June 13, 2012

Hon. Lois Wolk, Chair
Senate Governance and Finance Committee
Room 5114, State Capitol
Sacramento, California 95814

Dear Senator Wolk:

Staff of the Senate Governance and Finance Committee asked our office to evaluate the February 2012 report, *Economic and Production Impacts of the 2009 California Film and Television Tax Credit*, which was prepared by staff members of the UCLA Institute for Research on Labor and Employment (UCLA-IRLE). This UCLA-IRLE study analyzed a 2011 study by the Los Angeles County Economic Development Corporation (LAEDC) concerning the economic impact of California's film and television tax credit program.

Below, we provide (1) background on California's motion picture and video industries, (2) a brief discussion of California's current film and television tax credit program, (3) a description of the main findings of the LAEDC study, (4) a summary of the UCLA-IRLE report's findings concerning the LAEDC study, and (5) our observations concerning the UCLA-IRLE and LAEDC reports. Given the limited time available for this review, we did not have the opportunity to discuss these issues in detail with LAEDC or UCLA-IRLE researchers.

California's Entertainment Industry

California's Role in the Entertainment Industry. California—in particular, Los Angeles County—has long been the center of film and television production in this country. According to the LAEDC, 39 percent of U.S. employment in motion picture and video industries is in California, and 60 percent of U.S. labor income in the industry is earned here. The LAEDC report estimates that this translates to 159,000 motion picture and video industry jobs in the state. Estimated industry output in California in 2009 was $48.5 billion (59 percent of the U.S. total), including labor income of $15.5 billion (60 percent of the U.S. total), according to the report. Average annual pay in the sector is higher than in the rest of the state's economy.

The LAEDC report notes that California's deep history with the entertainment industry "makes it possible for the industry to find suppliers for almost all its needs within the state," thereby allowing about 92 percent of all goods and services purchased by the industry here to be bought within the state. In fact, critics of tax subsidies for the industry in other jurisdictions sometimes note that workers with specialized skills often have to be imported from Los Angeles and New York.

"Runaway Productions" and Trends in California Production Activity. In recent decades, the film and television industry has expanded its activity and infrastructure in other states and international locations. Other states and countries have, among other things, implemented sometimes-generous tax expenditure programs to encourage the development of local film production industries. At times, favorable exchange rates can incentivize international production activity, and comparatively high labor or other production costs in California also can influence decisions to produce elsewhere.

The issue of runaway productions has been a major topic in legislative discussions of film and television tax credits. There has, however, been considerable debate about the extent to which runaway productions are a problem. The LAEDC report, for example, describes a "gradual shrinking of the industry in California." The UCLA-IRLE study states that California's share of movie and video industry employees in North America as a whole dropped from 40 percent in 1997 to 37 percent in 2008. By contrast, a March 2011 report by the California Research Bureau stated that "available employment and wage data for the motion picture industry do not provide clear evidence that any significant damage to the state's industry or economy has resulted from efforts by other states to draw movie production away from California in the past decade." The UCLA-IRLE study also notes that after initial boosts following implementation of tax credits, most U.S. states now have stopped seeing large increases in production-related employment.

Film L.A., a nonprofit organization coordinating permit activity for public-sector agencies in the Los Angeles region, estimates that permitted production days (PPDs) in the area peaked in 2006 at 55,399 PPDs before dropping in 2008 (to 47,117 PPDs) and 2009 (to 37,979 PPDs). According to Film L.A., feature films have been a particularly problematic issue for the Los Angeles region's production industries in recent years. While overall PPDs grew between 1996 and 2006, feature film PPDs peaked in 1996 at 13,980. By 2009, however, feature film PPDs had dropped to 4,976 (including about 300 PPDs of productions allocated a state tax credit). Since then, these figures have improved somewhat, with overall Los Angeles area PPDs rising to 45,484 in 2011, including 5,682 feature film PPDs (which includes 652 PPDs of productions allocated a state tax credit).

Film and Television Tax Credit Program

Tax Credit Program Initiated in 2009 and Extended in 2011. Chapters 10 and 17, Statutes of 2009-10 Third Extraordinary Session (ABX3 15, Krekorian, and SBX3 15, Calderon), created the state's film and television tax credit program. This February 2009 legislative package authorized the California Film Commission (CFC) to allocate $100 million of tax credits annually beginning in 2009-10 and ending in 2013-14 (for a total of $500 million of tax credits). The legislation, however, effectively allowed CFC to allocate the first two fiscal years of tax credits in 2009-10, the third fiscal year of credits in 2010-11, and so on, such that the initial allocation of credits was on track to expire during the 2012-13 fiscal year. Chapter 731, Statutes of 2011 (AB 1069, Fuentes), authorized the allocation of an additional $100 million of the credits, thereby extending the current program for one more year. Senate Bill 1167 (Calderon), now under consideration by your committee, would extend the program for five additional years by authorizing another $500 million of credits over that period (equal to $100 million per fiscal year).

Income or Sales Tax Credits. The tax credit program provides personal or corporate income tax credits—or, if taxpayers choose, credits applied against the state General Fund portion of the sales and use tax—based on "qualified expenditures" for qualified productions that are made in California. Qualified expenditures include crew and staff salaries and benefits, rental costs of facilities and equipment, and many production costs like construction, wardrobe, food, lodging, and lab processing. Non-qualified expenditures include wages paid to writers, directors, producers, and performers, as well as publicity expenses and federal payroll taxes.

The program provides tax credits equal to 20 percent or 25 percent of the qualified expenditures. Certain feature films, movies of the week, miniseries, and new television series licensed for original distribution on basic cable are eligible for a 20 percent credit. Television series that filmed all of their prior seasons outside of California or certain independent films are eligible for a 25 percent credit. The tax credits are nonrefundable and nontransferable, except that certain qualified independent productions are allowed to sell their tax credits. Because the program is capped at $100 million of allocations per year, films with a production budget larger than $75 million are excluded from the program.

Various Types of Productions Ineligible. In an attempt to focus the credit on the types of productions least susceptible to "running away" to other jurisdictions, various types of productions are excluded from eligibility altogether. Among the types of productions excluded from the credit are commercials, television pilots, news programs, music videos, talk shows, reality television, award shows, daytime dramas, sporting events, student films, animated shows, variety programs, and adult films.

Credit Program Has Been Oversubscribed. The CFC may only allocate $100 million of tax credits each year but now receives between $400 million and $500 million of applications each year. Accordingly, since 2010-11, the commission has required that applications be completed and submitted by June 1, one month before the July 1 start of the fiscal year (when $100 million of new allocations becomes available under current law). On July 1, the CFC conducts a random selection of applicants until the $100 million is completely allocated. The remaining applicants are "waitlisted." Industry and CFC officials have stated that the limited supply of credits and the lottery calendar mean that productions that just happen to be proceeding on a calendar compatible with a July 1 lottery decision are more likely to apply for the credit. As a recent report by the Headway Project, an advocacy group, described it, "after the credits are allocated on July 1, California effectively has no film and TV tax credit program at all."

LAEDC Study

Studied Productions Receiving the First $199 Million of Tax Credit Allocations. The LAEDC study considers the economic impact of the first 77 productions approved in 2009-10 for tax credits totaling $199 million. These include 33 productions with projected qualifying expenditures of $10 million or more and 44 productions with qualifying expenditures of less than $10 million. Most of these productions were feature films. In total, the 33 productions with over

$10 million of qualifying expenditures were allocated tax credits valued at $164 million (83 percent of the total).

Projected Economic and Tax Benefits. The LAEDC estimates that these productions generated direct, indirect, and induced economic output of $3.8 billion and supported 20,040 jobs with labor income of $1.4 billion. For every tax credit dollar, the LAEDC report concluded that at least $1.13 in tax revenue would be returned to state and local governments—consisting of $1.06 per tax credit dollar in initial economic impact and $0.07 per tax credit dollar from ancillary production. (The study describes ancillary production as follow-on production spending facilitated by the local availability of talent, supplies, and services.)

The LAEDC report omits the economic and tax benefits of film-related tourism. Film-related tourism, for example, could include visitors who watched the film *Sideways* (which was produced before the tax credit was adopted) and were more likely to visit Santa Barbara wine country locations because they saw them in the film. The report states that the statewide economic effects of tourism related to credited films, although not quantifiable, may be significant and would add to the returns noted above.

Assumptions Used by LAEDC Study. Studies of the economic benefit of tax expenditures rely extensively on various assumptions. Among the key assumptions in the LAEDC study are the following:

- ***Sample of Production Budgets.*** The LAEDC researchers were able to obtain production budgets for 9 projects out of the 77 that received the first $199 million of credits. These nine productions had combined tax credit allocations valued at $41 million. Their production budgets totaled $336 million (a budget-to-credit ratio of about 8-to-1), while estimated total economic output was $847 million (an output-to-credit ratio of about 20-to-1) and total state and local tax liabilities were $45 million (a tax liability-to-credit ratio of just over 1-to-1). The LAEDC study appears to have essentially extrapolated these 9 productions' results to the entire group of 77 tax credit recipients, with some adjustments.

- ***Multiplier for Overall Economic Activity.*** The study projected that the multiplier, or eventual increase in overall state economic activity resulting from the initial increase in film production spending, was about 2.5:1. This translates to an estimate that total film production expenses of around $1.5 billion for the 77 projects resulted in total economic activity of $3.8 billion in the state's economy. These estimates were derived using the IMPLAN input/output model, which has often been used in this type of study.

- ***Assumes Films Would Have Been Produced Elsewhere but for the Credits.*** The LAEDC study appears to adopt an assumption that the productions that qualified for tax incentives would not have been retained in California but for their receipt of the tax credits. The LAEDC researchers state that "the flight of productions to other states and nations in response to competing incentives give credibility to the assertion that the cost reductions made possible by California's tax credit are responsible for keeping those productions here."

UCLA-IRLE Review of LAEDC Study

The UCLA-IRLE report included several sections, including one that reviewed the LAEDC study. The key conclusions of the UCLA-IRLE report with regard to the LAEDC study are as follows:

- ***LAEDC Analysis Is Reasonable.*** The UCLA-IRLE study found that the analysis presented by the LAEDC was reasonable. Specifically, the LAEDC's use of the IMPLAN model and its analyses concerning economic impact and job creation were found to be reasonable. The UCLA-IRLE researchers note that because some benefit from film-related tourism is unaccounted for in the LAEDC study, this would help compensate if the study overestimated other types of production benefits.
- ***Sample of Nine Production Budgets Not Representative.*** The UCLA-IRLE researchers found that the nine productions in the LAEDC sample were not representative of the rest of the tax credit recipients and this factor may have overstated the benefits of the tax credit program to some extent. The LAEDC researchers acknowledged this in their report and attempted to account for it, but the UCLA-IRLE researchers were unable to determine if they did so adequately. Moreover, the UCLA-IRLE researchers note their uncertainty concerning the origin and accuracy of the LAEDC report's figures for ancillary production benefits, such that these ancillary benefits may be overstated or understated.
- ***Assumption That All Productions Without a Credit Would Leave "Is Not True."*** The UCLA-IRLE study concludes that "while many producers are swayed by the enticement of a tax credit in their production location decision making, the [LAEDC report's] assumption that all productions that do not receive a credit will leave the state and only productions that do receive a credit will stay, is not true." The UCLA-IRLE report noted that while many waitlisted productions that have lost the CFC's tax credit lotteries were never "green lit" or were unable to come up with funding to film, 14 of the waitlisted did begin filming. Of these 14 waitlisted productions, 5 filmed in California despite receiving no tax credit. These five productions had budgets totaling $20 million and represented about 8 percent of the total estimated production budgets of waitlisted productions in the UCLA-IRLE sample. Using these figures, the UCLA-IRLE study makes a rough estimate that about 8 percent of tax credit production spending comes from productions that would film in California even with no tax incentive. Due to this adjustment, UCLA-IRLE researchers found that tax revenue returned to state and local governments likely totaled $1.04 for every tax credit dollar, instead of the $1.13 indicated in the LAEDC study. (The UCLA-IRLE report did not include adjustments for most other economic figures cited in the LAEDC report.)

LAO Comments

Assumptions Embedded in Methodology May Overstate Results. Economic analyses of this type rely on extensive assumptions upon which all results are premised. The LAEDC's use of the IMPLAN model obscures many assumptions underlying its analysis. While noting IMPLAN is respected among modelers, the UCLA-IRLE researchers write that neither they nor the LAEDC "has access to the exact assumptions" that went into the proprietary IMPLAN model.

Moreover, in a footnote, the UCLA-IRLE report states that the LAEDC study does not consider the "opportunity cost" of the state using tax credit money in this way—specifically, "spending on some other program, or programs [that] will be foregone" due to the state's budgeting of the credit funds. What would the return have been if a tax credit dollar was spent instead on an alternative public or private purpose? The lack of specific assumptions in this regard is a frequent problem with this type of study and may result in the net benefit of the tax credit being dramatically overstated.

UCLA-IRLE Correctly Notes Some Productions Film Here Without Any Credit. The UCLA-IRLE study is correct in noting the fact that some waitlisted productions proceeded anyway and were filmed in California without the credit. As the study states, it is difficult to ascertain with precision the exact proportion of spending by productions that would film in the state even without a tax incentive. The sample of waitlisted productions considered by UCLA-IRLE was very small. Better estimates may become available if the credit is extended and there continues to be an annual tax credit lottery (assuming that good data concerning waitlisted productions remains accessible). The UCLA-IRLE study noted that all of the waitlisted productions that filmed in California were independent films, which are likely to have smaller budgets than other productions. In the event that future studies consider these issues, it will be interesting to see if this trend continues.

Productions Filmed in Other States Generate Economic Activity Here. It is unclear the extent to which the LAEDC and UCLA-IRLE studies consider the fact that productions made in other states and countries often generate some economic activity here in California. Often when a production is made elsewhere, various specialized personnel are brought into those jurisdictions from California, and some categories of work on the project may occur in California even if principal production occurs elsewhere. These types of activities result in direct and indirect expenditures by production participants in the California economy. Thus, even when a production is outside California, some economic activity continues to be generated here. In general, this factor may result in the economic, employment, and tax *net* benefits from the credit program being overstated in the LAEDC and UCLA-IRLE reports. An exact estimate of these potential overstatements of the net benefit is not available.

Studies Seem to Omit "Crowding Out" Effects. The LAEDC and UCLA-IRLE studies—like many other studies of film incentives—do not seem to deal explicitly with crowding out effects in the state's economy. In this context, crowding out would occur when a production encouraged by the credit program to remain in California uses available staff and industry infrastructure that then are not available for use by other productions. Put another way, the films encouraged to remain in California by the credit tie up some workers and facilities that otherwise would be used in other productions. This could defer, reduce, or eliminate altogether the opportunity for those other productions to film here in California.

The crowding out effect would differ from year to year based on general employment trends and specific levels of capacity and activity in various specialized areas of the entertainment industry. For example, if a given part of the entertainment industry (say, a particular type of special effects production) is particularly busy with projects, crowding out effects related to that aspect of the industry may be significant. By contrast, if there is a slump in demand for that type of special effects, there could be little or no crowding out effects from the credit. In general, crowding out probably would reduce the employment, tax, and economic net benefits of the tax credit program at least somewhat below the levels indicated in the LAEDC and UCLA-IRLE studies.

Exactly how much excess capacity (such as unoccupied specialized workers, unbooked facilities, and other issues) exists in particular parts of California's entertainment industry at any given time is difficult to measure. During our brief time reviewing these reports, we were unable to locate very good data concerning these matters. We suspect that in some years the crowding out effect would be close to zero, while in other years, it could be much more substantial.

Tourism Related to the Credit Likely Not Significant. As noted above, the tax credit-related economic effects of film-related tourism were omitted from the conclusions of the LAEDC and UCLA-IRLE studies. Such effects would be difficult to measure, would sometimes (based on the content of particular credited films) be positive, and could hypothetically be negative at times (based on negative perceptions of the state created by some films). It is difficult to assume, however, that the content of credited films would routinely be significant in terms of inducing film-related tourism to California.

Net Credit Benefit Likely Much Less Than Reported. Above, we have discussed five issues that could affect the results of the LAEDC and/or UCLA-IRLE studies:

- Unknown assumptions embedded in the LAEDC economic models and their failure to consider the benefits of alternative public or private uses of tax credit funds (which could result in the credit program having significantly *less* net benefit than shown in the studies).
- In-state film activity that would occur in California without any tax credit (which results in the credit program having *less* economic and tax net benefits than shown in the LAEDC study).
- In-state economic and employment activity resulting from out-of-state productions (which results in the credit program having *less* net benefit than shown in the studies).
- Crowding out effects (which result in the credit program having *less* net benefit than shown in the studies in at least some years).
- Effects of film-related tourism (which would likely not result in significant changes in net benefits in most years).

While the total effects of these issues are impossible to quantify, their combined effects are likely to be negative in any given fiscal year—that is, resulting in the net benefit of the credit program being less than shown in both the LAEDC and UCLA-IRLE studies.

Given the conclusion that the net benefit of the credit program is likely less than shown in the LAEDC study, the LAEDC's finding that the output-to-credit ratio was about 20-to-1 is likely overstated, as is its estimate of job gains resulting from the credit program. Moreover, given that

UCLA-IRLE adjusted downward to $1.04 the projected state and local tax revenue return from every credit dollar and given that we find that this also was overstated, we believe it is likely that the state and local tax revenue return would be under $1.00 for every tax credit dollar—perhaps well under $1.00 for every tax credit dollar in many years. In any event, even if the combined state and local tax revenue return is right around $1.00 for every tax credit dollar, the state government's tax revenue return would by definition be less than $1.00 for every tax credit dollar. The credit program, therefore, appears to result in a net decline in state revenues.

For more information, please feel free to contact Jason Sisney at (916-319-8361 or Jason.Sisney@lao.ca.gov) or Justin Garosi (916-319-8359 or Justin.Garosi@lao.ca.gov) of my staff.

Sincerely,

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