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DO CAPITALIZATION REQUIREMENTS MAKE SENSE FOR THE CANNABIS INDUSTRY?

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As marijuana is decriminalized and businesses form to take advantage of the opportunity, some states, such as Michigan¹ and Connecticut,² are imposing on them capital reserve requirements similar to those required of insurance companies and banks. To give an idea of the numbers, Michigan will require \$300,000 for a dispensary, \$500,000 for a grower of up to 1,500 plants, \$300,000 for a processing facility, \$200,000 for a secure transporter, and \$200,000 for a testing facility. For the cannabis industry, capitalization requirements are likely to be counterproductive.

Banks and insurance companies have capital reserves because they have substantial liabilities and may be required to make payments to counterparties (depositors, insurance claimants) at any time. A significant decline in the value of bank assets or increase in insurance liabilities due to unforeseeable events (such as a recession or natural disaster) could otherwise result in the businesses becoming insolvent and thereby unable to honor commitments to a large number of counterparties, with potentially widespread consequences for consumers, businesses and the economy. The capital reserve creates a cushion against such eventualities, reducing the likelihood of insolvency. Capital reserve requirements are intended to counter incentives for the management of these companies to engage in excessively risky lending and underwriting practices that can generate outsize bonuses for those managers but also increase the negative effects of unforeseen events. Nonetheless, many banks³ and insurance⁴ companies still fail.

Most marijuana businesses are not structured in the same way as banks or insurance companies. Growers, wholesalers and retailers are more like their analogues in the food industry, operating as part of a supply chain to deliver a final retail product to consumers. As such, their liabilities tend to be short term and limited to a small number of others in the supply chain.

While firms in the food supply chain may be adversely affected by economic downturns, disintermediation and other forms of innovation, and changes in consumer purchasing habits, the consequences are usually felt primarily by investors in those firms, not by consumers or the wider economy. As such, they are not subject to capital reserve requirements.

Capitalization requirements are not well suited to help marijuana businesses, despite the claims of proponents. Consider what might happen if some unforeseen event, innovation, or change in tastes dramatically reduces demand for marijuana, or eliminates the need for one step in the supply chain. In the absence of a capital reserve, there will be consolidation and some businesses will fail. The scaled-down industry will then be in a better position to thrive in the long-term. However, if businesses are forced to have a capital reserve, the consequences could be more severe because in addition to the normal costs of doing business, the firms will be forced to hold additional assets that they do not require. In this way, capitalization reserve requirements would likely accelerate the demise of existing businesses, including some that might otherwise have thrived.

Meanwhile, during times of growth, capitalization requirements force businesses to save, when they should instead be investing. Firms⁵ that survive and thrive⁶ in the modern economy are those that make the right investments, offer competitive prices, high quality services, and effective management, all of which lead to solid returns for investors. Governments do not know how best to allocate capital and should not seek to control such decisions. There is scant business or economic logic to show that legally imposed, industry-

wide capitalization requirements will increase the “financial viability” of any particular firm when competing in such landscapes.

So if capitalization requirements don't boost the odds of business survival, what do they do for the marijuana business? Unfortunately, these laws potentially undermine two major goals of legalization—eliminating the black market and providing legal economic opportunity in the marijuana industry.

First, as is currently happening in California,⁷ legal retail prices subject to strict regulation and taxation schemes remain higher than unregulated street prices. Capitalization requirements risk adding to that deficit by raising the retail price of marijuana via increasing the total cost of doing business. Consumers will go where prices are cheaper: the black market.

Second, legalizing marijuana was intended to create new economic opportunities, particularly for those affected by prohibition if possible. Capitalizations requirements represent a large financial barrier to entrepreneurs seeking to enter the industry.

One Michigan resident planning to buy a license thinks⁸ the state just wants to “weed out some of the bad actors” (no pun intended, apparently). If “bad actors” are former illegal marijuana dealers who now theoretically could open legal operations, the state does not fulfill its goal of creating economic opportunities for those affected by prohibition by *de facto* keeping these people out of a legal industry with unnecessarily high capital requirements. Even if they weren't former dealers, small business owners without lots of capital deserve the opportunity to enter the industry without burdensome requirements that do not fulfill their intended purpose.

CONCLUSION

Policymakers who are serious about the positive fiscal, economic and social impact of marijuana legalization should recognize that capitalization requirements risk some of those benefits by unnecessarily raising the retail price of marijuana and the cost of doing business. And they do this while providing no necessary protections to the industry or consumers, as there is little to no economic logic as to why these requirements would help the marijuana industry survive or grow.



For more on cannabis policy, see reason.org/topics/drugpolicy



ENDNOTES

- ¹ Gray, Kathleen. “Despite Complaints, State Sticks With Pricey Asset Requirements For Medical Pot Licenses.” Detroit Free Press. October, 2017. <https://www.freep.com/story/news/local/michigan/2017/11/08/state-asset-requirements-medical-pot-licenses/843392001/>
- ² Gunelius, Susan. “The High Cost of Marijuana Licenses in Connecticut.” Cannabiz Media. December, 2015. <https://cannabiz.media/the-high-cost-of-marijuana-licenses-in-connecticut/>
- ³ Federal Deposit Insurance Corporation. Failed Bank List. October, 2000. <https://www.fdic.gov/bank/individual/failed/banklist.html>
- ⁴ National Organization of Life and Health Insurance Guaranty Associations. <https://www.nolhga.com/factsandfigures/main.cfm/location/insolvencies>
- ⁵ Andrews, Dan. “Frontier Firms, Technology, Diffusion and Public Policy: Microevidence from OECD Countries.” 2015. <https://www.oecd.org/eco/growth/Frontier-Firms-Technology-Diffusion-and-Public-Policy-Micro-Evidence-from-OECD-Countries.pdf>
- ⁶ Katz, Lawrence. “The Fall of Labor Share and the Rise of Superstar Firms.” MIT. NBER. May 2017. <https://economics.mit.edu/files/12979>
- ⁷ Harrison, Matt. “California’s High Taxes and Regulation Mean Black Market for Marijuana is Still Appealing.” *The Orange County Register*. April, 2018. <https://www.ocregister.com/2018/04/05/californias-high-taxes-and-regulation-mean-black-market-for-marijuana-is-still-appealing/>
- ⁸ Gray. “Despite Complaints, State Sticks With Pricey Asset Requirements For Medical Pot Licenses.”