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Film Production Incentives: a Game California Shouldn't Play

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and the Committee on Arts, Entertainment, Sports, Tourism, and Internet Media

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Mr. Chair, Madame Chair, and Members of the Committees:

I appreciate the opportunity to speak with you about the effectiveness of film tax credits in California. For those unfamiliar with the Tax Foundation, we are a non-partisan, non-profit tax policy research organization founded in 1937. Through research and education we aim to promote sound tax policy at all levels of government.

Over the past decade film tax credits have gone from being an obscure tax benefit available only in a few states to a ubiquitous nationwide policy tool. Film tax credits are credited with creating jobs, economic activity, and tax revenue for states, as well as bringing a little glamour to some states that aren't accustomed to the spotlight. But a great deal of economic misunderstanding surrounds film tax credits. In the next few minutes I'm going to lay out some of the concerns that the Tax Foundation has with film tax credits, and talk about how what California can and should do to address these concerns.

Costs and Benefits

The economic benefits of film tax credits are often exaggerated and misunderstood, while their costs are underestimated or completely ignored. States are currently locked in an unproductive arms race of film tax incentives, with film producers reaping most of the benefit. California would do well to reexamine this costly program in this time of fiscal distress.

First, I must address some of the economic misunderstandings surrounding film tax credits. There are many studies and statistics that claim to show that film tax credits provide an economic benefit for states. But unfortunately, the economic effects of film tax credits are often overstated and many costs are left out of the equation all together.

For example, supporters claim that tax credits do not cost states any revenue, because the tax credits lure companies that would not have located in the state without the credit. But this claim is based on the false assumption that all the credit recipients would have filmed elsewhere were it not for the credit. This is certainly not true in most states, and especially in California. Many, if not most, of the productions receiving credits would have located in California anyway. After all it is the home of Hollywood. For these production companies, the credit is a pure windfall and represents a *real* loss in revenue for the state. If this were *not* true, there wouldn't be any reason for states to cap the amount of film tax credits they approve. Proponents cannot credibly claim that film tax credits don't cost the state money.

However, some advocates go even further, claiming that by increasing jobs and economic activity, film tax credits actually "pay for themselves" with increased tax revenue generated from these activities. This claim is simply false, and for the same reason I just discussed: this claim is largely based on the assumption that all the credit recipients would have located elsewhere in the absence of the credit. This is not true, and much of the tax subsidy represents a real loss of revenue with *no net new jobs* to offset the cost.

Ultimately, film tax credits cost states revenue even if the exact amount is hard to pin down. This loss of revenue has important costs that are often ignored. To see why, it helps to understand that highly targeted tax benefits, such as film tax credits, are really just substitutes for government spending. They are economically equivalent to collecting the tax revenue and implementing a government spending program to spend this revenue on film makers. Film tax credits are government spending funneled through the tax code.

As is the case with any tax cut or tax benefit, there is an opportunity cost associated with giving tax dollars to film producers. Those dollars might have been used on other, more productive government spending that instead never happens. Or the lost revenue might have been made up with higher taxes on other taxpayers, reducing their well-being. Unfortunately these costs are almost always left out of the analysis of film tax credits, leading to highly biased results.

For example, proponents usually cite a number of jobs created or supported by the film industry, and the economic impact of film production spending. But these numbers suffer from some serious misunderstandings that greatly affect how film tax credits are evaluated.

For one thing, as I stated already, some of these jobs would have existed anyway in the absence of film tax credits. What is important is the number of *additional*, or induced, jobs, their impact on the economy, and the tax revenue they generate. In order to be a revenue gain for the state, any net new jobs, or net jobs saved, would have to generate enough tax revenue to outweigh the revenue wasted on productions that would have located in-state anyway.

There are other reasons to be cautious when using economic impact statistics. Advocates rightly point out that one dollar of film spending trickles through the economy and creates more economic activity. For instance, if a film production spends one dollar on wages for a worker, that worker will take that income and spend it in the economy, creating income for others, and so on. The additional economic activity generated by a dollar of spending is known as an economic multiplier. But the fact that film productions impact the broader economy is not *unique* to this industry. Other industries have a similar effect.

Also, as I noted a moment ago, spending tax dollars on film tax credits means forgoing other opportunities, and these missed opportunities have their own economic multipliers. If instead of giving 50 million dollars to movie producers, you spent those 50 million dollars on social assistance programs, that spending would also trickle through and impact the broader economy.

Or, if the revenue was instead left in the pockets of taxpayers they would spend the money in whatever way they see fit, benefiting the economy. Both the public and private spending opportunities that are forgone in favor of film tax credits would have their own economic impacts and their own multiplier effects. Some may have an economic multiplier greater than film production, some less, but the film industry is not unique in its ability to stimulate broader economic activity. The fact that the film industry impacts the broader economy alone is not enough to justify choosing the film industry over other uses of taxpayer dollars. Lawmakers need to weigh the benefit of film tax credits against other possible uses of the same revenue.

Though there are embarrassingly few of them, the studies that use more realistic assumptions and take into account more economic effects have always showed that states lose money on film tax credits. In fact they find that states only recapture somewhere between 8 cents and 28 cents in new revenue for every dollar of tax credit.[1]

Are Film Tax Credits Worth the Cost?

So with all these caveats, the question still remains, are they worth the cost for the state of California? California is obviously in a unique position among the states. For the most part, you are not trying to lure new businesses and industries to the state, as many other states are doing. Instead California's film tax credit was implemented as a defensive mechanism to avoid losing business to other states.

Indeed some reports have purported to show that the film industry in California is in trouble. However some of these claims are supported by data that is somewhat ambiguous. One report compares California’s share of total US film employment in 1997 and 2008 and finds that it has fallen by 2.6%, from 40% to 37.4%.[2] However, comparing market share during the 2009 recession to peak market share in 1997, right after a rapid 4-year spike, may be somewhat misleading. Using similar data from the Bureau of Economic Analysis (or BEA), I can make a similar comparison beginning in a trough year such as 2000, and show that California's share of film employment has increased from 36% to 38% between 2000 and 2009.

Obviously the picture can be skewed depending on the time frame one chooses to examine. That is not to say that California has not lost market share. Certainly, California's market share has fallen somewhat since 1990, the first year that the BEA has consistent data. According to the BEA, California's share of US film employment fell from 39% to 38% from 1990 to 2009. Similarly, total US film employment grew 26% over the last two decades, while California film employment grew only 23%. But these are hardly devastating numbers. It simply shows that other states are expanding into an area where California has historically dominated. And don't forget that California’s total film industry employment *has* grown since 2000, though it *has* had its ups and downs.

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[1] For a summary of these studies, see the South Carolina Policy Council, *Unleashing Capitalism,* Chapter 7.

[2] See Kevin Klowden, Anusuya Chatterjee,and Candice Flor Hynek, *Film Flight: Lost Production and Its Economic Impact on California*, Milken Institute, July 2010.

Ultimately, the data seem to show that California's share of film employment over the last two decades has fluctuated around about 39%, sometimes going higher, sometimes lower. In 2009 the state was below its average, and was trending down, but the trend is not a strong one.

So, film tax credits cost California much needed revenue. And it's not entirely clear what effect the national trend of film tax credits has had or will have on California in the long term. It has probably led some films to locate elsewhere, but it certainly has not devastated California's industry.

A Race to the Bottom

What *is* clear is that with your enactment of film tax credits in 2009, California is a late-comer to an extremely competitive and crowded playing field. In 2002 only five states had tax incentives for film productions. By 2009, *all but* six had them. Since about 1997, states have awarded over 4 billion dollars in film tax credits and incentives to film productions around the country. Obviously the arms race of incentives took off pretty quickly in the last decade. But it's not over. The pressure is mounting and many states are continuing to increase their incentives to gain an edge over other states.

Just last week in Oregon, film industry rallies broke out in support of a bill that would nearly triple the state's total cash rebate funds and increase the wage rebate rate from 10% to 20%.

This war of one-upmanship is what economists call a race to the bottom. In the context of state taxes, a race to the bottom is an *unhealthy* form of tax competition, where states compete to offer the best subsidy to one individual industry. The outcome of this race to the bottom is a bad one for all involved, except of course for the industry you're competing for.

The vast majority of states that have film incentives offer refundable or transferable tax credits, or direct cash rebates for expenses (the only exception is California). In these states the tax incentives have lost *all* connection to a production's actual tax liability. These states actually cut a check to companies whose tax credit is greater than their tax liability. When production incentives have no connection to a company's tax liability, they are really more accurately described as grants.

We have refundable tax credits in state and federal income taxes: they are targeted at low-income, needy families. The most well-known is the Earned Income Tax Credit, or EITC. The EITC is appropriately acknowledged by public policy experts as a form of welfare or social assistance implemented through the tax code. Similarly, film tax credits are a form of corporate welfare and have been criticized by policy experts on the right and the left.[3]

Film incentive advocates want to make is seem like states just need to enact one more expansion, to increase the credit rate just a little more, or allow just a few more eligible expenses, and then they will have the upper hand. The truth is that in the long run no state can ever win at this game. If California lawmakers think they will be able to hold the line on film tax credits and still remain competitive, they're deeply mistaken. It is naïve to think that your credit program will stay competitive when other states (not to mention others countries) have implemented and expanded on refundable, transferable tax credits and direct cash rebates, often at higher reimbursement rates than California is offering. Even by joining the arms race of tax incentives you may never be able to offer enough to win back those productions you have lost. But you will waste a lot of money trying.

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[3] See Robert Tannenwald, *State Film Subsidies: Not Much Bang For Too Many Bucks*, Center on Budget and Policy Priorities, December 9, 2010.

In a sense, film tax credits can be thought of as a highly competitive market, with governments acting as the "producers" of film tax credits and filmmakers as the "consumers". And as any economist will tell you, in a highly competitive market such as this, the buyers can buy from whichever seller offers them the best deal, and therefore they reap all the economic benefit of film tax credits; the economic benefit for the seller, that is the states, eventually goes to zero.

How Should California Move Forward?

While the national situation with film tax credits has devolved into an unproductive race to the bottom, I acknowledge that California potentially has a lot to lose. California still has a legacy and history that you want to preserve. You also want to continue to support and promote the arts in your state. But these concerns are not economic and are hard to quantify. It is up to you to decide whether it is worth the cost of film tax credits to maintain California's image and artistic dominance.

The Tax Foundation would obviously like to see the end of all film tax credits nationwide. But that is a long way off from the current state of affairs, and beyond your control. So what are the Tax Foundation's recommendations for California? Here are our suggestions, in order of our preference.

Ideally, we would like to see you eliminate California's tax credit. No doubt there will be a lot of protest from the beneficiaries: once a tax benefit is in the tax code, it can sometime seem almost impossible to eliminate. But this would be a move in the direction of sound tax policy and would save the state millions of dollars at a time when revenue is hard to come by.

Another suggestion is to change the budgetary treatment of film tax credits. As tax credits they are largely hidden from public view and from budgetary scrutiny. Because tax credits in general, and film tax credits specifically, are equivalent to government spending, if the subsidy stays it *must* be taken out of the tax code and shifted to the spending side of the budget. Lawmakers must admit that these credits cost the state money and must weigh them against other spending priorities, such as education and public health.

California also needs to study the costs and benefits of film tax credits in a comprehensive way, using realistic economic assumptions. A good place to start is the Michigan State Fiscal Agency's report from September 2010, entitled "Film Incentives in Michigan." The author, economist David Zin, discusses many mistakes that have plagued other studies of film tax credits. Still, even his analysis does not include the opportunity cost of film tax credits, and California must not ignore these costs.

Finally, you need to make your program more transparent. A recent report by Good Jobs First, an organization that pushes for transparent and accountable economic development, noted that California has no publicly available online database of film tax credit recipients and amounts. They gave California a failing grade for film tax credit transparency.[4] Californians deserve to know where their tax dollars are going. This information is essential for transparent government and a well-informed electorate.

[4] See Philip Mattera, et al. *Show Us the Subsidies: An Evaluation of State Government Online Disclosure of Economic Development Subsidies*, Good Jobs First, December 2010.

There are two things you shouldn't do: increase subsidies to film companies or remain satisfied with the status quo.

Times are tough around the country. Budgets are tight and the economy is still sluggish. Recently, in recognition that film tax credits are a costly luxury that they can't afford, a few states have cut back or eliminated their programs.[5] Likewise, I urge you to take responsible action on film tax credits.

Thank you very much for your time.

[5] See Joseph Henchman, *Special Report No. 188: State Tax Changes During 2010*, Tax Foundation, January 12, 2011.