

The 2017-18 Budget:

The Governor's Cannabis Proposals



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2017-18 BUDGET

EXECUTIVE SUMMARY

Regulation of Cannabis Has Been Evolving

Proposition 215 Legalized Medical Cannabis. In 1996, voters approved Proposition 215, which legalized the use of medical cannabis in California. However, the measure did not create a statutory framework for regulating or taxing it at the state or local level. In 2015, the Legislature passed the Medical Cannabis Regulation and Safety Act (MCRSA) to provide a statutory framework for the state to regulate medical cannabis. MCRSA (as amended by the 2016-17 budget package) requires specified state agencies—including the Department of Consumer Affairs (DCA), Department of Public Health (DPH), and California Department of Food and Agriculture (CDFA)—to regulate and license the medical cannabis industry.

Proposition 64 Legalized Nonmedical Cannabis 20 Years Later. In November 2016, voters approved Proposition 64, which legalizes the nonmedical use of cannabis. Proposition 64 also creates a statutory framework for the state to regulate nonmedical cannabis. Specifically, the measure requires state agencies to regulate and license the nonmedical cannabis industry and gives the agencies responsibilities similar to those established under MCRSA for medical cannabis. Proposition 64 also includes taxation provisions for both medical and nonmedical cannabis to be administered by the Board of Equalization (BOE).

Governor’s Budget Proposal

Budget Includes \$51 Million for Implementation Activities in 2017-18. The Governor’s budget proposes a total augmentation of \$51.4 million in 2017-18 across four departments (DCA, DPH, CDFA, and BOE) and about 190 positions across these departments to implement MCRSA and Proposition 64. The budget-year funding would mainly support (1) licensing and enforcement programs in DCA and CDFA, (2) development and implementation of licensing and “track and trace” information technology (IT) systems, and (3) tax administration activities in BOE. The budget also proposes a General Fund loan of up to \$62.7 million in 2017-18 to help fund these activities. Furthermore, the administration’s budget proposal includes funding and positions in future years, with funding decreasing to \$32.1 million and staffing increasing to 219 positions in 2020-21 and ongoing.

Governor Will Propose Bill to Align MCRSA and Proposition 64. While there are many similarities between the statutory frameworks of MCRSA and Proposition 64, there are also some key differences between the laws. The administration indicates it plans to propose budget trailer legislation that will align MCRSA and Proposition 64. At the time this analysis was prepared, the administration had not provided the Legislature with a draft of its proposed statutory changes.

LAO Assessment

The Legislature will face an important policy choice regarding the degree to which it wants to align the statutory frameworks of MCRSA and Proposition 64. We believe that it makes sense to

align the state's regulations. The Legislature's authority to amend regulatory structures depends on the nature of the changes the Legislature proposes to make. While the Legislature has significant authority to amend the regulatory structures for medical and nonmedical cannabis, its authority to modify MCRSA is broader than for Proposition 64. We note that decisions about this statutory alignment will be important in determining the level of staffing and other resources needed to implement the two measures.

We find that there is significant uncertainty regarding the resource needs for departments to regulate and tax medical and nonmedical cannabis. This lack of clarity stems from various factors including uncertainty regarding (1) the specific details of future regulations, (2) the number of applicants that will seek licenses from the state and the associated workload, (3) the ongoing costs for new IT systems, (4) when departments will be able to fully implement licensing programs, and (5) the future federal stance towards states legalizing cannabis use. We also find that the General Fund loan is larger than necessary to cover proposed expenditures and maintain a reasonable fund balance.

LAO Recommendations

We recommend the Legislature work with the administration to enact legislation to align the regulation of medical and nonmedical cannabis to the maximum extent possible. We further recommend that the Legislature make its decisions on the extent to which it wants to align the regulatory structures for medical and nonmedical cannabis before making its decisions on the Governor's requested funding and related positions. Doing so could better enable the Legislature to provide funding and staffing levels consistent with the ultimate regulatory structure.

In addition, given the high level of uncertainty regarding the resource needs that will be required in the future to regulate cannabis, we recommend taking a more incremental approach to budgeting for departments that are requesting resources in 2017-18. Under our proposed approach, the Legislature would fully fund departments' budget requests in 2017-18, but in some cases less funding would be provided in subsequent years. This incremental approach would allow the Legislature to re-evaluate resources as part of the 2018-19 budget process when additional information is available on actual workload. (To the extent that the Legislature enacts legislation to align MCRSA and Proposition 64, our recommended funding levels may need to be revised.) Once the Legislature determines its preferred level of funding for 2017-18, we recommend it tailor the size of the General Fund loan to meet those needs, without providing a bigger than necessary loan. We also recommend the Legislature require an annual report on implementation and outcomes. This type of report would both facilitate legislative oversight and help inform subsequent decisions for how best to implement future stages of the cannabis regulatory system.

INTRODUCTION

While voters legalized the use of medical cannabis in California in 1996, the state did not create a regulatory framework for medical cannabis until the Legislature approved the Medical Cannabis Regulation and Safety Act (MCRSA) in 2015. Prior to the act, most regulation of medical cannabis was left to local governments. In November of 2016, voters approved Proposition 64, which legalized and created a regulatory framework for the nonmedical use of cannabis.

In the coming year, the Legislature will face key choices about whether it wants to make statutory changes to bring the regulatory frameworks of MCRSA and Proposition 64 into greater alignment. Additionally, the Legislature will need to determine the staff and other resources to provide to the

various agencies charged with regulating and taxing the cannabis industry.

This report is intended to help guide the Legislature through these important decisions. We begin by providing background information on MCRSA, Proposition 64, and the funding that the Legislature provided in 2016-17 to begin implementation of MCRSA. Next, we summarize the Governor's 2017-18 budget proposals for four regulatory agencies with responsibility over cannabis. Finally, we assess the Governor's proposals and provide recommendations to the Legislature as it faces these key decisions about implementing a regulatory structure for medical and nonmedical cannabis.

BACKGROUND

Regulation of Medical Cannabis

Proposition 215 Legalized Medical Cannabis.

In 1996, voters approved Proposition 215, which legalized the use of medical cannabis in California. However, the measure did not create a statutory framework for regulating or taxing it at the state or local level. For most of the past two decades, medical cannabis has mainly been regulated and taxed by local governments through ordinances and permit requirements. While the state largely did not regulate medical cannabis, it did collect sales tax on these products. Local jurisdictions throughout the state have imposed restrictions on the cultivation and sale of medical cannabis or in some cases banned it entirely.

MCRSA Created the Regulatory Framework for Medical Cannabis. In 2015, the Legislature passed three state laws (Chapter 688 [AB 243, Wood], Chapter 689 [AB 266, Bonta],

and Chapter 719 [SB 643, McGuire])—known collectively as MCRSA—to provide a statutory framework for the state to regulate medical cannabis. As shown in Figure 1 (see next page), MCRSA (as amended by the 2016-17 budget package) requires specified state agencies to regulate the medical cannabis industry. For example, it gives the (1) Department of Consumer Affairs (DCA) the authority to license distributors, transporters, dispensaries, and testing laboratories; (2) California Department of Food and Agriculture (CDFA) the authority to license cultivators; and (3) Department of Public Health (DPH) the authority to license manufacturers of cannabis-related products (such as baked goods). (As we discuss later, the 2016-17 budget package transferred oversight over medical cannabis testing laboratories from DPH to DCA.) MCRSA established a target date of January 1, 2018 for accepting license applications.

Figure 1

Medical Cannabis Industry to Be Regulated by Multiple State Agencies Under MCRSA

Regulatory Agency	Primary Responsibilities
Department of Consumer Affairs (DCA)	<ul style="list-style-type: none"> • License distributors, transporters, dispensaries, and testing laboratories.^a
Department of Food and Agriculture	<ul style="list-style-type: none"> • License cultivators. • Implement track and trace information technology system.
Department of Public Health (DPH)	<ul style="list-style-type: none"> • License manufacturers.
Department of Fish and Wildlife	<ul style="list-style-type: none"> • Monitor and reduce environmental impacts of cultivation.
State Water Resources Control Board	<ul style="list-style-type: none"> • Regulate water-related impacts of cultivation.
Department of Pesticide Regulation	<ul style="list-style-type: none"> • Develop pesticide use guidelines for cultivation.

^a Responsibility for medical cannabis testing laboratories was transferred from DPH to DCA pursuant to Chapter 32 of 2016 (SB 837, Committee on Budget and Fiscal Review).
MCRSA = Medical Cannabis Regulation and Safety Act.

Regulatory agencies are also required to set standards for the labelling, quality testing, and packaging of medical cannabis products. MCRSA further requires the establishment of an information technology (IT) system that uniquely identifies cannabis plants and enables licensing authorities to track cannabis through the distribution chain (commonly referred to as “track and trace”). Additionally, MCRSA authorizes state departments to establish licensing fees to cover regulatory costs. These fees are to be deposited into a new state fund, the Marijuana Control Fund (MCF). MCRSA authorizes a \$10 million loan from the General Fund to the MCF to pay for initial activities associated with implementing the legislation.

2016-17 Budget Provided Resources to Implement MCRSA. The 2016-17 budget provided a total of \$33.1 million and 134 positions to six state departments in 2016-17 to implement MCRSA. Figure 2 summarizes the various proposals approved and their out-year effects. First, the budget included funding—primarily for DCA and DPH—to develop and implement regulations for different parts of the medical cannabis industry. Second, the budget included a total of \$8 million for DCA (\$6 million) and CDFA (\$2 million) to begin

development of licensing IT projects and for CDFA’s track and trace project. Third, the budget included resources for the Department of Fish and Wildlife and State Water Resources Control Board to reduce the environmental impacts of cannabis cultivation—such as on water quality and instream flows needed for fish spawning and migration. Fourth, the budget included an additional loan of \$19 million (in addition to the \$10 million authorized in MCRSA) from the General Fund to the MCF to cover costs associated with implementing MCRSA. (The Governor’s 2017-18 budget assumes an additional \$11.5 million loan in the current year to implement CDFA’s IT projects.)

The 2016-17 budget package also included legislation—Chapter 32 of 2016 (SB 837, Committee on Budget and Fiscal Review)—that made various statutory changes, including shifting authority to license medical cannabis laboratories from DPH to DCA.

Legalization and Regulation of Nonmedical Cannabis

Proposition 64 Legalized and Created a Regulatory Framework for Nonmedical Cannabis. In November of 2016, voters approved Proposition 64,

which legalizes the nonmedical use of cannabis. Under Proposition 64, adults 21 years of age or older can legally grow, possess, and use cannabis for nonmedical purposes, with certain restrictions.

Proposition 64 also creates a statutory framework for the state to regulate nonmedical cannabis. Specifically, the measure requires state agencies to regulate and license the nonmedical cannabis industry and gives them responsibilities similar to those established under MCRSA for medical cannabis. For example, for nonmedical cannabis, the measure:

- Authorizes CDFA to license cultivators.
- Charges DPH with licensing testing laboratories and manufacturers, consistent with MCRSA as originally adopted.
- Authorizes DCA to license distributors, retailers (similar to medical cannabis

dispensaries), and a new license category called microbusinesses. (Microbusinesses can engage in cultivation of less than 10,000 square feet, distribution, manufacturing, and retailing.)

- Expands CDFA’s track and trace IT system developed under MCRSA to include cannabis for nonmedical use.
- Requires each licensing agency to charge fees to cover its regulatory costs for nonmedical cannabis.
- Requires licensing agencies to begin issuing licenses by January 1, 2018.

Local Jurisdictions May Pass Ordinances to Regulate Nonmedical Cannabis. Proposition 64 states that the measure is not intended to limit the authority of local jurisdictions to adopt and enforce

Figure 2
Summary of Previously Authorized Funding and Positions for MCRSA Implementation

(Dollars in Millions)

Department	Funding Authorized			
	2015-16	2016-17	2017-18	2018-19 and ongoing
Consumer Affairs	\$1.6	\$9.7	\$4.0	\$0.5
Food and Agriculture	3.3	5.4	3.4	3.4
Public Health	0.5	3.9	2.5	5.7
Fish and Wildlife	—	7.7	5.8	5.8
State Water Resources Control Board	—	5.7	6.7	5.7
Pesticide Regulation	—	0.7	0.7	0.7
Totals	\$5.3	\$33.1	\$23.1	\$21.7
Department	Positions Authorized			
	2015-16	2016-17	2017-18	2018-19 and ongoing
Consumer Affairs	9.7	33.0	33.0	33.0
Food and Agriculture	5.5	18.0	18.0	18.0
Public Health	6.0	14.0	16.0	37.0
Fish and Wildlife	—	31.0	31.0	31.0
State Water Resources Control Board	—	35.0	35.0	35.0
Pesticide Regulation	—	3.0	3.0	3.0
Totals	21.2	134.0	136.0	157.0

MCRSA = Medical Cannabis Regulation and Safety Act.

their own local ordinances to regulate nonmedical cannabis businesses. This could include through local zoning and land use requirements, business license requirements, and other requirements.

Proposition 64 Sets Up Framework for Taxation. Proposition 64 includes taxation provisions for both medical and nonmedical cannabis to be administered by the Board of Equalization (BOE). Specifically, Proposition 64 imposes new excise taxes on (1) each ounce of cannabis grown and (2) the retail price of cannabis products sold. Additionally, the sale of medical cannabis, which had been subject to sales tax, is specifically exempted from part of that tax under Proposition 64. (Based on an alternative interpretation of this provision, BOE has implemented a full sales tax exemption.) The measure does not change local governments' existing ability to place other taxes on medical cannabis. Nor does it restrict their ability to tax nonmedical cannabis.

Revenues collected from the new state excise taxes will be deposited in a new state fund, the California Marijuana Tax Fund. Certain fines on businesses or individuals who violate regulations created under the measure will also be deposited into this fund. Monies in the fund will first be used to pay back certain state agencies for any cannabis regulatory costs not covered by license fees. A portion of the monies will then be allocated for specified purposes, such as for substance use disorder treatment and education.

Proposition 64 Authorizes Additional General Fund Loans. The measure authorizes General Fund loans of (1) up to \$30 million to the MCF for initial regulatory costs and (2) \$5 million in 2016-17 for the Department of Health Care Services to provide a public information campaign about the dangers of driving under the influence of cannabis and the repercussions of cannabis use by minors and pregnant women.

MCRSA and Proposition 64 Contain Some Differing Regulatory Requirements

Proposition 64 Statutory Framework Mirrors MCRSA in Many Areas. In many areas, the statutory framework established by Proposition 64 mirrors the one established by MCRSA to regulate medical cannabis. For example, as mentioned above, the measure gives state agencies similar roles to those assigned by MCRSA. Additionally, some of the licenses established under Proposition 64—such as those for small- and medium-size cultivators—are identical to the licenses established under MCRSA in terms of size limitations.

Some Key Differences Between MCRSA and Proposition 64. While there are many similarities between the statutory frameworks of MCRSA and Proposition 64, there are also some key differences between the laws. For example, there are some differences between the types of licenses they establish. Notably, Proposition 64 allows cultivation license types that permit cannabis grows (beginning January 1, 2023) larger than is allowable under MCRSA. As previously mentioned, Proposition 64 also creates the microbusiness license type.

Another key difference is in the degree to which entities can control multiple steps in the cultivation, distribution, and retail chain. For example, MCRSA generally limits a medical cannabis licensee to holding state licenses in no more than two categories. In contrast, Proposition 64 generally allows a licensee to hold licenses in more categories. Additionally, while both MCRSA and Proposition 64 have distributor license categories, distributor licensees under MCRSA generally are required to be independent entities that do not hold licenses in other license categories. In contrast, under Proposition 64, distributors generally can hold licenses in other license categories.

Some Changes to Proposition 64 Could Require Voter Approval. Proposition 64 allows for modifications to the framework of nonmedical cannabis regulation by a majority vote of the Legislature. (Modifications to Proposition 64’s framework for nonregulatory issues, such as taxation and criminal offenses, require a two-thirds vote of the Legislature.) Under the measure, any legislative changes must be consistent with the proposition’s stated intent and further its purposes. In some cases, it may be unclear whether a future change to Proposition 64 would meet this criterion and, therefore, could be enacted by the Legislature or would require voter approval.

recent years, the U.S. Department of Justice has chosen not to prosecute most cannabis users and businesses that follow state and local cannabis laws if those laws are consistent with federal priorities, such as preventing cannabis from being taken to other states. However, this federal policy could change in the future, which might affect the state’s ability to effectively implement regulations on cannabis. Additionally, because possession or use of cannabis is illegal under federal law, cannabis cultivators, manufacturers, and retailers and dispensaries typically do not have the same access to federally regulated financial services, such as banking, that other businesses have. Accordingly, cannabis businesses often rely heavily on cash transactions for their operations.

Cannabis Continues to Be Illegal Under Federal Law

Under federal law, it is illegal to possess or use cannabis, including for medical use. In

GOVERNOR’S PROPOSALS

Proposes \$51 Million in 2017-18 for Four Departments

As shown in Figure 3, the Governor’s budget proposes a total of \$51.4 million from MCF in 2017-18 across four departments: DCA, DPH, CDFA, and BOE. The budget also requests about 190 positions in 2017-18 across these departments. Figure 3 also shows how these funding and position levels are proposed to change over the next couple of years. We discuss

Figure 3
Summary of Governor’s 2017-18 Budget Proposals for Cannabis Implementation

(Dollars in Millions)

Department	2017-18	2018-19	2019-20	2020-21 and After
Consumer Affairs	\$22.5	\$30.9	\$30.4	\$30.2
Food and Agriculture	22.4	16.1	16.1	0.0
Board of Equalization ^a	5.4	2.7	2.1	2.0
Public Health	1.0	0.1	-0.2	-0.2
Totals	\$51.4	\$49.8	\$48.4	\$32.1

Positions				
Department	2017-18	2018-19	2019-20	2020-21 and After
Consumer Affairs	120.0	188.0	205.0	205.0
Food and Agriculture	50.8	60.0	60.0	0.0
Board of Equalization ^a	22.0	21.3	17.4	16.9
Public Health	-3.0	-3.0	-3.0	-3.0
Totals	189.8	266.3	279.4	218.9

^a Budget proposal also identified \$1.1 million and 1.9 positions for the Board of Equalization in 2016-17.

the proposals for each of these four departments in more detail below.

DCA's Proposal Funds Licensing, Enforcement, and IT (\$22.5 Million). As shown in Figure 3, the Governor's budget proposes a total of \$22.5 million for DCA in 2017-18, an amount that would grow to roughly \$30 million in out years. The budget year funding would support the following:

- **Licensing and Enforcement (\$17.4 Million).** DCA requests additional resources for licensing and enforcement of medical and nonmedical cannabis businesses, including dispensaries/retailers, microbusinesses, distributors, transporters, and testing laboratories. Specifically, the request would support 120 staff, relocation to a new headquarters office for DCA's Bureau of Marijuana Control (BMC), laboratory testing, and vehicles and equipment. Of these proposed positions, 50 are for enforcement, 35 are for licensing, and 35 are for various support functions. Out-year funding includes the establishment of a total of five field offices by 2019-20.
- **IT Implementation and Ongoing Maintenance (\$5.1 Million).** DCA also requests funding to continue to implement a licensing and enforcement IT project for medical cannabis that was initially approved in 2016-17, as well as expand the project to cover its nonmedical cannabis licensees. Funding is proposed to decrease to \$3.6 million beginning in 2018-19 to cover the ongoing operations and maintenance costs of the project.

CDFA's Proposal Funds Licensing and Track and Trace (\$22.4 Million). The Governor's budget proposes \$22.4 million for CDFA in 2017-18 to

continue to implement statutory requirements for cannabis cultivation licensing. This amount would decrease to \$16.1 million in 2018-19 and expire after 2019-20. The funding would support the following:

- **IT Implementation and Ongoing Maintenance (\$16.9 Million).** The budget requests \$16.9 million and 13 positions in 2017-18, decreasing to \$10.5 million in 2018-19 (expiring after 2019-20) to develop and support the cultivator licensing and track and trace IT projects. (Funding includes \$15.1 million in 2017-18 and \$8.7 million in 2018-19 and 2019-20 for contracted services for the cultivator licensing and track and trace systems.)
- **Licensing and Enforcement (\$5.5 Million).** The budget requests three-year limited-term funding of \$5.5 million and 34.3 permanent positions (growing to 40 positions in 2018-19) for license and enforcement activities related to cultivators, as well as one human resources support position.
- **Measurement Standards.** The budget requests 3.5 permanent positions in 2017-18, growing to 7 permanent positions in 2018-19, to enforce standards established by CDFA to ensure the accuracy of all weighing and measuring devices (such as scales) used in connection with the sale or distribution of cannabis. No funding is requested because revenues received from weighmaster license and registration fees are deposited into a continuously appropriated account within the Agriculture Fund to support these activities.

BOE's Proposal Funds Tax Administration Activities (\$5.4 Million). The Governor's budget

proposes \$5.4 million for BOE in 2017-18, decreasing to \$2 million annually beginning in 2020-21, to administer the new excise taxes required under Proposition 64. (The budget also assumes BOE spends \$1.1 million in the current year.) The funding would support drafting regulations; conducting outreach and education; registering taxpayers; and processing payments, returns, collections, and appeals. This proposal does not include funding for audits or enforcement, so it does not reflect the full ongoing cost of administering the new tax program.

DPH's Proposal Funds IT and Redirects Positions to BMC for Licensing of Testing Labs (\$1 Million). The Governor's budget proposes a net increase of \$1 million for DPH in 2017-18, an amount that would decrease in future years and be a net reduction to its budget of \$172,000 beginning in 2019-20. This includes the following changes:

- ***IT Implementation and Ongoing Maintenance (\$1.4 Million)***. The Governor's budget requests funding to design, configure, and maintain an IT application to process medical cannabis manufacturers' licenses. Although DPH will also be responsible for licensing nonmedical manufacturers, it has not requested funding to incorporate this responsibility into its IT application at this time.
- ***Transfer of Testing Laboratories (-\$0.4 Million)***. DPH also proposes to redirect three positions (and \$410,000) from DPH to DCA for licensing medical cannabis testing laboratories, consistent with the transfer of authority over these laboratories made in the 2016-17 budget package.

Other Provisions of the Administration's Cannabis Proposal

Anticipate Trailer Bill Language Will Be Forthcoming. The administration indicates it plans to propose 2017-18 budget trailer legislation that will align MCRSA and Proposition 64. However, at the time this analysis was prepared, the administration had not provided the Legislature with a draft of its proposed statutory changes. Nor has the administration indicated what specific changes it proposes to make to bring the two pieces of law into greater conformity. One exception to this is that the administration has indicated that it expects to propose moving the oversight of nonmedical testing laboratories from DPH to DCA, so that DCA has exclusive authority over testing laboratories. (This is consistent with the budget proposals discussed above.)

Budget Assumes Licensing Revenue but Not Excise Tax Revenue in 2017-18. The Governor projects a total of \$11.5 million in revenues to the MCF from various license fees in 2017-18. In contrast, the Governor's budget does not project that the state will receive any excise tax revenue in 2017-18. (The administration projects excise tax revenues to be over \$550 million in 2018-19, growing to over \$950 million in 2021-22.)

Governor Proposes General Fund Loan in 2017-18. The Governor's budget includes a General Fund loan to the MCF of up to \$62.7 million in 2017-18. (The administration's fund condition statement for MCF actually shows a higher budget-year loan amount of \$78.3 million.) This amount would be in addition to a total of \$45.5 million projected to be loaned from the General Fund in 2015-16 and 2016-17, including the loans authorized under MCRSA (\$10 million), the *2016-17 Budget Act* (\$30.5 million), and Proposition 64 (\$5 million).

LAO ASSESSMENT

The Legislature will face an important policy choice regarding the degree to which it wants to align the statutory frameworks of MCRSA and Proposition 64. Decisions about this statutory alignment will further be important in determining the level of staffing and other resources needed to implement the two measures. However, determining the level of resources needed in 2017-18 and beyond is complicated by the significant uncertainty caused by other issues, such as the future size of the cannabis industry and potential federal actions. In addition, we find that the proposed General Fund loan that would be used to fund the initial implementation costs is oversized based on the current cost estimates proposed by the administration.

Aligning MCRSA and Proposition 64 Makes Sense

In the 2017-18 budget summary, the Governor indicated that as the state moves forward with the regulation of both medical and nonmedical cannabis, one regulatory structure of cannabis activities across California is needed. Therefore, the administration will provide trailer bill language to align the state's cannabis regulations. The concept of aligning the state's regulations where feasible makes sense. The extent to which the regulatory structures for medical and nonmedical cannabis are aligned would affect the resources necessary for state departments to regulate the cannabis industry. Alignment would likely eliminate some duplicative regulatory functions, thereby reducing government costs to implement and operate the program. Alignment would also affect the regulated community. For example, a single regulatory system could reduce confusion amongst licensees regarding regulatory requirements, and it could

result in state agencies providing more efficient services to licensees by reducing complexity. Even with a unified regulatory structure, the Legislature could still maintain some differences between the regulation of medical and nonmedical cannabis where doing so makes sense. For example, the Legislature could consider whether it wants to allow higher potency limits for medical cannabis.

Legislature's Authority to Amend Regulatory Structures Depends on Nature of Changes. As described above, the Governor indicates that he will propose changes to the regulatory structures for MCRSA and Proposition 64 to better align the two systems. Under the California Constitution, the Legislature is prohibited from making changes to statutes added by a voter-approved initiative (such as Propositions 215 and 64) unless the initiative includes provisions specifically allowing legislative changes. Otherwise, those changes would need to be submitted to voters.

While both measures provide the Legislature with significant authority to amend the regulatory structures for medical and nonmedical cannabis, its authority to modify MCRSA is broader than for Proposition 64. Because Proposition 215 did not establish a regulatory structure for medical cannabis, the Legislature has broad latitude to decide all aspects of how medical cannabis will be regulated without having to submit those changes to voters. Thus, the Legislature is not limited by Proposition 215 in enacting changes to MCRSA's regulatory structure to align it with the provisions of Proposition 64.

In contrast to Proposition 215, Proposition 64 establishes a regulatory structure for nonmedical cannabis. However, Proposition 64 also explicitly allows the Legislature to amend the measure. Under the measure's provisions, changes would

require a majority vote, a two-thirds vote, or voter approval depending on the nature of the changes. For example, legislative changes to the regulatory structure for nonmedical cannabis are permitted with a majority vote as long as they conform with the stated intent of the measure. Changes to the regulatory structure not deemed to be in conformance with the measure's intent would have to be approved by voters.

Legislature's Decisions About Aligning Proposition 64 and MCRSA Will Affect Resource Needs. The Legislature's ultimate decisions about aligning the regulatory structures for medical and nonmedical cannabis will affect the level of resources state agencies need to implement their programs. For example, DCA indicates that its IT proposal cost estimates are based on current law with two regulatory systems. It further indicates that IT costs could decline if changes in the law resulted in a consolidated regulatory framework. Additionally, we expect that the number of entities that seek licenses and therefore licensing workload could be affected by the specifics of the regulatory structure that is ultimately selected. For instance, the number of entities seeking distributor licenses would likely be affected by whether the regulatory structure generally allows these licenses to be held along with other license types or not. The resulting number of licensees would, in turn, have effects on the level of resources required to regulate those licensees. Once the Legislature makes key decisions about which requirements of MCRSA and Proposition 64 to align, it will be in a better position to assess the resource needs of the state agencies that will be implementing the regulatory scheme.

Significant Uncertainty Regarding Resource Needs and Timing

We find that there is significant uncertainty regarding the resources that will be needed

to regulate and tax medical and nonmedical cannabis. This lack of clarity stems from various factors, including uncertainty in the (1) regulatory decisions regarding medical and nonmedical cannabis, (2) number of licensees and associated workload related to this market that has not been previously regulated by the state, (3) ongoing needs for funding new IT systems, (4) timing of implementation, and (5) federal stance on cannabis.

Regulatory Decisions Likely to Affect Resource Needs. Various departments—including DCA, DPH, and CDFR—are in the process of drafting regulations to implement MCRSA and Proposition 64. These three departments have indicated that they anticipate that they will complete their medical cannabis regulations in the spring and their nonmedical cannabis regulations later in the year.

Some of the decisions that are made in the regulations could have implications on the level of funding and positions needed to implement the regulations in the future. This is because the regulations will specify what types of information—such as information related to criminal history, ownership, or residency—have to be provided, reviewed, and verified by the regulating agencies. The more information that is required will probably result in a greater level of licensing staff needed for these reviews.

Licensing Workload Uncertain Given New Regulatory Program. The state has not regulated the medical cannabis industry in the past, and nonmedical cannabis has operated on the black market. Therefore, there is a lack of reliable information on the current size of the cannabis industry in California, and tremendous uncertainty about the number of licensees that will seek to be regulated by state agencies in the future. Given this uncertainty, implementing agencies have taken different approaches to estimating the size of the cannabis industry, resulting in workload

projections based on notably different estimates of the licensee population. For example, BOE's budget request assumes that there will be 1,700 dispensaries/retailers remitting taxes (based on a study performed in 2014), while DCA's request assumes there will be 6,000 dispensaries/retailers (based on extrapolations from Colorado's experience with cannabis legalization). While there could be different reasonable approaches to estimating the licensee population given the lack of reliable information, ideally all implementing departments should be operating under similar assumptions for the purposes of crafting the budget.

Furthermore, the assumptions about licensee populations used by departments has a large effect on the licensing, enforcement, and tax administration resources requested. Thus, if departments' estimates of future licensee populations turn out to be incorrect, there could be a significant impact on their resource needs.

There is also uncertainty about other aspects of the workload costs associated with each licensee. For example, DCA estimates it will conduct enforcement-related investigations on 10 percent of its licensees that require testing of cannabis products. The request assumes that it will cost \$1,000 to test each cannabis sample. This cost estimate for testing is based on information from the University of California, Davis. However, private testing labs reportedly charge much less than this—often less than a couple hundred dollars—so it is unclear what the costs will be for this testing.

The uncertainties about the number of licensees and associated workload become even greater in out years as the share of new versus renewal applications would likely change compared to the initial years of regulation. We would expect renewal workload to be lower than for new applications. However, DCA's budget request does

not account for this likely change. Accordingly, we find that there is even greater uncertainty regarding the DCA's anticipated resource needs in future years.

Amount of Resources Necessary for IT Systems Uncertain Given Early Project Stage. There are also uncertainties regarding the costs associated with creating the IT systems to regulate this new industry. Implementing departments are still in the relatively early stages of IT project development and implementation. For example, DCA has not yet provided the California Department of Technology or the Legislature with the alternatives analysis—including cost-benefit analyses—of their project, information that is critical in informing the Legislature on the merits of the proposed approach. Additionally, DCA and CDEFA have not yet completed the selection of vendors to customize their software solutions (known as a “Systems Integrators”). We expect that future-year funding needs for the projects will become more certain as they proceed.

We further note that the specific ongoing resources requested by DCA for its IT system appear inflated. For example, the department has identified \$1.8 million in ongoing costs for system integration. However, we would expect that these expenses should decline after the initial development is complete.

Timing of Expenditures Uncertain Given Ambitious Timeline. January 1, 2018 is an ambitious timeline to begin accepting and issuing licenses because departments must conduct environmental reviews, finalize regulations and guidelines, have staff in place, and set up IT systems in a shorter period of time than is normal for such a large and complex new regulatory program. If there are delays, for example, with environmental reviews, it could make it very difficult to meet the January 1, 2018 implementation date. Moreover, if the Legislature chooses to modify the regulatory

requirements under MCRSA or Proposition 64, this could require departments to restart some regulatory development activities, thereby affecting their timelines for finalizing regulations. Thus, there is some uncertainty as to the extent to which departments will be able to begin issuing all new licenses by January 1, 2018. (This uncertainty is reflected in the administration’s estimate that there will be no excise tax revenue from cannabis in 2017-18.) The timing of issuing new licenses will, in turn, affect the amount of resources needed in the budget year. For example, if licensing entities are significantly delayed in issuing new licenses, there may be limited tax collections and reduced need for BOE tax administration staff in the budget year.

Federal Enforcement of Cannabis Laws

Uncertain. Existing federal policy could change in the future. If the federal government decides to begin enforcing federal law more stringently, this could affect the state’s ability to effectively implement regulations on cannabis. If operation of medical and/or nonmedical cannabis businesses were no longer allowed by the federal government, this would decrease the level of resources needed by all of the state licensing agencies involved. The coming months may bring some additional clarity regarding whether recent leadership changes at the federal level will bring any modifications to federal policies regarding cannabis enforcement.

Departments Have Taken Various

Approaches to Requests Given Uncertainty.

Notably, departments have taken different approaches to crafting their budget proposals in light of uncertainty about future workloads. Some departments used more conservative estimates of licensee populations and the resulting workload, and in some cases, departments took an incremental approach of phasing in funding over a couple of years. For example, DCA phased in its funding request over a three-year period. DCA further requests the majority of its resources

on an ongoing basis. In contrast, CDFA and BOE have generally taken more modest approaches to requesting resources. Specifically, CDFA does not propose significant additional resources in 2018-19 beyond what it requests for 2017-18, and it requests that all of its funding be approved on a three-year limited-term basis. Additionally, BOE’s request (1) assumes relatively modest workload (assuming a retailer population of only 1,700, as discussed above), (2) seeks less funding than its workload justifications would support in many cases, and (3) proposes limited-term funding for over 20 percent of its positions and almost two-thirds of its overall request. In our view, the more conservative and incremental approaches taken by CDFA and BOE are reasonable given the significant uncertainty surrounding future resource needs.

General Fund Loan Amount Needed Will Depend on Amount of Funding Approved

The administration proposes a General Fund loan to the MCF of up to \$62.7 million in 2017-18. As shown in Figure 4, once the starting fund balance and anticipated expenditures and licensing revenues are taken into account, this General Fund loan would result in an estimated fund balance at the end of the fiscal year of \$29 million, which is likely to be higher than necessary. Even if the state did not generate any license revenues in 2017-18,

Figure 4
Marijuana Control Fund (MCF) Fund Condition

(In Millions)

	2016-17	2017-18
Resources		
Beginning balance	\$6.9	\$17.5
License revenues	—	11.5
General Fund loans	35.5	62.7 ^a
Expenditures	-24.8	-62.7
Fund Balance	\$17.5	\$29.0

^a Based on budget bill. Administration’s fund condition statement for MCF shows a higher loan amount of \$78.3 million.

the MCF would have a projected balance in the fund of \$17.5 million, almost 30 percent higher than total estimated expenditures in 2017-18. The administration indicates that the high loan amount was to provide financial flexibility in the event that it decided to propose additional expenditures in

the future (such as for increased IT costs). In our view, it is reasonable for the General Fund loan to be of an amount that provides sufficient funding for proposals in the event that revenues are lower than anticipated. Beyond that, a large fund balance is not likely to be needed.

LAO RECOMMENDATIONS

Create One Regulatory Structure of Cannabis Activities

We recommend the Legislature work with the administration to enact legislation to align the regulation of medical and nonmedical cannabis to the maximum extent possible. The administration's approach of creating one regulatory structure of cannabis activities makes sense because it would likely eliminate some duplicative regulatory functions and reduce confusion among licensees. For example, there are currently two departments (DCA and DPH) charged with regulating testing laboratories. In our view, it makes more sense for a single department to perform this licensing function. In addition, licensees that want to participate in both medical and nonmedical activities could face confusion in an unaligned system because they would face different rules under the two sets of regulations.

Make These Policy Choices Before Making Budget Decisions. To the extent possible, before making its decisions on the Governor's requested funding and related positions, we recommend that the Legislature make its decisions on the extent to which it wants to modify the provisions of MCRSA and Proposition 64 to better align the regulatory structures for medical and nonmedical cannabis. Doing so could better enable the Legislature to provide the funding and staffing levels consistent with the ultimate regulatory structure. In addition,

over the next few months, the Legislature could get more information that will assist it in making its budgeting decisions, such as progress in implementing regulations and IT systems, as well as potentially some additional clarity on the federal government's approach to cannabis.

Limit Funding Provided for Out-Years

Given the high level of uncertainty regarding the resource needs that will be required in the future to regulate cannabis, we recommend taking a more incremental approach to budgeting for these departments by authorizing certain budget requests on a limited-term basis. This approach is reflected in Figure 5, which compares the Governor's proposed funding amounts to our recommended funding amounts. (In some cases, our recommended funding amounts reflect our estimates based on available information.) Under our proposed approach, departments would be budgeted as proposed in 2017-18, but in some cases receive less funding than requested in subsequent years. This incremental approach would allow the Legislature to re-evaluate resources as part of the 2018-19 budget process when additional information is available on actual workload. In a few cases—such as for BOE and CDFA's non-IT-related request—we recommend providing the multiyear funding requested because we either find it to be critical or the department's estimates are

clearly based on conservative assumptions. (We note that these recommendations assume that the current statutory framework remains in place and might need to be revised if the Legislature enacts legislation to align MCRSA and Proposition 64.)

The specific proposals that we recommend modifying to be limited term are described below.

- All IT-Related Funding.** We recommend approving all of the IT funding requests for 2017-18, but reject proposed funding in the out years. Next year, we anticipate that better information will be available to assess future IT costs because departments will have selected systems integrators, and the new IT systems should be largely complete. At that point, departments will have a better sense of additional work needed to ensure the IT systems have the desired functionality, as well as the necessary costs to operate and maintain their IT systems. This approach would provide the additional benefit of giving the Legislature an opportunity to use future budget hearings to oversee the projects and ensure that they remain on-track. We note that this oversight is particularly important for DCA given its recent challenges with successfully managing the BreZze IT project.

- Share of DCA’s 2017-18 Licensing and Testing Costs.** We recommend approving a portion of the funding requested by DCA in 2017-18 on a two-year limited-term basis. Given DCA’s relatively high assumption about the number of licensees in 2017-18, we recommend making a share—20 percent—of its licensing and support staff funding limited term. This would be consistent with the share of its enforcement staff that DCA proposes to fund on a limited-term basis. Furthermore, while DCA will very likely have ongoing enforcement-related testing costs, we recommend funding these costs on a two-year limited-term basis rather than an ongoing basis at this time given the level of uncertainty regarding future-year costs.
- None of DCA’s Licensing and Enforcement Out-Year Requests.** We also recommend denying requests for future increases in DCA’s licensing and enforcement request at this time. While the department might need to increase its licensing and enforcement activities over time (for example, to staff the new proposed field offices), it is too early to tell what DCA’s ongoing level of resource needs will be.

Figure 5
Summary of Governor’s and LAO’s Recommendations for Funding Cannabis Implementation

(In Millions)

Department	2017-18		2018-19		2019-20		2020-21 and After	
	Governor	LAO	Governor	LAO	Governor	LAO	Governor	LAO
Consumer Affairs	\$22.5	\$22.5	\$30.9	\$18.6	\$30.4	\$13.3	\$30.2	\$13.3
Food and Agriculture	22.4	22.4	16.1	5.5	16.1	5.5	—	—
Board of Equalization	5.4	5.4	2.7	2.7	2.1	2.1	2.0	2.0
Public Health	1.0	1.0	0.1	-0.4	-0.2	-0.4	-0.2	-0.4
Totals	\$51.4	\$51.4	\$49.8	\$26.4	\$48.4	\$20.5	\$32.1	\$14.9

Reduce General Fund Loan to Reflect Actual Budget Actions

Once the Legislature determines its preferred level of funding for 2017-18, we recommend it tailor the size of the General Fund loan provided to the MCF to meet those needs, without providing a bigger than necessary loan. For example, if the Legislature were to approve the Governor's current requests for 2017-18, we would recommend that the Legislature reduce the Governor's proposed General Fund loan by \$17.5 million—from \$62.7 million to \$45.2 million. This would leave an estimated reserve in the MCF of \$11.5 million, which would provide sufficient funds to cover all projected costs even if the state collected lower license revenues than projected in 2017-18.

Require Additional Reporting on Implementation of Cannabis Regulatory Programs

Annual Report on Implementation and Outcomes. We recommend the Legislature enact legislation to require the administration to submit a report by April 1 of each year on the implementation of MCRSA and Proposition 64. This report should summarize department activities and program outcomes. Specifically, we recommend that this report include data on (1) the activities each regulatory department expects to complete in the coming year, such as the number of licenses that will be issued and the number of inspections that will be performed; (2) the actual number of these activities completed in the past year; and (3) program outcomes. Outcomes reporting should include measurable performance

data to indicate how well programs are functioning. This might include, for example, the average amount of time to process licenses and to complete formal discipline actions against licensees. In our view, this requirement would not constitute much of an administrative burden for administering departments because the information contained in the report would be data that departments should be collecting anyway.

We recommend that this report be required for each of the next five years, at which time we would expect that the programs would be fully implemented. Until that time, however, such a report would provide the Legislature and stakeholders with a consolidated, single source of information on the implementation of MCRSA and Proposition 64. This type of report would both facilitate legislative oversight and help inform subsequent decisions for how best to implement future stages of the cannabis regulatory system. Moreover, such information could help shape future cannabis policy by providing information that would illuminate how well different aspects of the programs are working.

Quarterly Briefings on IT Projects. We recommend the Legislature adopt budget bill language to require the departments implementing new cannabis-related IT projects—DCA, CDFSA, and DPH—to provide legislative staff with quarterly briefings on the status of these projects. It is important for the Legislature to have the information necessary to monitor the projects given the implementation challenges inherent in developing and implementing large new IT projects in an expedited time frame.

LAO Publications

This report was prepared by Helen Kerstein and Shawn Martin—with assistance from Seth Kerstein and Sonja Petek—and reviewed by Brian Brown. The Legislative Analyst’s Office (LAO) is a nonpartisan office that provides fiscal and policy information and advice to the Legislature.

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