Second, personal cultivation would put a bigger dent in marijuana tax collections, due to the relative ease of growing marijuana. Almost no one grows tobacco for personal consumption; the plant is temperamental, geographically sensitive, and even somewhat dangerous to handle. In addition, it takes nearly one year to cure tobacco leaves for consumption. By comparison, marijuana is quite easy to grow at home. Hence, a consumer might grow her own marijuana to evade a 37 percent tax even if she would not grow her own tobacco to circumvent an 84 percent tax.

Despite these differences, the tobacco cigarette and marijuana markets and taxes seem similar enough such that—with the aforementioned caveats in mind—we can gauge, albeit only roughly, what sort of impact evasion might have on the value of the proposed marijuana tax. In particular, if we assume that California would experience a gap in line with the national average for all state cigarette taxes—a range of 7.2 percent to 12.7 percent—evasion would reduce marijuana tax revenues by $100 million to $176 million annually compared to extant BOE estimates. If a higher estimate of the tax gap is used—namely, one based on California’s own cigarette tax gap (14.9 percent)—the state would lose $206 million to evasion. A final basis of comparison could be the cigarette tax gap suffered by the state of Washington. Analysts have studied Washington closely and have found it to have one of the highest tax gaps of any state: 24 percent. California would lose $332 million if Washington’s tax gap applied.

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86 Compare Bates, Economic Implications in Alaska (cited in note 26); Caputo and Ostrom, 53 Am J Econ & Soc at 487 (cited in note 26) (noting that since marijuana is easier to produce than alcohol, "it is likely that a larger proportion of marijuana will be grown at home than the proportion of alcohol produced in homes in the 1930s.").
Table 1. Projected marijuana tax gap and revenues lost ($ millions) under varying scenarios

<table>
<thead>
<tr>
<th>Scenario</th>
<th>High</th>
<th>Midpoint</th>
<th>Low</th>
</tr>
</thead>
<tbody>
<tr>
<td>California cigarette tax gap$^{87}$</td>
<td>14.9% ($206)</td>
<td>12.7% ($176)</td>
<td>24% ($332)</td>
</tr>
<tr>
<td>Average cigarette tax gap across United States$^{88}$</td>
<td>14.9% ($206)</td>
<td>12.7% ($176)</td>
<td>24% ($332)</td>
</tr>
<tr>
<td>Washington cigarette tax gap$^{89}$</td>
<td>24% ($332)</td>
<td>14.9% ($206)</td>
<td>14.9% ($206)</td>
</tr>
</tbody>
</table>

Table 1 displays the three basic tax gap scenarios, including ranges. The cells display estimates of the revenue that would be lost under each scenario, based on the BOE's estimate that the California tax would generate $1.382 billion in new revenue assuming no evasion. It should be noted, however, that the revenue loss figures could be adjusted even if the BOE's estimate of the tax base—namely, 19.8 million ounces consumed at a value of $3.58 billion—is incorrect.

While these are substantial losses, it seems unlikely that they would significantly reduce public support for reform even among citizens who care only about the financial implications of the proposals. After all, assuming the BOE's tax base figure is reasonable—a BIG assumption—the proposals would still generate $1.050–1.286 billion in new tax revenue, in addition to cost savings of nearly $120 million. The glass, in other words, is still more than half full. In short, overlooking the tax compliance

$^{87}$ BOE, Revenue Estimates (cited in note 72). In earlier studies, the BOE estimated the tax gap was as high as 27 percent. Alam, Mahmoud, and Glantz, Research and Education at 7 (cited in note 72) (reporting BOE's earlier estimates). At least one (pro-tax) group, however, has criticized the BOE's earlier estimates as overly pessimistic. Id at 20 (suggesting gap due to smuggling is only 14.2 percent).

$^{88}$ All three estimates are taken from Stehr, 24 J Health Econ at 280 (cited in note 72) (estimating the national average tax gap at 7.2 percent in 1985, 12.7 percent in 2001, and 9.6 percent across 1985–2001).

$^{89}$ The Washington state tax gap estimate is from Smith and Huynh (cited in note 72). Smith and Huynh indicate that Washington imposed a tax of $1.60 per pack (on average) in 2004 and the average price of a pack in the state was $4.68. Id at 31 n 27, 33 tbl A1, 37. Using these figures, the state tax rate would be 52 percent of the (pre-tax) retail price. The federal government imposed an additional $0.37 per-pack excise tax at the time, bringing the combined tax rate to nearly 73 percent.
issue is a costly mistake, but not one that would likely affect the fate of the legalization and taxation proposals.

* * *

Proposals to tax marijuana distribution are generating a buzz in California; by some estimates, a tax would generate $1.4 billion in new revenues for the beleaguered state. Notably, however, the leading estimate of the tax’s revenue impact has altogether ignored the potential for evasion. The tax gives marijuana distributors an obvious incentive to cheat. California could deter evasion by maintaining high expected sanctions \((p \times S > T)\), but doing so is easier said than done. The state would probably need to monitor marijuana distribution through a closed licensing system. Other options, like increasing gross sanctions, seem infeasible. The licensing system California has proposed should help weed out evasion, but it is no panacea. A portion of marijuana consumption will escape taxation. Decades of experience with cigarette taxes could help gauge the marijuana tax gap. On average, the tax gap for cigarettes runs between 7.2 percent and 24 percent. A similar gap range for the marijuana tax would cost California $100–$332 million, but the proposal would still generate substantial revenues of $1.050–$1.286 billion (if the underlying BOE estimates are correct).

III. INCENTIVES UNDER FEDERAL LAW

The above analysis assumed a unitary system, that is, a marijuana market governed only by state law. This Part adds another layer of complexity and realism by considering how federal law changes distributors’ incentives. Once federal law is considered, tax evasion becomes a much bigger concern and the tax proposal loses much more of its luster.

Federal law bans the possession, cultivation, and distribution of marijuana.\(^90\) Though the federal government has repeatedly dismissed calls to decriminalize marijuana outright, the Obama Administration has recently assumed a more tolerant stance towards medicinal uses of marijuana. In particular, Attorney General Eric Holder has announced that the Department of Justice (“DOJ”) will no longer target distribution of medical marijuana.\(^91\) The Administration, however, remains

\(^90\) 21 USC § 841(a)(1).

\(^91\) David W. Ogden, Deputy Attorney General, Memorandum for Selected United
steadfastly committed to enforcing the federal ban on recreational marijuana (a bigger market). Thus, anyone who possesses, cultivates, or distributes recreational marijuana, even pursuant to state law, remains subject to harsh federal sanctions. (For example, distribution of any quantity of marijuana carries a possible five-year prison term and $1 million fine.)

This Part provides the first in-depth analysis of the unique issues posed by state taxation of federal crime. Section A sets the necessary foundation by discussing preemption and the legal status of state taxation. Section B discusses the federal ban's impact on the structure of the marijuana market. And Section C discusses the federal ban's effect on state monitoring. Section D concludes by reevaluating estimates of the marijuana tax gap in light of the special hurdles posed by federal law.

A. Preemption

Before discussing whether California's proposal would satisfy its considerable promise ($4.4 billion!), it seems prudent to discuss whether California could constitutionally legalize and tax something Congress expressly forbids. After all, if preempted by federal law, the California reforms would be null and void, in other words, unenforceable ($1.4 billion! $0).

As it stands, federal law does permit California to legalize (under state law) and tax marijuana. By congressional design—and constitutional limitation—the Controlled Substances Act (“CSA”) preempts state law only to the extent it positively conflicts with the federal ban. In a nutshell, this means a state may not 1) engage in or 2) aid and abet conduct banned by the CSA (that is, the possession, distribution, or production of marijuana). California's proposal passes muster because it does neither of these things. First, the state itself would not produce or dis-
tribute marijuana; rather, it would merely allow its residents to do so, unimpeded by state sanctions. (Of course, the state could more easily and effectively control marijuana if it were allowed to grow and distribute the drug itself; after all, state ownership of alcohol establishments contributed to the states' ability to impose controls on alcohol immediately following Prohibition's repeal.\footnote{7} Second, California would not aid and abet others who produce and distribute marijuana, in the legally relevant sense.\footnote{8} In other words, it would not subsidize private production and distribution of marijuana. Indeed, the state marijuana tax would, if anything, \textit{curb} CSA violations by raising the cost of marijuana.

California's power to legalize marijuana is protected by the anti-commandeering rule. That rule blocks Congress from simply forcing California to ban marijuana.\footnote{9} However, that protection is somewhat limited, for the anti-commandeering rule does not block Congress from 1) bribing California to forego legalization or even 2) forcing California to scrap the marijuana tax. As to the former (bribe California), the anti-commandeering rule does not curb Congress's conditional spending power, since states can (ostensibly) decline federal grants. Thus, in theory Congress could offer California federal grants (\$1.4 billion!) on the condition that California maintain its criminal ban on marijuana. As to the latter (scrap just the tax), the anti-commandeering rule is not implicated by congressional field preemption, that is, by wiping out all state regulation of a given field in Congress's expansive domain. Thus, in theory Congress could preempt California's tax on marijuana (a form of regulation), even though it could not preempt California's legalization of the drug (a form of non-regulation).\footnote{10}

\footnote{7} Harry G. Levine and Craig Reinarman, \textit{From Prohibition to Regulation: Lessons from Alcohol Policy for Drug Policy}, 69 Milbank Q 461, 473–82 (1991) (suggesting that one of the primary means of controlling alcohol once Prohibition was repealed was through state ownership of retail distribution).

\footnote{8} California would merely tolerate violations of federal law by its citizens, something it is entitled to do under the anti-commandeering rule. See Mikos, 62 Vand L Rev at 1445–50 (cited in note 93), for an in-depth explanation.


\footnote{10} As I have explained elsewhere, the distinction is best explained by reference to the state of nature. A tax departs from the state of nature and is thus preemptable; legalization merely restores the state of nature and is thus not preemptable. Mikos, 62 Vand L Rev at 1445–50 (cited in note 93) (developing the state-of-nature benchmark).
As a practical matter, however, Congress seems unlikely to pass legislation aimed at blocking California’s proposed reforms. First, there is substantial public support for marijuana legalization. A recent poll shows that 45 percent of Americans now favor legalization, versus 54 percent who favor prohibition—not a majority, but probably enough to thwart anti-legalization measures (for example, conditional grants) in Congress. Second, preempting a state marijuana tax represents a serious gamble for drug hawks, since California might legalize marijuana anyway, even if could not tax the drug. Given that the federal government’s own drug enforcement resources are quite limited, drug hawks would probably prefer that California impose some sanction on marijuana (that is, a tax) than no sanction at all.

B. Market Structure

Though the federal government would probably allow the states to legalize and tax marijuana, its continuing ban on marijuana would impair enforcement of a state marijuana tax for two reasons: 1) it would preserve the current fragmented structure of the marijuana market, by giving marijuana distributors an incentive to remain small and to operate inconspicuously; and 2) it would put state tax collectors in a dilemma, because federal authorities could use state tax rolls (and similar state-gathered information) to track down and punish tax-paying marijuana distributors. This Section discusses the structure of the marijuana market and its implications for the enforcement of the proposed marijuana tax. The next Section discusses federal law and the dilemma it poses for state monitoring of marijuana distribution.

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103 Interestingly, AB 390 preemptively adopts this posture—its tax provisions would take effect only if the federal government legalized marijuana. See AB 390 at 4.
1. The fragmented marijuana market.

As it stands, the marijuana market is highly fragmented; in other words, there are many small producers and distributors. Not surprisingly, the exact number of "firms" is unknown; however, law enforcement data suggest it is several thousands. In 2008, for example, law enforcement agents seized 2,455 marijuana grow sites in California.\textsuperscript{104} Assuming this number represents between 10–25 percent of all California grow sites,\textsuperscript{105} and assuming that one grow site represents one firm, there would be anywhere from 10,000 to 25,000 firms operating illegally across the state.\textsuperscript{106} The fragmented structure of the legal medical marijuana market in California lends some support to the high estimate. In Los Angeles County alone, for example, there are more than 1,000 dispensaries that distribute medical marijuana; in other words, it is now easier for patients to obtain cannabis than a Frappucino or Big Mac.\textsuperscript{107}

2. Why market structure matters.

California's ability to monitor marijuana distribution is severely constrained by the fragmentation of that market. Monitor-
ing thousands of growers and distributors would overwhelm the state's limited enforcement capacity. Indeed, market structure is one reason prohibition has been such a costly—and largely futile—endeavor; despite investing billions annually, law enforcement agencies apprehend only a small fraction of all marijuana offenders (perhaps 10 percent).

Contrast the highly fragmented marijuana market with the highly concentrated cigarette market. Three firms dominate cigarette production: Altria, R.J. Reynolds, and BAT/Brown & Williamson in combination control more than 85 percent of that market. Although cigarette distributors are more numerous, consolidation at the manufacturing stage greatly enhances government monitoring and taxation of distribution. Most importantly, it means government need not monitor individual distributors closely to figure out how much a given distributor sells; rather, it can estimate sales (and tax burdens) by examining manufacturers' sales records. For example, if the government examined Altria's accounts and found that Altria had sold 100 thousand cartons of cigarettes to Firm A, it could easily infer Firm A's (probable) tax burden. If Firm A reports only 10 thousand cartons sold, government investigators would know to target Firm A for audit. As suggested above, the industry's highly concentrated structure helps explain why the cigarette tax gap remains tolerably low.

3. The prospect of consolidation.

To be sure, one might expect the marijuana market to consolidate post-legalization. The alcohol industry sets a precedent for such consolidation. During Prohibition, tens of thousands of small distillers supplied spirits, largely unchecked by law enforcement. In the decades following the repeal of Prohibition,

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108 See Leitzel, Regulating Vice at 162-63 (cited in note 56) (discussing the need to limit the number of vice vendors). The difficulty will be compounded by the fact that marijuana can be grown inconspicuously—in basements, backyard gardens, and so on—meaning that all but the largest growers could easily conceal themselves from prying eyes.


111 For discussions of the procedures used to monitor cigarette distribution and collect taxes, see, for example, General Accounting Office, Cigarette Smuggling at 3–4 (cited in note 72).

112 Levine and Reinarman, 69 Milbank Q at 473–74 (cited in note 97) (“In 1933 a sprawling illegal industry for producing and distributing alcoholic beverages was in place,
the market has become increasingly concentrated; by 2003, for example, three firms together controlled more than 80 percent of the beer market.\textsuperscript{113}

Similarly, various barriers to entry that enabled the cigarette market to become—and remain—consolidated could enable the marijuana market to become consolidated as well. First, there are enormous economies of scale to cigarette manufacturing.\textsuperscript{114} Cigarette rolling machines significantly reduce the cost of manufacture and increase the minimum efficient scale of firms. In fact, scholars attribute the consolidation of the cigarette industry in part to the introduction of such machines in the late 1800s.\textsuperscript{115} Presumably, the production of marijuana joints, like the production of cigarettes, could be mechanized as well. Such mechanization would give larger growers and distributors a competitive edge, eventually weeding out numerous smaller, less efficient firms.\textsuperscript{116}

\textsuperscript{113} Kenneth Elzenga and Anthony Swisher, \textit{The Supreme Court and Beer Mergers: From Pabst/Blatz to the DOJ-FTC Merger Guidelines}, 26 Rev Indust Org 245, 246 (2005) (also noting that in 1947, the top five firms controlled only 19 percent of the beer market); see also Victor J. Tremblay and Carol Horton Tremblay, \textit{The U.S. Brewing Industry: Data and Economic Analysis} 41 (2005) (noting that the number of independent beer producers declined from 421 to 22 between 1947 and 2002).


\textsuperscript{115} For a thorough examination of the history of and factors behind the consolidation of the cigarette industry, see generally Porter, 43 Bus Hist Rev 59 (cited in note 114) (concluding that mechanization, patents, and anti-competitive practices contributed to consolidation).

\textsuperscript{116} See Bates, \textit{Economic Implications in Alaska} at 30 (cited in note 26) ("Were marijuana to be grown commercially, with industrial methods utilizing scale economies, \ldots small operations [that currently dominate the market] would be almost completely supplanted. This in turn would facilitate tax collection, so long as the tax is not so exorbitant as to keep production in the black market."); Kenneth W. Clements and Xueyan Zhao, \textit{Economics and Marijuana: Consumption, Pricing, and Legalisation} 323 (2009) (suggesting marijuana could take advantage of large-scale production, like cigarettes, if legalized).
Second, there is strong brand loyalty among consumers in the cigarette market.\textsuperscript{117} Strong brand loyalty, built up through substantial firm investments in advertising, helps explains why new cigarette firms cannot easily capture market share from the entrenched firms.\textsuperscript{118} Namely, it would take enormous investments to dislodge customers from their existing brands. It seems plausible that commercial marijuana firms could cultivate similar brand loyalty, which would enable them eventually to consolidate market share.

To be sure, the marijuana market might never achieve the same level of consolidation as the alcohol or cigarette markets. For example, the comparative ease of producing marijuana could enable smaller producers (including many users) to survive in the marijuana market. And, in any event, it could take years for the above-mentioned forces to consolidate the marijuana market.\textsuperscript{119} In other words, the tax gap could be especially large at the outset, that is, when California needs the revenue most. But one could reasonably suppose that over time, only a few firms would survive in a truly legal marijuana market. If so, the task of collecting the marijuana tax would be made much simpler.

4. How the federal ban blocks consolidation.

California, however, does not have the power to lift prohibition \textit{writ large}, only state prohibition. Marijuana would remain criminal under federal law. And for at least two reasons, the federal ban would impede consolidation of the marijuana market.\textsuperscript{120}

\footnotesize
\begin{itemize}
  \item \textsuperscript{117} Chaloupka, \textit{Cigarettes} at 97–99 (cited in note 114) ("Cigarettes enjoy extremely high rates of brand loyalty among smokers.").
  \item \textsuperscript{118} Id (suggesting that heavy investments in marketing, coupled with government restrictions on advertising, raised cost of entry and thereby contributed to concentration of cigarette manufacturing industry).
  \item \textsuperscript{119} The alcoholic beverage and cigarette markets seem to have consolidated in a few short years, once certain forces—the repeal of Prohibition and introduction of cigarette rolling machines—were put in play. See Levine and Reinarman, 69 Milbank Q at 477 (cited in note 97) (discussing consolidation of distilled alcohol industry following repeal of Prohibition in 1933 and noting that by end of 1930s, four firms had captured 80 percent of market); see generally Zitzewitz, 51 J Indust Econ 1 (cited in note 114) (discussing consolidation of cigarette market brought on by mechanization of the manufacturing process in late 1800s).
  \item \textsuperscript{120} In addition to hampering consolidation of the market, federal law would also tend to keep the marijuana market underground, again, where it is harder to observe. Observing 1,000 distributors (as opposed to 10) is difficult enough. Observing 1,000 distributors who do not advertise themselves is even more difficult.
\end{itemize}

To be sure, there would be some advantages to operating openly—which would ease tax collection. Some customers would prefer buying from a dealer who complies with (state) law. But firms that operate in plain sight of customers also operate in plain sight of state tax collectors and federal law enforcement authorities.
First, the federal ban creates a strong disincentive for distributors to grow big. Compared to smaller distributors, larger distributors are more likely to be caught and punished by federal authorities. Every drug transaction conducted by a distributor carries a distinct risk of detection. To be sure, the risk probably declines with every transaction, since the distributor who evades detection once probably acquires knowledge that could help her evade detection again. At the same time, however, the consequences of being caught escalate with every transaction, since the detection of one transaction could reveal others. For example, if authorities catch D distributing marijuana once, they might search D’s home; in the course of the search, the authorities might discover evidence of previously undetected transactions. 

In the ensuing plea deal (or trial), D would be punished for all of the offenses, boosting the effective sanction for the nth transaction.

In a related vein, if caught, a larger distributor is more likely to be prosecuted and punished. The United States Attorneys (USAs) have wide latitude to decide what cases to pursue. And when it comes to marijuana offenses, some USAs decline to pursue cases unless they involve substantial quantities of the drug. Many United States Attorneys’ Offices have set this threshold at 200 pounds or more. To be sure, the USA can ignore these guidelines; but their very existence suggests a reluctance (or perhaps inability) to expend resources chasing down mom-and-pop marijuana operations. The CSA’s graduated penalty schedule provides added incentive for USAs to focus on cases involving substantial quantities; for example, cases involving more than 100 kilograms trigger mandatory sentences of five years imprisonment and fines up to $10 million, and those figures are doubled for cases involving 1,000 kilograms or more. A marijuana distributor might choose to forgo the benefits of expansion (for

121 For my purposes, distributor size is based on the number of transactions (bigger distributors engage in more), rather than the quantities involved in them.

122 The consequences of being caught increase, even though the discrete probability of being caught falls. At some point, the former effect outweighs the latter; this point helps determine the optimal size for any distributor.

123 Howie Padilla and Paul Gustafson, Not Prosecuting Pot Case Baffles Some Authorities, Star Trib B1 (Feb 21, 2007) (reporting that the DEA does not bring a marijuana case to the Minnesota United States Attorney unless it involves more than 500 pounds); James Pinkerton and Susan Carroll, As Border Emphasis Changes, Drug Cases Show Drop, Houston Chron A1 (Apr 14, 2007) (reporting that the Arizona USA refers cases involving less than 500 pounds of marijuana to state authorities).

124 21 USC § 841(b)(1).
example, economies of scale) in order to avoid detection and prosecution by federal authorities.\textsuperscript{125}

Second, federal laws impede distributors’ ability to build brand names and consolidate market share. The federal Lanham Act bars the registration of a trademark used on any product proscribed by federal law, including marijuana.\textsuperscript{126} For similar reasons, federal law would presumably bar common law protection of an unregistered trademark on marijuana.\textsuperscript{127} Hence, a distributor that wanted to expand its market share by building a brand name could not seek federal protection of its trademark.\textsuperscript{128} Suppose, for example, that D, our distributor, develops a new strand of marijuana she labels “Acapulco Gold.” D could not easily capture the benefits of her development. If her new strain becomes a hit, other distributors could exploit the name “Acapulco Gold” to push their own (inferior) products. D could not sue for

\textsuperscript{125} There is also a related disincentive to being the biggest fish, because smaller fish can arrange lenient plea deals with prosecutors for frying their larger brethren.

\textsuperscript{126} To register a trademark, the owner must demonstrate actual use in commerce or bona fide intent to use. 15 U.S.C. § 1051 (a)(3)(C). The use in commerce requirement poses two problems for marijuana distributors. First, courts and the Patent and Trademark Office (“PTO”) have interpreted it to mean \textit{lawful} use in commerce, making it impossible to satisfy as long as marijuana distribution remains illegal under federal law. See, for example, \textit{United Phosphorus v Midland Fumigant}, 205 F3d 1219, 1225 (10th Cir 2000) (“[S]hipping goods in violation of federal law cannot qualify as the ‘use in commerce’ necessary to establish trademark rights.”). See also 8-900 Gilson on Trademarks 907 (2009) (Matthew Bender 2009) (“Use of a mark in commerce must be lawful use to be the basis for federal registration of the mark.”). Second, in any event, a distributor would admit to a federal crime—in a federal court no less—by attesting to having sold marijuana in commerce. Such an admission could expose the owner to federal criminal and civil sanctions.


\textsuperscript{127} To obtain common law protection of a trademark, the owner would need to demonstrate use in commerce; in so doing, she would presumably encounter the same problems discussed above concerning registration of the mark. For a discussion of trademark rights conferred by common law, see 1-3 Gilson on Trademarks at § 3.02 (cited in note 126) (“Actual use of most kinds of trademarks, without more, establishes protectible trademark rights under common law.”).

\textsuperscript{128} It is, of course, possible that the distributor could seek protection of her brand under state trademark (or unfair competition) law, but such protection would arguably be preempted by federal law. To be sure, federal trademark law—the Lanham Act—probably would not preempt state protection of a trademark on marijuana goods; however, the CSA probably would preempt state protection, because state protection of a trademark on marijuana goods arguably generates a “positive conflict” with the CSA. See 21 USC § 903 (preempting state laws that generate a “positive conflict” with the CSA). As I have explained elsewhere, a positive conflict arises under the CSA when a state takes any action that violates the CSA. Mikos, 62 Vand L Rev at 1452 (cited in note 93). By protecting the trademark of a marijuana distributor, a state would arguably “aid and abet” the distribution of marijuana, in clear violation of the CSA. Id at 1445–60 (discussing in detail the CSA’s preemption of state law).
trademark infringement (in federal court, anyway), so any money spent building the brand name would be lost. Lacking the means to differentiate their products through branding, marijuana distributors and producers could not achieve the high concentration seen in the cigarette market.

In short, the federal ban would frustrate California's monitoring of marijuana distribution by preventing consolidation of the marijuana market. The federal ban on marijuana gives firms an incentive to stay small, and, in any event, hampers attempts to grow via branding. To detect tax evasion, California would need to adopt costly enforcement measures (for example, random audits) that may not yield positive returns.\(^\text{129}\)

C. The Monitoring Dilemma

Even supposing, arguendo, that California could find a way to observe marijuana distribution (for example, via licensing), it would not be out of the woods yet, for the federal ban creates another, even more daunting problem: federal law enforcement could use California's monitoring system to track down and sanction marijuana distributors who obey state law.

Monitoring marijuana distribution creates a long paper trail. If successful, a state licensing or tax administration system would reveal the name, place of business, and sales of every marijuana distributor in the state. Such data may be needed for enforcing a state tax, but it could also be used to help enforce the federal ban. Federal law enforcement agents could seize the data and there is nothing the states can do to stop them.

First, the states cannot shield distributors from federal sanctions. Although states may "legalize" marijuana distribution for purposes of state law, they cannot eliminate federal sanctions.\(^\text{130}\) Second, states cannot necessarily conceal data from federal authorities, even when that data is privileged under state law. As I argue elsewhere, federal statutory privileges, the anti-

\(^{129}\) My colleague, Paul Edelman, has suggested an ingenious strategy to incentivize consolidation—reduce the tax rate for larger distributors. To some extent, the fixed fee for a marijuana distribution license would serve this purpose, though it seems California has no interest in limiting the number of licenses or in setting the fee ($5,000 at first, declining to $2,500) high enough to spur consolidation. See AB 390 (cited in note 8).

Importantly, however, California cannot force consolidation on the market, for example, by restricting the number of licenses, because it would not squarely address one force that would continue to drive fragmentation: the federal ban.

\(^{130}\) Gonzales v Raich, 545 US 1, 29–33 (2005) (holding that California medical marijuana law does not bar federal prosecution). See also Mikos, 68 Vand L Rev at 1463 (cited in note 93) (explaining why state medical marijuana laws do not bind federal authorities).
commandeering rule, and the privilege against self-incrimination, among other legal doctrines, provide only limited protection for sensitive information states require citizens to report.\textsuperscript{131}

As a consequence, marijuana distributors could be made worse off by obeying state law. To be sure, distributors could be prosecuted by federal authorities regardless of whether they pay the state tax; however, the probability they would be detected by federal authorities goes up dramatically if they do so—the federal government simply would not have the resources to track down any but the largest marijuana distributors without using a state database.\textsuperscript{132} Of course, evading state taxes carries a risk as well; a distributor who does so faces state punishment if caught. But a drug distributor might still find it worthwhile to face this risk (it is only a risk) rather than face near certain (and very large) sanctions that could be imposed by the federal government upon paying the state tax.

Simply put, to the extent expected federal sanctions increase by paying the state tax, distributors are given added incentive to evade the tax. Ironically, the better information states gather, the worse off they (or drug distributors) become. Even if marijuana distributors would rationally choose to pay the state tax in the absence of the federal regime, they may opt to evade the tax in the presence of the federal regime. Marijuana tax proponents have overlooked this threat.\textsuperscript{133}

\textsuperscript{131} Mikos, Commandeering States' Secrets (cited in note 16) (explaining why the anti-commandeering rule, privilege against self-incrimination, and federal evidentiary privileges provide at best limited protection for state confidences).
\textsuperscript{132} See Mikos, 62 Vand L Rev at 1463–69 (cited in note 93) (discussing practical limits on federal police power in marijuana cases).
\textsuperscript{133} Reconsider the standard depiction of evasion incentives: a distributor would evade tax (\(T\)) if it exceeds the expected legal sanctions (\(p \times S\)). The federal ban adds a new sanction to the mix (\(S_f\)); unlike the state sanction for tax evasion (\(S_s\)), \(S_f\) may be imposed regardless of whether \(T\) is paid—it is, after all, a sanction for marijuana distribution. In fact, as this Section has demonstrated, it seems more likely that \(S_f\) would be imposed if \(T\) is paid because federal authorities have an easier time identifying distributors who pay the tax than those who evade it. If we assume, at the extreme, that every tax-paying distributor would also incur the federal sanction, the expected cost of the tax is now \(T + S_f\). The federal ban also increases the cost of evading the state tax, but not by as much. Realistically, the federal government cannot detect many marijuana distributors without the assistance of state law enforcement—its resources are too limited. Suppose the state and federal authorities cooperate in tracking down tax evading distributors; the joint probability of detection is \(p\), where \(p < 1\). The cost of evasion is thus \(p \times (S_s + S_f)\). Under various assumptions, a distributor who would be willing to pay the state tax in the absence of the federal ban would find it worthwhile to evade the tax once the federal ban is implemented. In particular, evasion looks more appealing, \textit{ceteris parabus}: 1) the smaller is \(p\); 2) the smaller is \(S_s\) compared to \(T\); and 3) more interestingly, for present purposes, the larger is \(S_f\) relative to \(S_s\).
D. The Tax Gap (Version 2)

Given the persistence of the federal prohibition on marijuana, comparing the proposed marijuana tax to the tax on a legal vice like cigarettes seems less appropriate. A more fitting benchmark for assessing the marijuana tax gap could be, well, the marijuana tax gap.

Twenty-one states have laws on the books that tax the sale of marijuana (and other illicit drugs). In these states, however, the drug remains prohibited. The tax merely supplements the criminal and various other civil sanctions these states impose on the cultivation, distribution, and possession of marijuana.

Unfortunately for California, such taxes on illicit drugs are seldom paid and generate correspondingly paltry revenue. Until recently, for example, the state of Tennessee imposed a tax on possession of all illicit drugs—the rate was set at $3.50 per gram for marijuana. Nonetheless, the state collected only $10 million total over four years. The state of Oklahoma, which has a similar tax, has fared even worse—it collected only $80 in tax year 2005–2006.

It is easy to see why states have done poorly when it comes to collecting taxes on illicit substances. As discussed above, prohibition gives drug distributors ample incentive to hide from law enforcement authorities—this hinders monitoring that is necessary for effective collection of civil taxes. Proponents had hoped that by legalizing marijuana, California could reap significantly more tax revenues than are generated by extant taxes on illicit substances.

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134 Waters v Farr, 291 SW3d 873, 884–85 (Tenn 2009) (surveying state taxes on illegal substances and noting that taxes in all but eleven states have been found unenforceable on federal or state constitutional grounds). See also NORML, State Tax Stamp Data, online at http://norml.org/index.cfm?Group_ID=6668 (visited Oct 3, 2010) (providing useful information on the content and status of state taxes on illicit drugs).

135 See Leitzel, Regulating Vice at 158 (cited in note 56) (noting that many states already tax marijuana, though few dealers actually pay these taxes); Miron, Budgetary Implications at Appendix (cited in note 26) (estimating revenue generated from fines and forfeitures in drug-related cases).

136 West’s Tenn Code Ann §67-4-2803 (specifying tax rate).

137 Tennessee Tax on Illegal Drugs Ruled Unconstitutional, Associated Press (July 24, 2009) (reporting that the state Supreme Court found state law exceeded legislatures’ enumerated tax powers under state constitution). What is more, much of that revenue that has been collected has actually come from stamp collectors (the state provides a stamp when the tax is paid), as opposed to drug dealers. Id.

138 68 Okl St Ann § 450.2 (specifying tax rate).

drugs. In essence, the hope—or assumption—is that marijuana distribution would consolidate and come out into the open, enabling civil taxation and regulation to occur. The problem is that the federal ban mitigates the differences between California's proposed tax and extant marijuana taxes in prohibition states. To be sure, state legalization is likely to make some difference. Some consolidation could occur—and some marijuana distributors would operate in the open, because the federal government's law enforcement resources are limited. But it seems likely marijuana will remain a predominantly black market so long as federal prohibition—and some willingness to enforce it—remains in place. California may be able to decriminalize—even legalize—marijuana, but it cannot necessarily regulate the drug effectively. Hence, California could face a much steeper gap than anticipated above in Part I(C). In fact, the state might collect only a small fraction of taxes due, a realization that substantially diminishes the financial appeal of the proposals currently under consideration.

CONCLUSION

This Article has examined a proposed state marijuana tax to highlight previously ignored tax compliance problems states face when attempting to tax goods or services that are forbidden under federal law. Due largely to the strains caused by the recession and attendant fiscal crises, several states are seriously contemplating legalizing and taxing marijuana. The financial allure is enormous—policymakers and economists suggest that a marijuana tax could generate billions in new revenues for the states.

The federal ban on marijuana, however, complicates enforcement of the tax. In particular, the federal ban makes state monitoring of marijuana distribution especially difficult and potentially self-defeating. First, the federal ban will keep the marijuana market fragmented. This means that thousands of small growers and distributors will continue to compete on the marijuana market, potentially overwhelming limited state tax collection resources. Second, even assuming a state could find a way to track taxable marijuana sales, doing so would only create a new problem. Federal law enforcement agents could use this state-gathered information to impose harsh federal sanctions on taxpaying marijuana distributors. The threat of being exposed in

140 Mikos, 62 Vand L Rev at 1463–69 (cited in note 93) (detailing federal government's inability to effectively enforce its marijuana ban).
state records gives marijuana distributors an additional incentive—above and beyond the state tax—to evade state tax authorities. For both reasons, the continuing federal ban on marijuana is likely to exacerbate a marijuana tax gap. The states might collect only a fraction of the revenues proponents now claim a tax would generate.

There is no obvious solution to the problems posed by the federal ban, short of federal legalization. Many of the steps states could normally take to enhance tax compliance would be stymied or preempted by federal law. A state, for example, could not sell marijuana at state-operated stores; this option is clearly preempted by the CSA, which bars states—no less than private citizens—from distributing the drug. A state could attempt to foster consolidation of the marijuana market—for example, by limiting the number of licenses it issues or by imposing a lower tax rate on larger distributors—but doing so would not relieve distributors’ fears of getting caught in the crosshairs of federal prosecutors. Allowing distributors to pay the tax anonymously would eliminate the paper trail for federal authorities, but it seems unlikely to deter tax evasion—existing drug taxes are paid anonymously and generate paltry revenues. The most promising reform could be to focus on taxing medical marijuana. The federal government’s announcement that it would halt enforcement of the federal ban on medical marijuana would seemingly pave the way for consolidation of this niche market and would remove the concern that federal agents would use state gathered information against medical marijuana distributors. A tax on this niche market, however, would generate only a fraction of the revenues now being touted by tax proponents. What is more, singling out medical marijuana for taxation could prove politically unpalatable; indeed, many state lawmakers are considering exempting medical marijuana from any marijuana tax.

In sum, as long as federal law proscribes marijuana—and federal agents remain committed to enforcing the ban—a state tax on marijuana would be largely unsuccessful. The tax would not force marijuana users to internalize the social costs of their activity; nor would it be a panacea for state budget woes. There

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141 The state could encourage payment of a medical marijuana tax by giving consumers an incentive to report taxable transactions. For example, a state could impose a tax on marijuana distributors of $140 per ounce; it could then offer consumers a tax rebate of $70 per ounce, on condition that they report their purchases. These reports could then be compared against sales reports made by distributors. I am grateful to Amitai Aviram for the suggestion.
are reasonable arguments favoring legalization of marijuana; rescuing the states from dire fiscal straits, however, is not one of them.