The New York Times

Finding Just the Right Tax Rate

By: Kim Rueben, Senior Fellow at the Urban Institute
May 22, 2013

Now that Washington and Colorado have legalized marijuana use, and other states are discussing it, the next question for voters and officials is what role taxes can play in moving marijuana out of the black market and into the light. Marijuana should be subject to the same taxes other goods face, and as with alcohol and cigarettes, we might impose an additional excise tax to recognize potential social costs. States could use these taxes to help balance their budgets.

But what's the right level? Set the rate too high, and people will keep buying weed from the guy on the street. Too low, and you're leaving revenue on the table and use might boom. The sweet spot would capture the premium currently enjoyed by suppliers without pushing buyers out of the legal market.

Other issues also crop up. Should we tax medical marijuana, especially in states with generous definitions of medical need? And what about home-grown product? Should you pay taxes on plants from your own garden?

Two 2010 studies from the Cato Institute and the Rand Corporation suggest how much money could be raised. Cato estimated that legalizing and taxing marijuana would increase state tax revenue by about $9 billion a year and reduce enforcement costs by about the same amount. Rand found that California could raise about $1.4 billion with a tax of $50 per ounce — roughly equal to the current taxes on cigarettes — but the actual revenue was highly uncertain. Alcohol and cigarettes offer good models to follow in regulating and taxing marijuana. But, as happens when cigarette taxes are increased, we should be ready for lower tax revenue than some forecasts.

Four factors affect the level of revenue an excise tax will raise — the tax rate, supply, demand and price. And each one affects the others. Legalization could expand the market, and lower taxes could increase demand. Increased pot use will also affect other taxes as users change their consumption of other goods. Alcohol revenue may decrease, for example, but think of the money junk food taxes could raise.

Kim Rueben is a senior fellow at the Urban Institute and directs the Tax Policy Center's state and local program.