Getting Cannabis Legalization Right in Hawaii

By Michelle Minton and Geoffrey Lawrence

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Introduction

Hawaii may be poised to become the 25th state to legalize the recreational use of cannabis for adults aged 21 and over. Nearly 90 percent of Hawaii residents supported full legalization of cannabis for adult use in a January 2023 poll conducted by the Hawaii Cannabis Industry Association.[1] Gov. Josh Green has said he would sign a legalization bill if one is delivered to his desk—marking a significant departure from former Gov. Dave Ige, who left office in 2023.[2]

During the 2023 legislative session, lawmakers considered proposals to legalize adult-use cannabis. One of these bills was passed by the state Senate but was not heard in the state House of Representatives.

Between the conclusion of the 2023 legislative session and the convening of the 2024 session, Attorney General Anne Lopez met with key lawmakers to develop proposed language for a legalization bill that could gain the support of the administration and the legislature.[3] This working group produced a 315-page draft bill, introduced in each chamber of the legislature as House Bill 2600 and Senate Bill 3335 respectively. Despite having played a key role in drafting the legislation, however, the attorney general's office testified in early hearings that it "does not support the legalization of adult-use cannabis," although the current legislation is a "good faith effort toward protecting the public welfare and is an improvement on previous bills that have been heard by the legislature."[4]

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[1] "Poll: 86% of adult Hawaii residents favor legalizing recreational marijuana," KITV, 31 Jan. 2023, www.kitv.com/news/business/poll-86-of-adult-hawaii-residents-favor-legalizing-recreational-marijuana/article_e4ae2a70-a1c8-11ed-bf4c-fb0e58d3d885.html.

[2] Ben Adlin, "Hawaii Governor Says Legalizing Marijuana Can 'Blunt' Negative Effects of Other 'Horrible' Drugs," Marijuana Moment, February 8, 2024, https://www.marijuanamoment.net/hawaii-governor-says-legalizing-marijuana-can-blunt-negative-effects-of-other-horrible-drugs/.

[3] Office of Governor Josh Green, "AG News Release: Department of the Attorney General Provides Key Legislators with Report Regarding Cannabis Legalization," January 5, 2024 Press Release," https://governor.hawaii.gov/newsroom/ag-news-release-department-of-the-attorney-general-provides-key-legislators-with-report-regarding-cannabis-legalization/.

[4] Kyle Jaeger, "Hawaii Senators Approve Marijuana Legalization Bill, as State Agencies Undermine Pro-Reform Governor with Opposition Testimony," February 13, 2024, https://www.marijuanamoment.net/hawaii-senators-approve-marijuana-legalization-bill-as-state-agencies-undermine-pro-reform-governor-with-opposition-testimony/.

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Reason Foundation has offered recommendations for improvement to successive cannabis legalization proposals in Hawaii.[5] Several of these recommendations were adopted by Senate committees during the 2023 legislative session. Reason Foundation has also reviewed the provisions of Senate Bill 3335, as amended, and submitted recommendations for improvement.[6]

This brief goes beyond those recommendations and provides key background on the Hawaiian marijuana market and considerations for market structure and tax policy. Cannabis consumers are price sensitive and have many options for purchasing cannabis. Prices and availability within the licensed cannabis industry can strongly influence the decisions of both producers and consumers to either participate within this industry or to engage in illicit cannabis activity. In California, high taxes and a lack of legal sellers resulted in roughly two-thirds of cannabis demand being satisfied by the illicit market six years after legalization. The prevalence of illicit sales also negatively affects state tax collections, as only a minority of cannabis transactions are legal and subject to taxation.[7] California has recently begun to take corrective action to lower the tax-induced price disparity between licensed and illicit goods,[8] but Hawaiian lawmakers can circumvent the rise of large illicit markets with an appropriate market design.

Background on Hawaii's Cannabis Medical Market

Hawaii legalized medical cannabis in 2000, becoming the first state to do so through the legislative process as opposed to a ballot measure. This original law only protected the rights of qualifying patients or their designated caregivers to cultivate or possess up to 10 cannabis plants but did not provide for a system of commercial production or sales.[9] In 2015, lawmakers passed Act 241, which authorized a commercial market regulated by the state health department. Act 241 directed the state health department to issue eight dispensary licenses statewide. Among these licenses, three would be made available in Honolulu County, while two each would be available in Hawaii and Maui counties, and one would be available in Kauai County. Each licensee would be permitted to operate up to three retail

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[5] Geoffrey Lawrence, "Comments and Analysis of Legal Marijuana Proposals and Regulation in Hawaii's SB 375 and SB 669," Reason Foundation testimony, March 1, 2023, https://reason.org/testimony/comments-and-analysis-of-legal-marijuana-proposals-and-regulation-in-hawaiis-sb-375-and-sb-669/.
[6] Geoffrey Lawrence, "Senate Bill 3335 (SD 2): Analysis and Recommended Changes," Reason Foundation testimony, March 13, 2024, https://reason.org/testimony/hawaii-senate-bill-3335-has-some-cannabis-protections-but-needs-improvements/.
[7] Geoffrey Lawrence, "The Impact of California's Cannabis Taxes on Participation within the Legal Market," Reason Foundation Policy Study, May 4, 2022, https://reason.org/policy-study/the-impact-of-california-cannabis-taxes-on-participation-within-the-legal-market/.
[8] Geoffrey Lawrence, "California Repeals Cannabis Cultivation Tax," Reason Foundation commentary, July 12, 2022, https://reason.org/commentary/california-repeals-cannabis-cultivation-tax/.
[9] Hawaii Legislature, 2000 Session, Act 228, www.capitol.hawaii.gov/sessions/session2000/acts/Act228_SB862_HD1_.htm.

locations and two production centers for cultivation, manufacturing, and packaging of medical cannabis products. Retail and production facilities could not be co-located on the same property, and no production facility would be allowed to cultivate more than 5,000 cannabis plants at a time.[10]

During implementation of Act 241, the department received a total of 66 applications for the available eight licenses over a 17-day application window in January 2016. The health department announced the license winners on April 29, 2016, and the first licensed cultivation and production facilities were allowed to commence operations in February 2017. The first retail sales of medical marijuana began in August 2017.[11]

All medical cannabis licensees were required to pay an initial license fee of $75,000 and annual renewal fees of $50,000. With eight licensees, these fees totaled to $600,000 in departmental revenues in 2016 and $400,000 each year thereafter, through 2022. In 2023, the renewal fees were reconfigured on a sliding scale that accounts for the number of facilities each licensee operates, with discounts based on market conditions within each county and the licensee's overall market share. This new configuration more than doubled total annual licensing fees, to $885,000.[12]

Medical cannabis is also subject to Hawaii's general excise tax (GET), which is a general sales tax with a statewide rate of 4%, although Hawaii, Honolulu, and Kauai counties impose an additional 0.5% surcharge. There is no special excise tax on medical cannabis in Hawaii.

Total GET remitted by the eight existing medical cannabis licensees totaled to $2.43 million in 2022, down slightly from a 2021 high of $2.57 million. During 2017—the first year of legal sales—GET receipts from the eight licensees totaled $99,871. Cumulative GET receipts from the eight licensees between passage of Act 241 and the end of 2023 totaled to $11.48 million.[13]

Medical Cannabis Patients in Hawaii

According to data maintained by the state health department, 31,789 residents held a valid registration for the use of medical cannabis as of December 31, 2023. During calendar year 2023, the department issued 5,801 new medical cannabis registrations and 15,381 renewals. Each registration remains valid for three years. The average age of registered patients was 52.57 years for males and 50.68 years for

[10] Hawaii Legislature, 2015 Session, Act 241, https://health.hawaii.gov/medicalcannabisregistry/files/2015/07/Act-241-signed-7-14-15.pdf.
[11] State of Hawaii, Department of Health, "Annual Report: Medical Cannabis Dispensary Licensing System," January 2024, https://www.capitol.hawaii.gov/reportstoleg/reportuploads/AnnualReportoftheMedicalCannabisDispensaryLicensingSystem,2023_12-29-2023-0.pdf.
[12] Ibid.
[13] Ibid.

females. Severe pain was the most frequently cited reason for patients to receive a cannabis recommendation, accounting for 82.5% of registrations.[14]

Although 40 states offer some form of medical cannabis program, states vary significantly in terms of who qualifies to participate and what procedures they must follow. Patient registration tends to be highest in states with the broadest array of qualifying conditions and low costs or other barriers for registration. In Hawaii, a patient qualifies for medical cannabis use if they have been diagnosed by a physician to suffer from a "debilitating medical condition," which may include: cancer, glaucoma, HIV/AIDS, wasting syndrome, severe pain, severe nausea, seizures, multiple sclerosis, Crohn's disease or "any other medical condition approved by the department of health pursuant to administrative rules."[15] After two decades of allowing qualifying medical patients to access cannabis, roughly 2.2% of the Hawaiian population has obtained medical registrations through the state health department. Among states without adult recreational use, only three—Oklahoma (9.2%), Pennsylvania (5.5%) and Florida (3.7%)—boast a higher proportion of the population registered as medical cannabis users.[16] A key reason Oklahoma has registered so many patients is Oklahoma does not specify a list of qualifying conditions, so anyone can receive a medical cannabis card if they have been recommended by a licensed physician.

2.2 Unlicensed Competition for the Retail Market

Hawaii's regulated commercial market for medical cannabis faces unlicensed competition. Pursuant to Hawaii's original medical cannabis law, patients can cultivate up to 10 plants on their own or can designate a caretaker to do so on their behalf. Many medical cannabis patients have relied on this law to establish cooperatives, in which cardholders pool their cultivation rights. This allows the cooperatives to cultivate large quantities of cannabis and sell this cannabis back to its membership. These cooperatives exist outside the regulated commercial system. Traditional illicit cannabis activity may also satisfy a portion of existing medical demand.

A 2022 analysis commissioned by the Hawaii Cannabis Industry Association reports that unique patient encounters amounted to roughly 13,000 in 2021. This implies that only about 31 percent of registered medical cannabis patients visited a licensed cannabis dispensary over the course of the year.[17]

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[14] State of Hawaii Department of Health, "Medical Cannabis (329) Registry Program, December 2023 Report" https://health.hawaii.gov/medicalcannabisregistry/files/2015/12/December-2023-Report_Valid_.pdf

[15] Hawaii Revised Statutes, §329-121.

[16] Marijuana Policy Project, "Medical Cannabis Patient Numbers," July 2023, https://www.mpp.org/issues/medical-marijuana/state-by-state-medical-marijuana-laws/medical-marijuana-patient-numbers/.

[17] Paul H. Brewbaker, "Hawaii's Medical Cannabis Industry: Performance, Policy and Economic Impacts," January 2022, https://irp.cdn-website.com/774e86c9/files/uploaded/HICIA%20Analysis%20of%202022%20Industry%20Report(FINAL).pdf.

A report compiled for the Tax Working Group of the Dual Use of Cannabis Task Force and prepared by the Hawaii Department of Taxation estimates that 79% of Hawaii cannabis sales are unlicensed, as the overall market was estimated at $240 million in 2021, but licensed dispensaries reported total sales of only $50 million. One cause is that the price of cannabis flower in a licensed dispensary is 40-100% more expensive than cannabis flower of comparable quality offered through an unlicensed seller.[18]

Limitations of the Medical Market

Growth of the existing medical market is impeded by numerous factors, which all contribute to a majority of cannabis demand being satisfied by unlicensed sellers. First, barriers to entry into the market are significant. Act 241 authorized only eight licensees and required these licensees to be vertically integrated. There have been no allowances for the issue of additional licenses. Vertical integration requires substantial capital to build out multiple facility types and a broad range of expertise. The availability of capital is highly constrained within the state-licensed cannabis industry because federal illegality dissuades most traditional capital providers like banks or institutional investors from investing.[19]

Second, licensees are only permitted to operate in the county in which they are licensed. This means cannabis inventory cannot be shipped around the state to areas of high demand. In June 2023, lawmakers authorized wholesale transactions between licensees for the first time, giving rise to the possibility of inventory transfers between licensed sellers across the four counties. The first inter-county transaction was recorded in September 2023, although these transports are complicated by the fact that the waters and airspace between the islands fall under federal jurisdiction.[20]

Third, until 2022, licensed cultivation spaces were limited to cultivating 3,000 plants at a time. Each licensee could operate two production facilities, which implied a statewide maximum of 48,000 plants. By contrast, California allows cultivators to collocate multiple licenses at a single facility, which means there are no hard limits on canopy size nor the number of plants allowed. And Nevada's cultivation license allows an unlimited cultivation operation. Hawaii's production limits sharply constrain supply in the regulated market, leading to reports of ongoing shortages,[21] which cause elevated prices. In 2022, the legislature passed SB 2260, which allows licensees to operate up to three production facilities and

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[18] Seth Colby, Hawaii Department of Taxation, "Getting Too High? Levels of Taxation and Potential Public Revenue from a Legalized Cannabis Market in Hawaii," Prepared for the Tax Working Group of the Dual Use of Cannabis Task Force, August 2022, https://health.hawaii.gov/medicalcannabis/files/2022/08/CANNABIS-TAX-PIG-REPORT-FINAL.pdf.

[19] Geoffrey Lawrence, "Marijuana Industry Financial Services: The Obstacles and the Policy Solutions," Reason Foundation policy brief, September 17, 2019, https://reason.org/policy-brief/marijuana-industry-financial-services-the-obstacles-and-the-policy-solutions/.

[20] Chris Casacchia, "Island Hopping: A New Cannabis Wholesale Route in Hawaii," October 16, 2023, Marijuana Business Daily, https://mjbizdaily.com/hawaii-cannabis-operators-sell-deliver-wholesale-flower-between-islands/.

[21] Ibid.

cultivate up to a total of 15,000 plants. Even with this relaxation of production restrictions, it is unclear if licensees hold the capital necessary to undertake these expansions.

Fourth, the regulated market faces open competition from so-called “gray market” alternatives, including home-grown and cooperative-supplied cannabis. The Department of Taxation conducted a series of interviews with market participants and determined, based on these interviews, that prices prevailing in licensed dispensaries were $100 to $200 more per ounce than prices on the gray market. Legal dispensary prices were 40% higher than gray-market cannabis on Oahu and Maui, 47% higher on Hawaii, and 100% higher on Kauai, where there is only one licensee.[22]

These factors have resulted in nearly 75% of patients availing themselves of homegrown cannabis, the gray market, or going unserved. That figure is an indictment against the ability of Hawaii’s commercial marijuana market to serve the existing population of medical cardholders. Legal constraints on production have rendered the commercial market incapable of producing sufficient supply on a cost-competitive basis with alternative supply sources that are legally tolerated. This environment holds important implications for a prospective recreational, adult-use cannabis market in which the number of prospective customers would presumably become substantially larger than the existent medical market.

Prevailing Prices and Estimated Demand

Consumer surveys indicate that price has a significant effect on cannabis consumer purchasing decisions. In a survey published in the International Journal of Drug Policy, price was the most important factor determining cannabis purchasing behavior for recreational and dual-use cannabis consumers and the second most important factor for medical cannabis patients (second to CBD content).[23]

Recent Price Trends

Prices in Hawaii’s medical marijuana dispensaries have remained significantly elevated above prices found on the mainland. Data presented in a 2022 report by the Hawaii Cannabis Industry Association compared the total weight of cannabis sold in licensed dispensaries each year to the total amount of

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[22] Seth Colby, “Getting Too High? Levels of taxation and potential public revenue from a legalized cannabis market in Hawaii,” Tax Working Group of the Dual Use of Cannabis Task Force, Hawaii Department of Taxation (August 2022), https://health.hawaii.gov/medicalcannabis/files/2022/08/CANNABIS-TAX-PIG-REPORT-FINAL.pdf.

[23] Yuyan Shi, Ying Cao, Ce Shang, Rosalie Liccardo Pacula, "The Impacts of Potency, Warning Messages, and Price on Preferences for Cannabis Flower Products," International Journal of Drug Policy, Dec. 2019, https://www.ncbi.nlm.nih.gov/pmc/articles/PMC6893125 (10 Feb. 2024).

reported sales to determine the average price per pound charged to patients during each year of the program.[24] Those results are reproduced in Table 1.

Table 1: Hawaii Medical Market, Average Consumer Prices per Pound			
Year	Total Sales	Total Pounds	Avg. Price/Lb
2018	$12,635,360	1,570	$8,048
2019	$26,470,200	3,768	$7,025
2020	$43,919,260	5,852	$7,505
2021 (thru Sept)	$54,945,056	6,278	$8,752

Hawaii followed a national trend of escalating cannabis prices during 2020 and 2021 as pandemic shutdowns and fiscal stimulus elevated consumer demand and led to rising prices for cannabis. However, throughout this time, Hawaii's consumer prices remained substantially higher than prices prevailing in other state markets. Chart 1 graphs the average wholesale price across U.S. state markets as tracked by market analytics firm New Leaf Data Services. It shows the price of the average pound of regulated cannabis rose from $1,100 in March 2019 to $1,665 in October 2020 and remained elevated through 2021 before falling back to $954 by October 2022. This data is for wholesale transactions, and cannabis retailers normally follow the "keystone markup," charging 200% of the wholesale price to final consumers. So, an average price in 2021 of around $1,500 wholesale would translate to a consumer price of $3,000 per pound. The prevailing price in Hawaii's medical dispensaries for the same time was $8,752, or nearly triple the prevailing prices in mainland state markets.[25]

Chart 1: U.S. Spot Cannabis Wholesale Prices

[24] Brewbaker, Paul. Randy Gonce, Tai Cheng, and Bill Jarvis (2022). "The Status of the Hawaii Cannabis Industry Report." Hawaii Cannabis Industry Association.

[25] Reason Foundation purchased access to proprietary data collected by New Leaf Data Services. Although any user can purchase access to this data, Reason Foundation and other users are contractually prohibited from distributing the raw data to third parties

In a prior study, Reason Foundation used reported sales and price data to estimate the price elasticity of demand for cannabis flower in licensed dispensaries in California and Oregon.[26] Both values were comparable, with California consumers exhibiting a price elasticity of -0.766 and Oregon consumers exhibiting a value of -0.765. These figures mean that if the retail price of cannabis rises by 1%, then consumers would purchase about 0.765% less cannabis from licensed retailers. By contrast, if consumer prices fall 1%, consumers would purchase about 0.765% more cannabis from licensed retailers.

Price elasticity demonstrates the importance of price on consumer behavior. Therefore, it also holds important implications for lawmakers regarding tax policies and regulatory constraints that may impose compliance costs leading to higher retail prices. These policies directly impact consumers' decisions about whether to purchase cannabis from licensed or illicit sellers. Illicit sellers can avoid regulatory compliance and taxation, which allows them to offer cheaper goods. At the same time, economies of scale and reduced risk and transaction costs can allow legal producers to hold down costs if regulatory guidance allows licensees to achieve these advantages through scale. Policymakers must remain aware of these dynamics when they launch any state-licensed marijuana market because licensed sellers will face competition from illicit supply chains that have developed over decades.

Total Market Demand

If Hawaii launches an adult-use cannabis market, all adults aged 21 and above would become eligible to purchase cannabis rather than only those who hold a valid medical card. This growth in the consumer base could be substantial. Around 10 million people visit Hawaii every year as tourists, with around 70 percent over 21 and thus potential customers.[27] The Hawaii Cannabis Industry Association estimates if

[26] Geoffrey Lawrence, "The Impact of California Cannabis Taxes on Participation Within the Legal Market," Reason Foundation policy study, May 2022, https://reason.org/wp-content/uploads/impact-of-california-cannabis-taxes-on-legal-market.pdf.
[27] Randy Gonce, Ty Cheng, Dylan Shropshire, "HICIA 2023 Adult Use Market and Tax Projection Report," Hawai'i Cannabis Industry Association, (2023).

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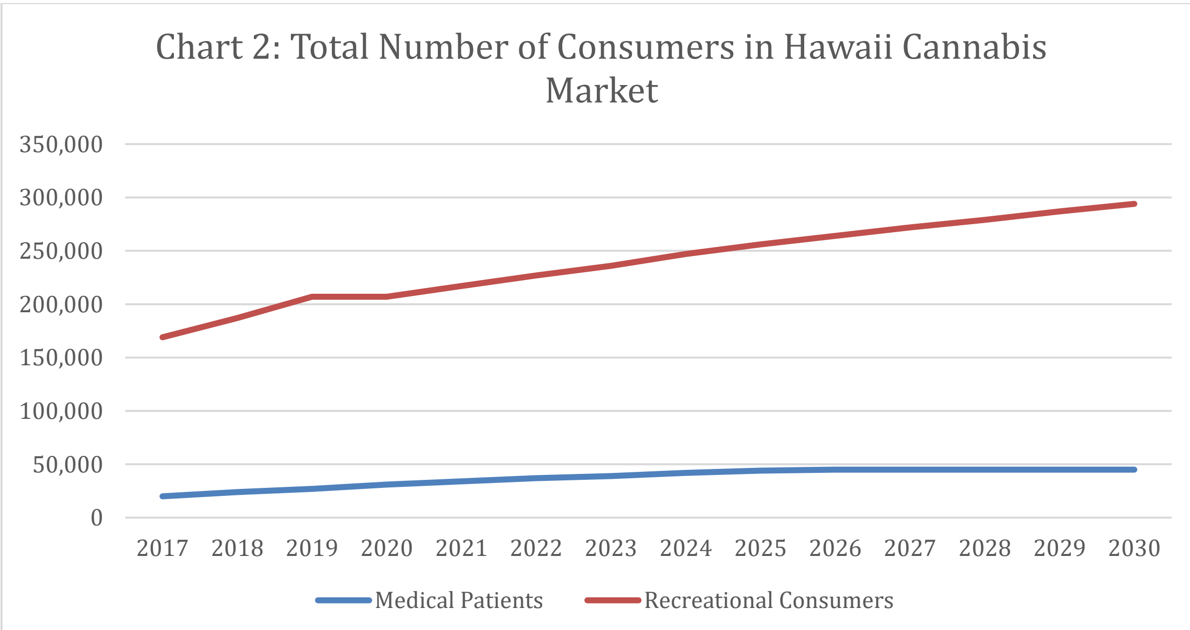
adult-use cannabis were legal, around 8% of international and over 27% of domestic tourists to Hawaii would make cannabis purchases on their trip, with 80% and 65% of such purchases likely to be made through licensed dispensaries.[28]

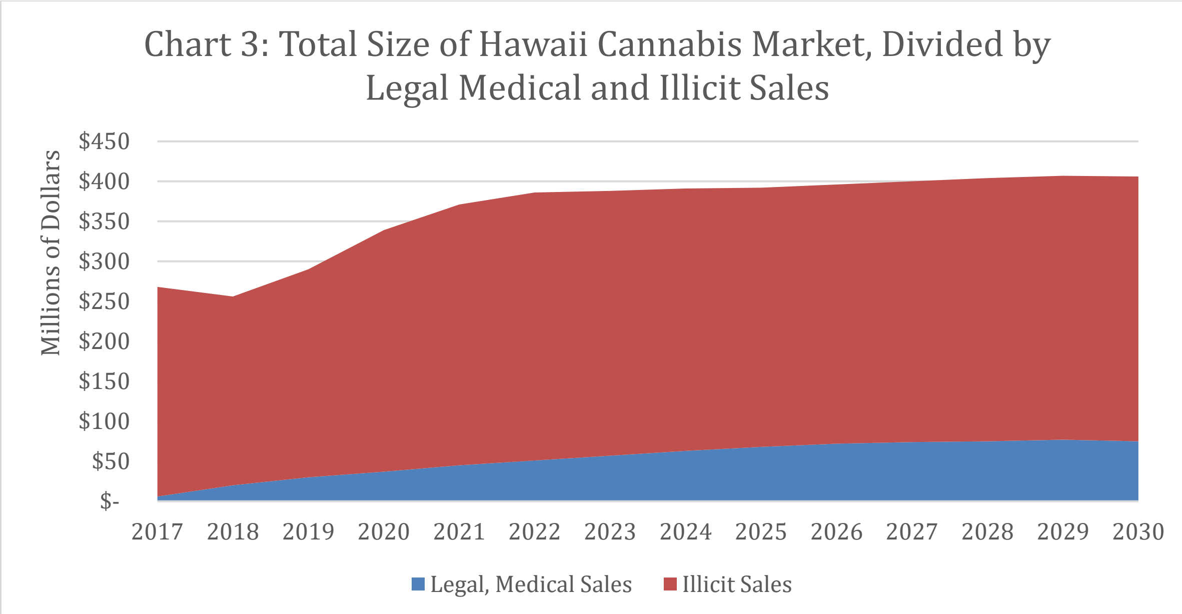
Market analytics firm New Frontier Data has developed forecasts of cannabis consumer behavior across all 50 states, including estimates for the size of both the legal and illicit markets. Chart 2 shows New Frontier's estimates that there will be 205,000 active cannabis consumers in Hawaii in 2024, and this figure will grow to 249,000 by 2030. By contrast, no more than 45,000 patients are expected to hold medical cards by 2030, so medical patients would account for only 15.3% of total cannabis consumers.[29]



Data Source: New Frontier Data.

Chart 3 shows illicit cannabis sales are forecast to total $328 million in 2024 and will grow only slightly to $331 million by 2030. By contrast, legal medical sales are estimated to total $63 million in 2024 and grow to $75 million by 2030.[30]

[28] HICIA 2023 Adult Use Marijuana
[29] Reason Foundation purchased access to proprietary data collected by New Frontier Data. Although any user can purchase access to this data, Reason Foundation and other users are contractually prohibited from distributing the raw data to third parties
[30] New Frontier Data, "Market Projections by State (2014 – 2030), May 2022, Updated June 2022, Data Accessed by Subscription Service.



Data Source: New Frontier Data.

Clearly, demand within the recreational market dwarfs the existing demand within the medical market. These estimates were developed by New Frontier Data assuming no change in law, which means the forecasts for recreational consumption occurs entirely on the illicit market. Transitioning these consumers (and their illicit suppliers) to the legal market will require a regulatory system that minimizes barriers to entry, allows convenient access to consumers, and allows licensees to offer products at prices that are competitive with those prevailing on illicit markets.

Key Provisions Proposed in Senate Bill 3335

During the 2023 legislative session, the Hawaii senate considered several measures to legalize cannabis for adult use and passed one version into which committees had incorporated recommendations from Reason Foundation.[31] That legislation was not taken up for consideration in the state House of Representatives, but incoming Attorney General Anne Lopez committed to hosting an administrative task force during the 2023-2024 legislative interim that would include key lawmakers and prepare

[31] Geoffrey Lawrence, "Comments and analysis of legal marijuana proposals and regulation in Hawaii's SB 375 and SB 669," Reason Foundation, 1 March 2023. reason.org/testimony/comments-and-analysis-of-legal-marijuana-proposals-and-regulation-in-hawaiis-sb-375-and-sb-669.

language for a separate proposal in 2024.[32] The result of that effort is Senate Bill 3335, which was introduced in January 2024.

Among the bill's strengths is its proposed excise tax. While taxes erode the price competitiveness of legal cannabis products relative to illicit products, the proposed 14% excise tax (inclusive of the General Excise Tax) would be among the most competitive nationwide. Table 2 compares the tax structures across states with adult-use marijuana programs to the proposed rates in Hawaii. If Senate Bill 3335 were to become law, only Maryland would have a lower tax rate on adult-use cannabis.

[32] Kyle Jaeger, "Hawaii Attorney General Now Supports Marijuana Legalization, Pledging to Work to Enact Reform Next Year," Marijuana Moment, April 13, 2023, https://www.marijuanamoment.net/hawaii-attorney-general-now-supports-marijuana-legalization-pledging-to-work-to-enact-reform-next-year/.

Table 2: Marijuana Tax Structure by State					
State	**Retail Excise Tax**	**Avg. Gen. Sales Tax**	**Addt'l Local Excise Tax**	**Total Retail Tax**	**Wholesale Tax**
AK		N/A	Varies	0.00%	$800/pound
AZ	16%	8.37%	2%	26.37%	
CA	15%	8.85%	Varies	23.85%	
CO	15%	Exempt	Varies	15.00%	15%
HI (SB 3335)	*10%*	*4%*		*14.00%*	
IL*	10%, 20%, 25%	8.84%	3.5%	22.34% - 37.34%	7%
MD	9%	Exempt		9.00%	
ME	10%	5.50%		15.50%	$335/pound
MA	10.75%	6.25%	3%	20.00%	
MI	10%	6%		16.00%	
MO	6%	8.36%	3%	17.36%	
MT	20%	N/A	3%	23.00%	
NV	10%	8.24%	3%	21.24%	15%
NJ		6.60%	2%	8.60%	$17.60/pound
NM	12%	7.60%		19.60%	
NY**	9%	Exempt	4%	13.00%	$0.005, $0.008, $0.03 /mg THC
OH	10%	7.24%		17.24%	
OR	17%	N/A	3%	20.00%	
RI	10%	7%	3%	20.00%	
VA	21%	5.77%	3%	29.77%	
VT	14%	6.36%		20.36%	
WA	37%	9.40%		46.40%	
*Illinois assesses different retail excise tax rates on marijuana flower (10%), edibles (20%) and concentrates (25%).					
**New York assesses different wholesale tax rates per milligram of THC in flower ($0.005), concentrates ($0.008) and edibles ($0.03).					

However, while Senate Bill 3335 contains numerous constructive provisions, it also includes components that may handicap the functioning of the regulated market and repeat errors from states that have been unable to transition illicit market participants to the legal and regulated market.

There are key elements to market structure that must be correctly aligned to ensure the marketplace remains dynamic, provides entrepreneurial opportunity, and efficiently delivers goods to customers a price and quality that meets their needs. First, minimize the barriers to entry so that unlicensed sellers are not excluded from the legal market as a matter of policy. Second, focus regulatory requirements on protecting public health and safety rather than controlling market outcomes. Third, permit licensees to begin commercial cannabis operations within a reasonable time following legalization to prevent unlicensed sellers from proliferating and capturing significant market share. Senate Bill 3335 could be improved in all these areas.

Barriers to Entry

State licensing programs for cannabis retailers, cultivators, manufacturers, distributors, and other businesses often impose significant barriers to become licensed and regulated due to both the unavailability and cost of licensing. Hawaii's medical cannabis program, for instance, only authorizes eight licenses within the entire state, and these licensees cannot operate across county lines. If a large cooperative or other unlicensed seller wanted to compete directly in the commercial market in Kaui County, for instance, they would be prohibited from doing so as a matter of policy because only one commercial license is authorized for Kaui County. This impedes the transition of unlicensed sellers to the legal market, results in lost tax dollars because unlicensed transactions are untaxed, and could lead to public health dangers inasmuch as unlicensed products are untested.

Senate Bill 3335 would similarly impose an arbitrary cap on the availability of licenses within Hawaii's adult use program. It would establish a cannabis control board and charge the board to "determine the maximum number of licenses that may be issued in order to meet estimated production demand." The implied premise of this proposal is that various cannabis products are interchangeable and so regulators can coordinate supply and demand by controlling the number of legal suppliers.

This premise is flawed for two reasons. First, there exists a wide variety of cannabis product types and varieties of cannabis flower. A consumer who prefers the aroma, taste, or effect of a particular strain of cannabis flower may not be able to find that strain from one of a limited number of licensed sellers. Likewise, a consumer with asthma who uses edibles as a sleep aid may not be willing to substitute smokable marijuana flower if the licensed seller in their area does not carry the edible products they prefer. Simply put, marijuana products are not fungible or interchangeable and consumers will seek the variety they prefer even if those products are not available from licensed sellers.

Second, measuring estimated demand for a product that has existed only in illicit markets is notoriously difficult due to the unavailability of data. Regulators in other states have produced market estimates that proved wildly inaccurate.[33] Further, limiting the availability of licenses is an imperfect mechanism for attempting to target supply levels because some licensees may be incapable of producing at large scale.

Lawmakers should recognize that the best regulator of supply is demand. If consumers value the products offered by one seller, that seller will prosper, while other sellers may go out of business. This is

[33] Spence Purnell and Allie Howell, "Marijuana and Market Size Estimates," Reason Foundation policy brief, April 2019, https://reason.org/wp-content/uploads/legal-marijuana-market-size-estimates.pdf.

the mechanism through which supply is successfully regulated in nearly every industry, from grocery stores to gas stations. This dynamism also presents entrepreneurial opportunities for individuals who can envision a better way of doing business—as upstart businesses bring new, innovative products to market they may displace incumbent firms. License caps, by contrast, inhibit market dynamism and suppress entrepreneurship.

High licensing fees or capitalization requirements have also created barriers to entry in some states. For instance, Connecticut charged a $3 million fee for a cannabis cultivation license. In Florida, applicants for a medical marijuana license had to demonstrate they held $10 million in liquid assets. These barriers dissuade unlicensed sellers from attempting to become licensed.

Moreover, capital tends to flow to commercial licensees only after they have secured a license to operate. The risk that a business may not gain the licensing necessary to carry on its proposed trade dissuades investment, whereas investors often feel more comfortable putting money into a business that has overcome these risks. So, states that have imposed minimum capitalization requirements as a condition of licensure have erected barriers that are at odds with the dynamics of capital markets.

States should not impose capitalization requirements for licensure and licensing fees should seek only to recoup or defray the cost of regulation. Senate Bill 3335 does not specify licensing fees, leaving this determination to agency discretion. To ensure an orderly market, lawmakers should specify an initial licensing fee at levels that will not dissuade the transition of unlicensed sellers to the legal marketplace and include language that expressly directs regulators not to impose minimum capitalization requirements.

Focus on Public Health, Not Market Outcomes

Consumers expect that a regulatory authority will police the safety of products and ensure the market is orderly. Regulations that govern testing protocols or manufacturing processes to ensure products are free of potentially harmful contaminants are expected. However, regulations that require specific production processes or constrain supply simply to target a market outcome go beyond legitimate regulation and veer into market manipulation.

Senate Bill 3335 would limit the capacity of licensed cultivation facilities to 5,000 square feet of canopy space. By far, this would be the most restrictive production restraint anywhere in the United States. Illinois and Massachusetts both limit canopy space to 100,000 square feet. In California, each cultivation license permits a set amount of square footage, but cultivators can collocate multiple licenses on any property which allows for an unlimited canopy size. In Michigan, a cultivator can grow up to 10,000 plants, while a Colorado cultivator can grow up to 13,800 plants. In Nevada, a cultivation license holds no limitations, so a cultivator can expand or contract capacity in accordance with consumer demand.

Hawaii's production constraint would prevent licensees whose products gain a popular following from expanding and would thereby limit the entrepreneur's commercial success. Hawaii should discard these capacity constraints and instead focus on consumer health and safety. Hawaii's commercial system for medical marijuana is already unable to satisfy patient demand. Significantly more production capacity will be necessary to satisfy a larger population of potential consumers in an adult-use market.

Prepare for Time to Market

Once the use of possession of cannabis by adults is made legal, interested consumers will begin to seek these products. If licensed sellers are not operational in time to satisfy this demand, unlicensed or "gray market" sellers may proliferate. As seen in New York, it can be difficult to successfully transition both buyers and sellers into the legal market once unlicensed sellers have established market share.

In New York it took nearly three years after the legalization of personal possession before the first licensed dispensary became operational. During this time, thousands of unlicensed retailers emerged and regulators have struggled to regain control of the marketplace.[34] To avoid this fate, new state-regulated cannabis markets should issue licenses as expeditiously as possible to ensure licensed sellers are available to satisfy consumer demand. It may behoove regulators to start issuing cultivation and manufacturing licenses before retail licenses because the production process for cannabis inventory takes four to six months. If this supply chain is not in place, retailers will have no products to sell. Senate Bill 3335 partially anticipates the importance of speed to market for licensed sellers by allowing existing medical licensees to acquire a dual-use license that would allow them to make adult-use sales. However, as detailed in Section 3, existing medical licensees already lack the capacity to satisfy existing medical demand on a cost-effective basis. To displace the illicit market, Hawaii needs more licensees subject to fewer production constraints.

Avoid Potential Legal Complications

Lawmakers should beware that certain approaches to state regulation may run afoul of the U.S. Constitution and could imperil the long-term success of a cannabis program. Senate Bill 3335 includes requires the owners of any prospective cannabis licensee to be Hawaii residents and requires them to sign a labor peace agreement with a bona fide labor organization as a condition of licensure. Any applicants for a commercial cannabis license must have been legal residents of Hawaii for five years and the majority of ownership interest to be continuously held by Hawaii residents. These requirements run afoul of federal case law and should be removed.

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[34] Ali Bauman, "Illegal Pot Shops Across New York City Are Hurting Legitimate Marijuana Dispensaries, Gov. Kathy Hochul Says," *CBS News*, March 2, 2024, https://www.cbsnews.com/newyork/news/new-york-city-illegal-cannabis-shops-kathy-hochul/.

In New York, licensing was delayed by a federal injunction against the Office of Cannabis Management that prevented the issuance of licenses. Regulators there had adopted a requirement for licensure that the majority owner of any applicant hold a "significant presence" in New York. An applicant whose majority owner was a Michigan resident sued in federal district court, claiming the requirement was facially discriminatory against out-of-state economic interests. Senior U.S. District Court Judge Gary Sharpe held the rule invalid as an unconstitutional usurpation of Congress's exclusive jurisdiction to regulate commerce between the states. According to the "dormant Commerce Clause" doctrine, states cannot use licensing regimes or other mechanisms to discriminate against out-of-state economic interests unless the rules are narrowly tailored to accomplish a legitimate local interest. Rules that simply seek to protect local businesses have routinely been invalidated in federal courts.[35]

In 2019, the U.S. Supreme Court struck down a Tennessee requirement that an applicant for a retail liquor license must have been a Tennessee resident for two years as violative of the dormant Commerce Clause.[36] In multiple cases, the rationale from that ruling has been extended to state-issued cannabis licenses. Federal district courts have issued injunctions against residency requirements for cannabis licenses in Missouri,[37] Maine[38] and New York. The injunction in Maine was appealed by an intervenor to the federal First Circuit Court of Appeals, which upheld the district court ruling.

An amendment to Senate Bill 3335 made by the House Committee on Consumer Protection & Commerce would require licensees to sign a labor peace agreement as a condition of licensure. The U.S. Supreme Court has been clear that the National Labor Relations Act grants exclusive jurisdiction to the National Labor Relations Board to regulate private-sector labor relations. The Court struck down a requirement in the City of Los Angeles, for instance, for a taxicab company to enter a labor peace agreement as a condition of licensure. The city's regulation of private-sector labor disputes, the Court ruled, was preempted by the National Labor Relations Board's authority and therefore no privileged license could be conditioned on a labor peace agreement.[39] Similarly, a federal Court of Appeals ruled in 2005 that a Wisconsin requirement for contractors with local governments enter a labor peace agreement exceed the state's authority and was invalid under the National Labor Relations Act.[40]

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[35] Geoffrey Lawrence and Michelle Minton, "The Case for Interstate Marijuana Commerce Right Now," Reason Foundation policy brief, January 2024, https://reason.org/wp-content/uploads/case-for-interstate-marijuana-commerce-right-now.pdf.

[36] Tennessee Wine and Spirits Retailers Association v. Thomas, 139 S. Ct. 2449, 204 L. Ed. 2d 801 (2019).

[37] Toigo v. Department of Health & Senior Services, 549 F. Supp. 3d 985 (W.D. Mo. 2021).

[38] Northeast Patients Group v. Maine Department of Administration & Financial Services, 554 F. Supp. 3d 177 (D. Me. 2021)

[39] Golden State Transit Corp. vs. City of Los Angeles, 660 F Supp. 571 (1987).

[40] Metro Milwaukee Commerce vs. Milwaukee County. United States Court of Appeals, Seventh Circuit, 431 F 3d 277 (2005).

These requirements in Hawaii would risk a federal injunction against the state's prospective adult-use licensing similar to what has been seen in other states and may frustrate the emergence of an orderly, legal market.

Conclusion

Hawaii has an opportunity to establish a thriving, legal cannabis market that provides legitimate entrepreneurial opportunity and displaces illicit activity. However, key provisions of Senate Bill 3335 may inhibit the success of this market. Hawaii's current approach to medical cannabis has met limited success due to a lack of competition, limitations on production, paucity of legal retailers, and high compliance costs. Unlicensed suppliers of medical cannabis are also tolerated by law, and these unlicensed suppliers currently satisfy a majority of patient demand.
With an adult-use market, Hawaii is forecast to have more than 300,000 active consumers by 2030—substantially greater than the 31,789 existing medical patients. Medical and recreational sales may total more than $400 million annually by 2030—again, much greater than the $63 million in sales forecast for the medical market alone in 2024.

To accommodate this growth, Hawaii will need a regulatory structure that encourages economic dynamism, entrepreneurship, and the orderly transition of unlicensed suppliers into the licensed and regulated marketplace. This means Hawaii should embrace an approach that minimizes barriers to entry, focuses regulation on protection of consumer safety rather than controlling market outcomes, and facilitates a rapid time to market for licensed suppliers.

Key provisions of Senate Bill 3335 would work against these goals by artificially limiting the availability of licenses, limiting the production capacity of each licensee, and imposing residency requirements that could invite a federal injunction against licensing. It is imperative that lawmakers correct these deficiencies to achieve an orderly and functional market.

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Lawrence has also served as senior appointee to the Nevada Controller’s Office where he oversaw the state’s external financial reporting. Prior to joining Reason in 2018, Lawrence had also spent a decade as a policy analyst on labor, fiscal, and energy issues between North Carolina’s John Locke Foundation and the Nevada Policy Research Institute. Lawrence is additionally founder and president of an accounting and advisory firm with expertise in the licensed marijuana and hemp industries. Lawrence holds an M.S. and B.S. in accounting, an M.A. in international economics and a B.A. in international relations. He lives in Las Vegas with his wife and two children and enjoys baseball and mixed martial arts.

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