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INDUSTRY REGULATION AND COMPETITION POLICY

Joint Venture: A Blueprint for Federal and Provincial Marijuana Policy

by
Anindya Sen

- The federal government has promised to legalize marijuana for recreational use. What should such a system look like? How should the federal and provincial governments divide their powers?
- In designing their regulatory policies, governments should prioritize achieving public health goals and eliminating black markets. The federal government should retain powers over health and safety regulations, and provinces should have the freedom to design their own distribution systems.
- Both levels of government should have the power to levy taxes on marijuana, with the federal government responsible for taxing manufacturers and imports, and provinces levying taxes at the retail level.

The federal government's recent throne speech confirmed its intention to proceed with the legalization and regulation of marijuana use, with appropriate checks. Despite four decades of federal reports calling for the decriminalization of marijuana,¹ the possession, sale, and consumption of marijuana remains a criminal offense under the *Controlled Drugs and Substances Act*. Limited access to marijuana has been permitted since 2013 for medical purposes. However,

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1 See, for example, the Le Dain Commission of 1972 and the 2002 Report of the Senate Special Committee on Illegal Drugs. Both recommended decriminalization.

the need for expansive policy change is undeniable. Despite the associated criminal penalties, Canada has one of the highest rates of cannabis use in the world: more than 40 percent of Canadians say they have used cannabis, with roughly 10 percent admitting usage during the past year. In contrast, no other illegal drug has a self-reported usage rate (during the past year) of more than 1 percent (Centre for Addiction and Mental Health 2014).

The objective of this report is to offer some possible directions to policymakers for an efficient and sustainable framework for legalized marijuana. Federal and provincial policymakers have a long list of policy design issues to consider, ranging from retail design to appropriate taxation. The focus of this report is on market issues and efficient taxation.² The key recommendations are:

- Responsibility for defining production and supply regulations and permissible limits of marijuana consumption should be with the federal government, for the same reason that Health Canada regulates other drugs and food safety. This would enable efficient monitoring and facilitate the implementation of policies that might be necessary to regulate supply. As with tobacco, the federal government should establish penalties for illegal trafficking and production, while provinces should have discretion over setting penalties for the purchase and sale of marijuana to minors.
- Provinces should design their own distribution systems with the primary objective being protecting public health and limiting black market sales, and the secondary objective being preventing uncompetitive concentration of suppliers.
- Both federal and provincial governments may levy sales taxes of various types on marijuana: the federal government should focus on suppliers and the provinces should focus on retailers.
- The federal government should consider pardoning individuals who have been convicted for illegal possession but who have otherwise not been convicted or charged for any other Criminal Code offence.

A Policy Framework for Canadian Marijuana Policy

The policy debate around marijuana in Canada should start with deciding on the specific goals of the new policy. This E-Brief takes the position that those goals should be first and foremost the protection of public health and the elimination of existing and future black markets. Other concerns, such as raising as much provincial and federal tax revenue as possible, should be considered secondary. For this reason, the lessons learned from regulating tobacco in Canada – which also seeks to protect public health and raise revenue – are instructive. The key side effect has been a thriving black market for tobacco products (Irvine and Sims 2012). Provincial and federal governments should strive to avoid a repeat of this experience with marijuana.

The Health Effects of Marijuana Consumption

The primary psychoactive chemical in marijuana is tetrahydrocannabinol (THC), which stimulates specific brain cell receptors that typically respond to other, natural THC-like chemicals in the brain. THC's over-activation of these parts of the brain is responsible for marijuana producing feelings of happiness and a pleasurable "high."

2 A discussion on international treaty amendments (e.g., Raaflaub 2004) is beyond the scope of this study.

Users may experience adverse side effects.³ Consistent and heavy marijuana use by teens also may have rather severe long-term impacts by impairing cognitive functioning and brain development.⁴

On the other hand, marijuana consumption is believed to have medical and therapeutic potential (often from chemical compounds in the drug other than THC), which is why physicians may authorize its use in Canada. However, there is not yet a consensus on the impacts of marijuana with respect to mitigating symptoms or side effects. This is probably because most studies are based on people who use marijuana for recreational and not medical purposes, resulting in a relevant knowledge base that is quite thin (Canadian Medical Association 2015). Since cannabis is a highly controlled substance in most countries, it is not typically available for medical research purposes.

The Legal Status of Marijuana in Canada

At present, the federal government regulates the production and supply of legal marijuana. Firms are permitted to produce marijuana for medical purposes after receiving a license from Health Canada. Licensed producers must follow stringent requirements regarding the safe and sanitary production of marijuana for medical purposes and are regularly inspected by Health Canada. Firms must also have a quality-assurance employee responsible for the implementation of compliance standards consistent with Health Canada-mandated good practices.⁵ More recently, the Federal Court struck down federal restrictions against medical marijuana patients who grow their own cannabis. The government has announced it will not seek an appeal, thus opening up another source of legal supply.

Penalties for Illegal Marijuana Production and Trafficking

Data from Cotter et al. (2015) reveal that two-thirds of police-reported drug offences in 2013 were driven by cannabis. Given that police reported incidents are usually the result of arrests, this figure, along with high levels of self-reported use relative to other drugs, suggests that resources spent on deterring marijuana use have not been effective. In this respect, the criminalization of marijuana may have resulted in a significant waste of police and judicial resources, and in fact has spawned a thriving underground industry that results in a significant loss in potential tax revenue to the federal and provincial governments.

The waste in police and judicial resources has been explicitly acknowledged by the Canadian Association of Police Chiefs (CAPC), which has recommended moving away from criminal charges and towards issuing tickets with fines for small-scale possession. The other benefit is that such an option would not result in a criminal record, which has very significant implications regarding future employment and travel. Former CAPC president

3 Please see Health Canada's page on the matter, <http://www.hc-sc.gc.ca/dhp-mps/marihuana/info/cons-eng.php> for further details.

4 A very nice non-technical summary of some these papers is available from 'Your kid's brain on pot: The real effects of marijuana on teens,' by Adriana Barton, published by the *Globe and Mail* on Thursday, Oct. 16, 2014 and available at <http://www.theglobeandmail.com/life/health-and-fitness/health/your-kids-brain-on-pot-the-real-effects-of-marijuana-on-teens/article21127612/>.

5 Please see <http://www.hc-sc.gc.ca/dhp-mps/marihuana/info/licencedproducer-producteurautorise/access-usage-eng.php> for further details.

Jim Chu has observed that some officers do not think that filing charges for simple possession is worth the effort, given the associated processing costs.⁶ This view is consistent with the notion that the vast majority of people charged for marijuana possession are otherwise law-abiding citizens (MacQueen 2013). The implication is that the current criminalization based approach does not have a strong deterrent effect as some police officers effectively turn a “blind-eye” (Gollom 2014).

One study estimates that police and judicial costs arising from enforcing cannabis possession laws in Canada during 2002 was roughly \$1.2 billion (Rehm et al. 2006). Marijuana legalization could initially result in an increase in consumption and a need for more police monitoring and enforcement, resulting in an increase in government spending. This discussion suggests that dropping charges against individuals for illegal possession who have no other Criminal Code convictions or charges, would save considerable government resources without other significant offsetting adverse spillovers. Similarly, the federal government should consider pardoning individuals who have been convicted for illegal possession but have not been convicted or charged for any other Criminal Code offence. Such individuals would benefit in terms of not experiencing possible travel restrictions and being able to access more labor market opportunities, resulting in economic benefits to governments as well.

Anecdotal evidence suggests that some drug dealers are also otherwise law-abiding citizens. In a limited but unique survey of nine drug dealers in the Kitchener-Waterloo region, Wyonch (2014) finds that eight had attended, or were currently attending, a post-secondary institution, with seven currently employed in legitimate occupations. Almost all the dealers surveyed viewed drug dealing as a temporary part-time occupation, and intended to exit with an upward swing in the economy and the availability of more rewarding legitimate jobs. Her estimates suggest that the dealers in her survey earned a bit more than they could have obtained working the same amount of hours at minimum wage. The returns appeared worthwhile to the drug dealers, who viewed the probability of apprehension as low, which is consistent with the above-discussed approach by some police officers. Finally, only one dealer in her survey was associated with a gang, with the rest working independently.

This is not to deny that organized crime participates in illegal marijuana distribution (Hager 2015). And analyses by Wynoch (2014) and Easton (2004) suggest significant profit margins throughout the supply and distribution chain, which might act as incentives for black market activity. Legalization can reduce these problems – if prices decline, say, or economies of scale grant producers higher profits. To discourage continued black-market activity after legalization, the federal government should not only define the legal amount of marijuana an individual may possess, but also maintain and elaborate penalties for illegal production and trafficking.

Regulating production and supply of marijuana should remain a federal responsibility (as it is currently for medical marijuana) to ensure uniform standards throughout the country. Federal control is also necessary in order to ensure a seamless coordination and regulation of national supply – especially important, given ongoing concerns about health effects of consistent marijuana use. The federal government should ensure that Health Canada has the ability to monitor production, inspect facilities, and take other measures to ensure a sufficient market supply of safe products.

6 ‘Canada Marijuana Laws: Criminal Charges for Small Amounts not Worth It, Police Chiefs Say,’ by the Canadian Press, posted on 08/20/2013 and available at http://www.huffingtonpost.ca/2013/08/20/canada-marijuana-laws-criminal-charges_n_3785957.html.

US states have taken different approaches to growing marijuana at home. Washington does not allow residents to grow marijuana at home for recreational use. Alaska, Colorado and Oregon have allowed residents to grow a small amount at home. Limits on home growth can ensure that consumers access products that meet regulatory standards in terms of quality and safety. However, recent judicial rulings in Canada allow individuals with medical needs to grow their own supply. If the federal government accepts this approach, such individuals should be subject to Criminal Code charges if their production is linked to illegal trafficking. Governments should be aware that any restrictions on people growing their own marijuana must strike a balance, likely to be enforced by courts, between the constitutional right to medical marijuana and the public safety of supply.⁷

A final Criminal Code offence that must be amended is impaired driving. Criminal Code impaired driving legislation should include drivers under the influence of marijuana. Currently, drivers in Colorado and Washington State are considered to be legally impaired from marijuana consumption if five or more nanograms of THC are found in their blood. However, there is a lack of scientific evidence on the exact levels of THC that can dangerously impair driving skills.

A final point is that judicial decisions are rapidly changing the policy landscape, and the federal government should move quickly in articulating a clear, transparent, and efficient framework.

How to Regulate Possession and Retail Distribution

Since a national standard would benefit provinces, the federal government should define the permissible limits of marijuana individuals may purchase and possess – likely 1 ounce (about 30 grams), as in Colorado – to ensure uniform standards across the country. It may be reasonable to only allow the sale of dried marijuana and cannabis infused oil at first – products that are currently permitted for medical consumption. These are products for which federal government expertise already exists. The regulation for sales of other marijuana-related goods (such as edible marijuana products) could be phased in later, again subject to the balance of legal access and public safety.

Retail Distribution

Provinces should seek a balance between effective retail distribution with appropriate product choice and ensuring safe and responsible consumption. We should expect differences of approach among provinces – a model that works well in Ontario might be different from one that works well in Prince Edward Island. In terms of retail delivery, there have been recommendations that government-owned liquor stores and/or independent pharmacies be permitted to sell marijuana. While these are familiar and established systems, stand-alone privately owned stores in Colorado, many of which resemble high-end boutiques with knowledgeable customer service and considerable product variety, seem to be successful.

One argument in favour of using government-owned liquor stores or pharmacies as retailers is that they already have strong age checks. However, age checks at independent retailers could be ensured through strong penalties for improper sale coupled with monitoring and inspection programs. The infrastructure for inspections of this kind already exists at the liquor control agencies in each province. Provincial governments may also be wary of making the necessary infrastructure and staff investments that would be required to sell marijuana at

⁷ This constitutional right is the outcome of the *Allard* case.

provincial liquor stores. For these reasons, stand-alone retail outlets specializing in marijuana sales may be a better option.

Finally, vertical integration should not be permitted – producers should not be allowed to have their own retail stores – at least at first. That would also likely mean that producers should not be able to mail marijuana directly to consumers. While vertical integration offers economies of scale and scope, maintaining separation during the early stages of legalized access could mitigate the risk of a small number of firms quickly dominating the market, to the detriment of consumers. The experience of alcohol retailing in Ontario shows the difficulty of breaking up large organizations in a heavily regulated market (Masson and Sen 2014) – it would be better to try to prevent their formation in the first place.

Penalties for Illegal Consumption Policy

As is the case for alcohol and tobacco, provinces should have the mandate to set penalties for the illegal possession of marijuana. Sensible provincial regulations would share similar principles. In Ontario, retailers of alcohol or tobacco must ensure that customers are of legal age by requiring photo identification, and must post age restrictions and health warnings. Retailers selling tobacco to underage youth face severe fines, with multiple offences resulting in a loss of license. Both these policies are suitable for marijuana regulation. As with tobacco, advertising and marketing intended to create demand and encourage consumption should be banned. Stand-alone retail shops, where they exist, should be permitted to advertise their location, but not specific products.

The Role of Medical Marijuana

The federal government currently regulates medical access to marijuana. Legalization for recreational purposes will have profound implications for the existing medical marijuana system (KPMG 2016). Although a single regulatory system for both medical and recreational use is conceivable, there are many reasons it may be impossible, at least in the near term:

- Levels of THC in medical-grade marijuana may need to be much higher than those desirable in recreational-grade products;
- The courts may grant medical marijuana users certain rights that do not apply to recreational users, such as exemption from taxation (as is the case for prescription drugs) or the freedom to grow their own supply; and
- The minimum age thresholds for people to access medical marijuana may need to be different from those for accessing recreational marijuana.

Initially, separate regulatory systems would give the responsible regulators scope to set rules based on the distinct issues each system faces. This approach could let existing dispensaries become licensed parts of the recreational system, rather than continue in a legal gray zone as part of the medical marijuana system in name but often not in practice. Finally, in consultation with physician groups, the federal government should review existing best practices and establish clear guidelines for the medical authorization of marijuana.

How to Regulate Pricing and Tax Marijuana

Recent research suggests that the demand for recreational marijuana among adults is relatively price inelastic, with a 1 percent increase in price being associated with a roughly 0.15 to 0.31 percent decline in consumption (Gravelle and Lowry 2014). This implies that tax revenue would be raised without significant efficiency costs.

Further, Easton (2004) suggests the possibility of significant price-cost margins and therefore a fertile field for commodity taxation. Colorado levies a number of taxes on marijuana.⁸ The challenge for policymakers is to set tax rates that do not foster an illicit market alongside legal sales. The basic principles are similar to those applied to taxing tobacco and alcohol. Higher commodity taxes – presuming they are passed on to consumers through higher retail prices – should help discourage youth consumption.⁹ They should also be able to offset and reduce some potential negative externalities created by consumption of marijuana, such as additional health costs, which are particularly relevant for a public healthcare system (Gravelle and Lowry 2014).

Both the federal and provincial governments should tax marijuana. One study has estimated the combined tax revenues would be as much as \$5 billion a year (Shenfeld 2016). Sharing tax revenues is efficient given the division in responsibilities. At the federal level, excise taxation based on grams of purchase (as with alcohol and tobacco) would be an effective way to raise revenue and discourage excessive consumption. However, some idea of market prices would be necessary in order to implement reasonable excise taxes. Since no such knowledge exists under the current law, the better initial option would be a sales tax based on a percentage of price. The other advantage of such *ad valorem* taxes is that they can be employed even when it is difficult to tax specific quantities.

The federal tax component should be levied directly on manufacturers. If imports become possible in the long term, importers should also face the federal tax – as with the GST – avoid unfairly burdening domestic producers. This would be easy to implement if the federal government continues to regulate and monitor suppliers. Provinces, on the other hand, should be allowed to enact a marijuana-specific sales tax at the retail level as well as apply any general provincial sales tax. This is the strategy followed by Colorado.

Each province has an alcohol/liquor control commission with the mandate of regulating the sale, service, and consumption of alcoholic beverages. Consistent with the priority placed on public health, the approach of these agencies should be to encourage firms to provide high-quality products and service as opposed to attracting customers through lower prices. The mandate could rest with a reorganized liquor/marijuana control commission. As in the case of alcohol, provinces could set a minimum price net of taxes, at a level that does not encourage an ongoing black market. Provincial price regulation also has the flexibility to accommodate discounts to consumers of medical marijuana, over and above commodity tax rebates.

These provincial commissions should work with federal agency or unit of Health Canada to ensure a close alignment between federal and provincial initiatives. As discussed, the federal agency would be responsible for supply-side issues and the provincial commissions for retail distribution. Given this distribution of responsibilities, it is reasonable that the federal agency have the mandate to regulate wholesale prices. This has parallels to how liquor pricing works in Ontario, with the Liquor Control Board of Ontario (LCBO) basically determining appropriate profit margins for wine and spirits through wholesale and retail price setting (Masson and Sen 2014).

8 In Colorado, recreational marijuana sales are subject to three different state taxes: (1) a 15 percent marijuana excise tax on the unprocessed product, (2) a 10 percent retail marijuana excise tax, and (3) a 2.9 percent general sales tax (Gravelle and Lowry 2014).

9 Ruggeri (2013) finds much higher price elasticities for marijuana consumption among youth relative to adults. In a similar vein, Sen, Arizumi, and Driambe (2010) obtain much higher smoking participation elasticities for younger teens relative to older peers.

Conclusion

From a policy perspective, the criminalization of marijuana consumption in Canada has not been a success. Self-reported consumption rates among adults and youths are high and black markets thrive. There is also evidence that some police officers are averse to charging individuals caught with modest amount of marijuana given the Criminal Code ramifications. Dropping charges for individuals without any other Criminal Code convictions and giving pardons to convicted individuals without any other charges or convictions would save significant resources as well as result in possible economic impacts through improved labour market opportunities.

The federal government should consider a market-driven approach that will allow for regulation and result in the supply of product that meets certain minimum thresholds for safety and quality. Provinces should have discretion in the design of retail access. Legalization and regulation will also result in potentially significant tax revenue, which is a rather important consideration given the prospects for long-term government revenue.

A smart division of responsibilities between the federal and provincial governments will help ensure that legalization of marijuana in Canada is a public policy success.

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Anindya Sen is Professor of Economics and Director of the Master of Public Service Program, University of Waterloo.

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