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OFFICE OF THE CONTROLLER
CITY AND COUNTY OF SAN FRANCISCO

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MEMORANDUM

TO: Supervisor Malia Cohen

FROM: Ted Egan, Chief Economist

DATE: July 11, 2018

SUBJECT: Additional Gross Receipts Tax on Cannabis: Impact on the Industry

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On July 2nd, our office determined that the proposed additional Gross Receipts Tax on cannabis products would not require an economic impact report, because of the relatively small amount of revenue that it would raise. Subsequently, your office indicated an interest in understanding how it would affect cannabis retailers, and whether it would severely undermine this emerging industry. This brief memo summaries what we know about this question.

The tax will clearly have some adverse impact on the cannabis industry, but whether it would lead to an actual contraction depends on two main factors. Firstly, the industry's rate of growth since the legalization of recreational cannabis could potentially sustain profits, even in the face of a new Gross Receipts tax. This would particularly be true if legalization was not accompanied by new businesses entering the industry, as that would tend to increase competition and lower prices and profit margins.

Secondly, if the tax could be passed on to consumers in the form of higher prices, that would also protect the profit margins of retailers and other cannabis sellers.

Based on recent sales tax data, and existing research on cannabis consumption, we have some information that speaks to these two questions. We have recently obtained San Francisco sales tax filings for the first quarter of 2018, which covers the first three months that recreational cannabis sales were legal. The data shows a 25% growth in revenue for sellers of cannabis products, between the January-March of 2017, and January-March of 2018.

With this data, we are unable to determine how much of this 25% growth in revenue since January 1 is due to higher retail prices, and how much is due to higher consumption. The data does show that none of the sales occurred at businesses that started in 2018. This absence of new entrants into the market suggests that at least some of the growth in revenue is due to higher retail prices. It also seems unlikely that the market for recreational cannabis products has fully developed as of the first quarter of this year, and that more growth can be expected in the future. If just one-quarter of the observed growth in industry revenue in the past year is due to price increases, then the industry could readily absorb a 2-5% gross receipts tax without reducing effective prices below the 2017 level.

In terms of the ability of businesses to pass the tax on to consumers, the consensus from existing research into cannabis consumption seems to be that consumers are relatively price-insensitive. This generally means that some pass-through is feasible. While this tax would of course not apply in other cities, and this could make San Francisco sellers less competitive, many nearby cities are also either considering similar taxes, or restricting cannabis sales entirely. For this reason, we think the tax is unlikely to lead to a significant leakage of retail cannabis product sales. A conservative assumption would be that one-half of the tax would be passed-through to consumers, in the form of higher prices. This means that a 2-5% tax would feel a 1% – 2.5% tax to businesses.

To summarize, both because of the rapid growth of the industry, and the ability to pass some of the tax through to consumers, it seems unlikely that the proposed tax would lead to a contraction of the cannabis products industry in San Francisco.