Assessing Tax Expenditure Programs in Light of California's Fiscal Challenges:

California's Film Tax Credit: A Preliminary Assessment

Testimony before the Joint Hearing of the Assembly Committee on Revenue and Taxation, and the Assembly Committee on Accountability and Administrative Review

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This testimony was prepared in response to a request from the Assembly Committee on Revenue and Taxation for information on film and television industry production incentives to guide the committee's analysis and assessment of policy options.

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Good afternoon, Chairman Dickinson, Chairman Perea, Vice-chairmen Garrick and Donnelly, and Members. My name is Brian Sala. I am the Acting Director of the California Research Bureau. Thank you for the opportunity to testify before you today.

The California Research Bureau is a division of the California State Library. Created in 1992, CRB was designed to provide high-quality, nonpartisan research and reference services to the Legislature, the Governor, the Cabinet, and other constitutional officers.

We were asked by committee staff to appear today to provide some background context for your discussions on California's Film and Television Credit Program.

In October 2011, the governor signed into law AB 1069 (Fuentes), Chapter 731 of the Statutes of 2011, extending to July 1, 2015 California's film and television tax credit program. Certain productions are eligible for credits against state income and/or sales and use taxes for qualifying film and television production expenditures within the state, up to a ceiling amount of credit per year.

The California Film Commission administers the program on a first-come, first-served basis, allocating rights to credits up to an annual ceiling of $100 million, beginning with fiscal year 2009-10. Applications for credits thus far have outstripped the statutory limit. The Commission received many more applications the past two years prior to the start of the fiscal year than could be funded each funding cycle. As a result, the Commission has allocated many credits via random drawings.

Qualifying applicants may include productions of Movies of the Week or television miniseries with production budgets of at least $500,000; independent films with production budgets between $1 million and $10 million; television series, and feature films with production budgets between $1 million and $75 million. Productions can qualify for either a 20 percent tax credit or a 25 percent tax credit depending on additional criteria.

My testimony this morning is intended to provide an early assessment of California's film and television tax credit program. I address three key topics.

First, to what extent do statistics on industry employment and production activity in the Los Angeles area, and the state, suggest a need for a subsidy to the film and television production industry in California? Beginning early last decade, other states began aggressively courting the film and television production industries through the use of Movie Production Incentives (MPIs) to relocate productions outside of California. The data covers several years prior to the 2009 implementation of film and television tax credits in California, as well as the first two years of California's incentive program.

Second, we briefly describe the status of state-level MPIs across the country.

Third, we reviewed the emerging literature, both from academic sources and from various official state sources such as equivalents to the Legislative Analyst's Office, on the economic and budgetary effects of MPIs in various states, including two recent studies of California's program.

WHAT DID WE FIND?

Our key conclusions are as follows.

First, with respect to employment and production figures, *we found little, systematic empirical evidence that the motion picture and video production industry was under significant duress during the 2000s*.

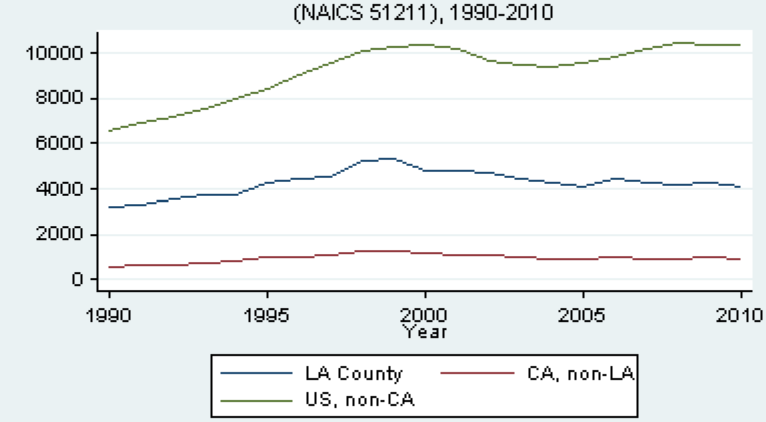
Industry advocates have focused on the threat of "runaway production" to the long-run vitality of the movie and video production industry in California, noting that the numbers of productions located in certain other states, such as Arizona, New Mexico, Louisiana, New York and North Carolina, grew substantially during the decade as those states enacted production incentive legislation.

We examined the evidence for these claims in two key ways. First, we looked at trends in the numbers of firms, employment, and wages in the movie and video production industry, both inside Los Angeles County and statewide, relative to trends outside the state. Second, we examined data on on-location "permitted production days" in the Los Angeles area, as compiled by Film L.A., Inc., a not-for-profit entity created by the City and County of Los Angeles to coordinate and process permits for on-location film and video productions in the region.

Official employment statistics, published by the federal government, do not provide a comprehensive measure of the economic impact of the movie and video industry, but they do provide a standardized way to measure *changes* in the size of the industry over time. That is, trends in official employment data should closely track trends in the economic impact of the industry under the assumption that the basic structure of production in the industry is relatively stable and that the *multiplier effect* associated with industry expenditures and jobs is likewise relatively stable.

These measures demonstrate that industry employment in both California and the nation as a whole has roughly doubled since 1990. Additionally, nominal wages grew steadily both in the L.A. industry and nationwide.

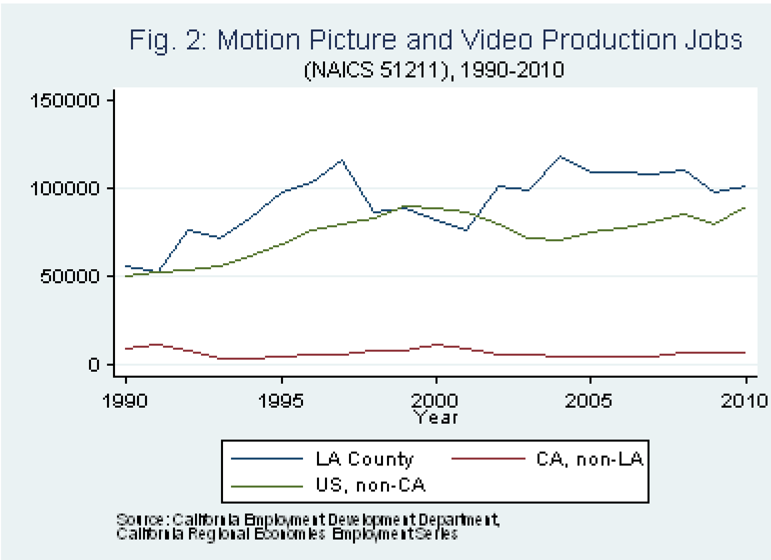
Fig. 1: Motion Picture and Video Production Establishments (NAICS 51211), 1990-2010



Source: California Employment Development Department, California Regional Economies Employment Series

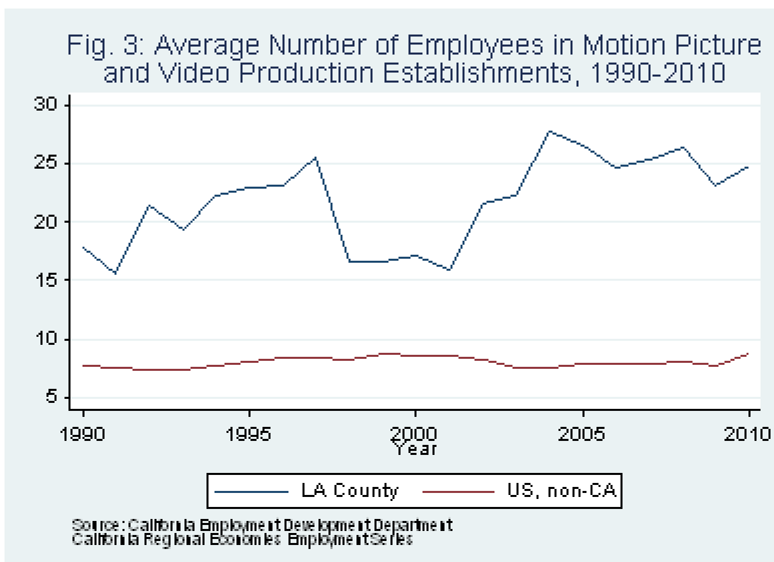
Figure 1 displays the number of "establishments" in the Motion Picture and Video Production category of the North American Industrial Classification System (NAICS, code 51211). This is a fairly narrowly drawn class of employers, as it excludes establishments primarily engaged in post-production and distribution activities. As Figure 1 indicates, there are about twice as many U.S.

production establishments located outside of California as are located inside the state. That gap widened somewhat during the 2000s, a result that is consistent with the concerns about "runaway production" from California.



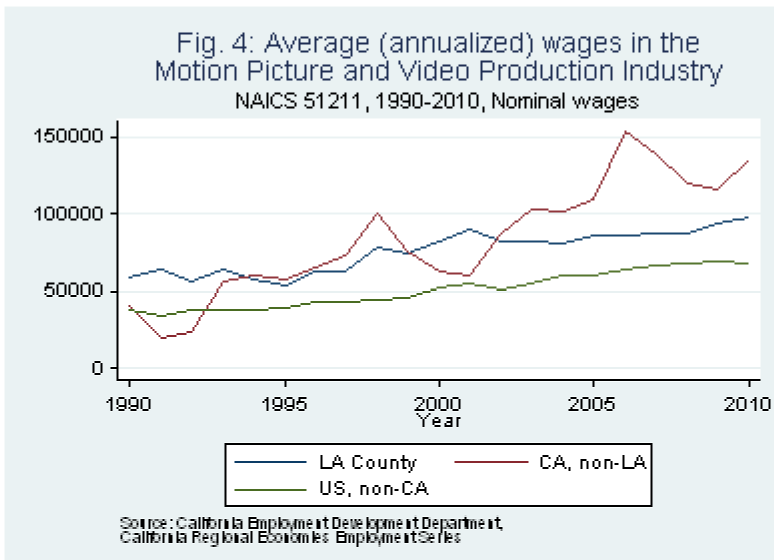
The relative decline in establishments within California has not been matched by a concomitant decline in employment, however, as shown by Figure 2.

This figure demonstrates that industry employment roughly doubled from 1990 to 2010 both within Los Angeles County and outside of the state. Employment growth occurred in L.A. during the early 2000s *at the expense of* industry employment outside of California. Employment evidence from the latter half of the 2000s, however, is consistent with the argument that Movie Production Incentives (MPIs) enacted in other states shifted employment – or at least employment growth – away from Hollywood. Total employment in the industry has fluctuated considerably over the last decade, from a low of 86,000 jobs statewide in 2001 to a peak of 123,000 in 2004.



The data on establishments and employment combine to raise questions about the composition of the movie and video production industry in California. Figure 3 displays the ratio of employees-to-establishments for L.A. county concerns and for establishments located outside of the state. It very clearly shows that the average production establishment in Los Angeles is about four times the size of the average non-California establishment, but that California did experience a brief period of decentralization within the industry. Between 1997 and 1998, the average establishment size fell by more than one-third in California, remaining at similar levels until 2002, when average establishment size rebounded, even as the number of establishments was falling. This consolidation in the industry could be read as consistent with the flight of small- and mid-sized production projects away from California during this period and an increasing industry focus on very large-scale productions.

Another suspected consequence of runaway production would be a decline in industry wages within California, as vulnerable productions looked elsewhere for lower labor costs. However, as Figure 4 demonstrates, nominal wages did not decline in California during the 2000s.



Within California, nominal averages wages in the film production industry nearly doubled over the 1990-2010 time period, keeping pace with wage increases in the industry nation-wide as well as with average wages in all private industry, both in the state and nation-wide. Wage data are tied to the location of the employer, not the location of the employment, so these data cannot definitively demonstrate that California's economy has not suffered from "runaway production."

Annual wages in the industry averaged just under $100,000 in 2010, up sharply from 2008 ($89,000). The average industry employee earns $1.90 for every dollar earned by the typical California private-sector employee.

Data on production establishments, employment, and wages thus provide very little direct evidence that the movie and video production industry suffered any significant, deleterious effects stemming from the adoption of MPIs by other states during the 2000s. The most direct measure available of production activity, Film L.A. Inc.'s "permitted production days" series, is more suggestive, however.

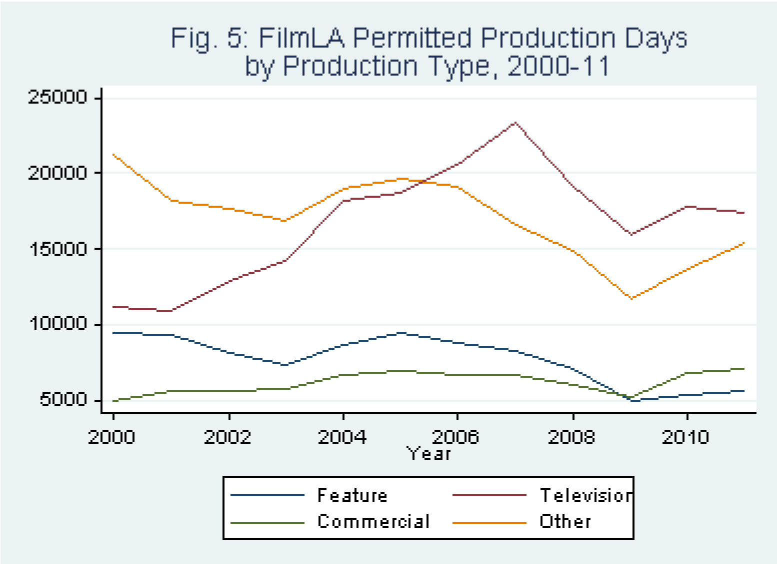


Figure 5 plots the number of permitted production days (PPDs) by production type for the years 2000-11. Two features of the figure stand out. First, the Writers' Guild of America's strike, which lasted just over three months from November 2007 to February 2008, combined with the global recession that began in December 2007 significantly depressed on-location production activity in all categories of movie and video production within the Los Angeles area. Second, permitted production days for television shoots grew dramatically from 2001 through 2007, whereas PPDs for feature films were stagnant or declining throughout the period.

These data, together with the employment and wage figures discussed above, seem to suggest that the movie and video production sector in Los Angeles has changed structure over the past decade, away from feature films and toward television productions. This transition appears to have cost neither direct-employment jobs nor direct-employment wages.

MOVIE PRODUCTION INCENTIVES IN THE STATES

The decline in feature film PPDs may, in part, reflect competitive pressures for feature film production arising from other states and foreign countries in recent years. Our second major area of emphasis in these remarks has to do with the growth of movie production incentives (MPIs) in other states. Between 2002 and 2010, the number of states offering some form of MPI rose from a low of five to a high of 44, including 28 states (including California) that offer film tax credits. Many states' programs are open to television productions as well as feature film productions.

However, those competing states' subsidy programs do not readily explain the concomitant rises in television and other production shoots in the Los Angeles area. In the aggregate, L.A. regional PPDs averaged more than 52,400 per year during 2003-07, when other states were adopting motion picture incentive policies. This compares to only 45,000 per year during 2000-02. It is possible that motion picture and video production companies in the Los Angeles area have adapted to cross-state competitive locational pressures in the feature film industry by diversifying or refocusing their activities on television and other productions, where Los Angeles may retain a strong competitive advantage.

The overall effect of state movie production incentive policies on the welfare of California's movie and video production industry is thus unclear. The Los Angeles region appears to have experienced a redistribution of productive activities away from feature films and into other market opportunities, coupled with an overall growth in the size of the market. Data are not yet available with which to assess fully the effects of ABX3 15 on the industry, but employment and wage data for the 2000-2010 period demonstrate that Los Angeles-area industry has kept pace with the rest of the nation over the decade. This conclusion is further supported by permit production day data from the Los Angeles area, which shows overall growth in movie and video production activity even as the feature film subcategory has declined.

State policies to subsidize movie and video production remain controversial, and have come under increasing attack as states across the country have struggled with budget constraints during the recent recession. One 2011 report, by the right-leaning Tax Foundation, found that at least eight states had ended or suspended their MPI programs (Arizona, Arkansas, Idaho, Iowa, Kansas, Maine, and New Jersey).[1]

The California MPI program is distinctive, however, a point emphasized in a recent report by Headway Project.[2] The authors of that report make five claims about California's credit program: (1) California's credit is "small" in aggregate scope; (2) it is "small" in terms of benefits to individual participants; (3) it is focused on "below the line" expenses; (4) it is selective in terms of the types of productions eligible for credit; and (5) it has high compliance requirements.

1. California's program scope is "small" in scope Annual credits are capped at $100 million, which translates to $400 million-$500 million in qualifying expenditures, the equivalent of somewhat less than five percent of annual statewide wages in the Motion Picture and Video Production industry. .

Numerous critics have emphasized that California's program benefits are capped, whereas credit programs in several other states (e.g., Alaska, Connecticut, Georgia, Illinois, Louisiana and Massachusetts) are "unlimited." These critics typically do not also observe that these other states' film industries are "small." Louisiana, whose program often is cited by industry advocates as an exemplar, reported total employment in motion picture and video industry establishments (NAICS 5121) of 4,240 (roughly comparable to the combined industry employment in Alameda County and San Francisco) and wage income of $96 million in 2010. New York State, with the second largest motion picture and

[1] Henchman, Joseph. "More States Abandon Film Tax Incentives as Programs' Ineffectiveness Becomes More Apparent." Tax Foundation Fiscal Fact No. 272, June 2, 2011.

[2] Kong, Michael B., and Aniruddha R. Bette. "There's No Place Like Home: Bringing Film & Television Production Home to California." Los Angeles: The Headway Project. February 2012.

video industry to California's, with 2010 employment of more than 60,000, still employs less than one-third as many industry workers as does California.

2. California's program offers "small" benefits. California's incentive is 25 percent (transferable, but not refundable) credit on qualifying expenditures for small, independent films, and 20 percent (non-transferable, non-refundable) credit on qualifying expenditures for other eligible productions. A recent review of state incentives cited 25 percent credit as the median credit offered by state programs.[3]

3. California's program targets "below the line" expenses – salaries and benefits to the film crew and staff, as well as most production and equipment costs. The Headway Project authors imply that this arrangement specifically benefits "the hundreds of thousands of unionized, middle class production jobs" in the industry (p. 16).

4. California's program is selective in terms of eligible production types. The Headway Project authors suggest that "the types of productions eligible for California's tax credit are the most mobile and are subject to the greatest flight risk due to other state and national incentives being offered" (p. 17).

5. California's program imposes "a rigorous set of auditing requirements" (p. 18), whereas many other states' programs do not require similar audit reports.

ECONOMIC EFFECTS OF MOTION PICTURE INCENTIVES

Finally, we reviewed the emerging research on the economic effects of MPIs. This literature consists of a handful of academic or "think tank" studies and a growing number of analyses produced by state revenue departments or legislative analyst's offices similar to California's LAO. The overriding theme of this

[3] Applembaum, Lauren D., Chris Tilly, and Juliet Huang. "Economic and Production Impacts of the 2009 California Film and Television Tax Credit." UCLA Institute for Research on Labor and Employment. Revised February 7, 2012.

literature is that film production tax credits do not generate new state tax revenues equivalent to the value of the tax credits provided. For example, the Louisiana Legislative Fiscal Officer estimated in a 2005 report that the state would recoup only 16-19 percent of its film tax credits in new revenue. Similarly, the Massachusetts Department of Revenue estimates that every dollar in tax credit has returned only 14 cents in new tax revenue over the first four years of that state's program.

In contrast, a recent analysis of California's program, sponsored by the Los Angeles County Economic Development Corporation, concluded that the state nets a return of six to thirteen cents for every dollar of initial tax expenditure. This finding of positive net tax benefits is quite unusual. It depends critically on several assumptions of varying plausibility.

Most credibly, the authors argue that the size and diversity of California's economy implies a relatively high multiplier effect for direct project expenditures in the state. To the extent that a tax credit deters a project from relocating outside the state, it leads to "indirect" and "induced" economic impacts, i.e., expenditures on suppliers and contractors, as well as spending by project employees out of their earnings in the state.

Conversely, the LAEDC report ignores the tendency for out-of-state projects to hire California workers for on-location activities or contract with California-based firms for subsequent work, such as post-production work or distribution. By ignoring the degree to which out-of-state productions employ California labor or firms, the study overstates the net effect of tax credit incentives by misattributing indirect and induced effects to other states' economies. Unfortunately, the magnitude of these misattributions is unknown.

Second, the LAEDC assumes that all projects that receive California credits would otherwise have relocated out-of-state. This assumption is overly strong, but one review of the study, by researchers affiliated with the UCLA Institute for Research on Labor and Employment, suggests that less than ten percent, by value, of tax credit applicants would have remain in California even without receiving the credit. This conclusion was based on a review of outcomes for a handful of waitlisted projects that eventually were produced.

These analyses are complex, and the specific conclusions appear to be quite sensitive to modeling assumptions. Perhaps the most difficult and controversial component of such models is determining how many productions would remain in a given state in the absence of the proffered incentives.

The California Film Commission is in a position to partially address this last question. California provides a capped pool of incentives. The industry in California is sufficiently large that the state's incentives pool is over-subscribed, which leads the Commission to award incentives to specific applicants via a random drawing. The Commission could provide the Committee with systematic data on the disposition of applicants who do not receive an incentive award relative to those who do, by production type. Such data would not provide a complete answer, as the lottery system itself may tend to deter potential applicants who are unwilling to wait for the lottery to be resolved before beginning production on a project. Nonetheless, tracking the locational decisions of non-awardees could help inform the Legislature about the function of the incentive program.

The Commission has begun to collect data to address these questions. Of the 82 projects to receive initial allocations in Year 2 of the program, 51 were produced in California, one withdrew and relocated to New York, and 30 were not produced (18 were not "greenlit," while 12 others failed to meet the requirement that principal photography begin within 180 days after receipt of a credit allocation).

Of 31 applicants who did not receive initial allocations in Year 2, five were produced in California anyway, nine relocated, and 17 were not produced. A further four projects withdrew and reapplied in Year 3, and received allocations in that round.[4]

These initial results seem to suggest that tax credit allocations, while important to the ultimate decision to produce a project in California, are secondary to other criteria. More than a third of the Year 2 projects selected for credit allocations were not produced, compared to just over half of non-selected projects.

Additional, critical evaluation of California's film and television tax credit program is merited. One recent study finds suggestive evidence that the program does not cost the state tax revenues on net. That study's conclusions are based on several optimistic modeling assumptions, but nonetheless merit serious consideration.

[4] Amy Lemisch, personal communication, February 17, 2012.