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ARE REFUNDABLE TAX CREDITS NEEDED TO SAVE CALIFORNIA'S FILM INDUSTRY?

A new proposal would provide generous tax credits for the film and related industries. Proponents of these incentives argue that these credits are needed to stem the tide of "runaway production" - which refers to the shift of productions from California to other states or countries. This paper examines the current proposal and key facts and trends related to this debate.

Introduction

The current proposal (AB 777, Núñez) would:

- Provide a cash payment of up to 15 percent of qualifying costs incurred with respect to qualified productions of features, movies of the week, miniseries, television series, or commercials where at least 75 percent of the principal photography shooting days occur in California. Qualified productions would exclude those required to register under federal laws governing sexual exploitation and other abuse of children.
- Allow the payments to be claimed as a refund of sales or use taxes paid or owed or as a refundable tax credit against personal or corporate income taxes owed. A refundable tax credit provides a cash payment if the amount of the credit exceeds any taxes owed.
- Define qualifying costs to include wages; fringe benefits; payments to independent contractors; payments to personal service corporations; and amounts paid for set design and construction, props, wardrobe, and similar costs.
- Give the California Film Commission responsibility to allocate the credits.
- Limit the total amount of credits to an unspecified amount and make the credit available for a ten year period beginning in 2005.

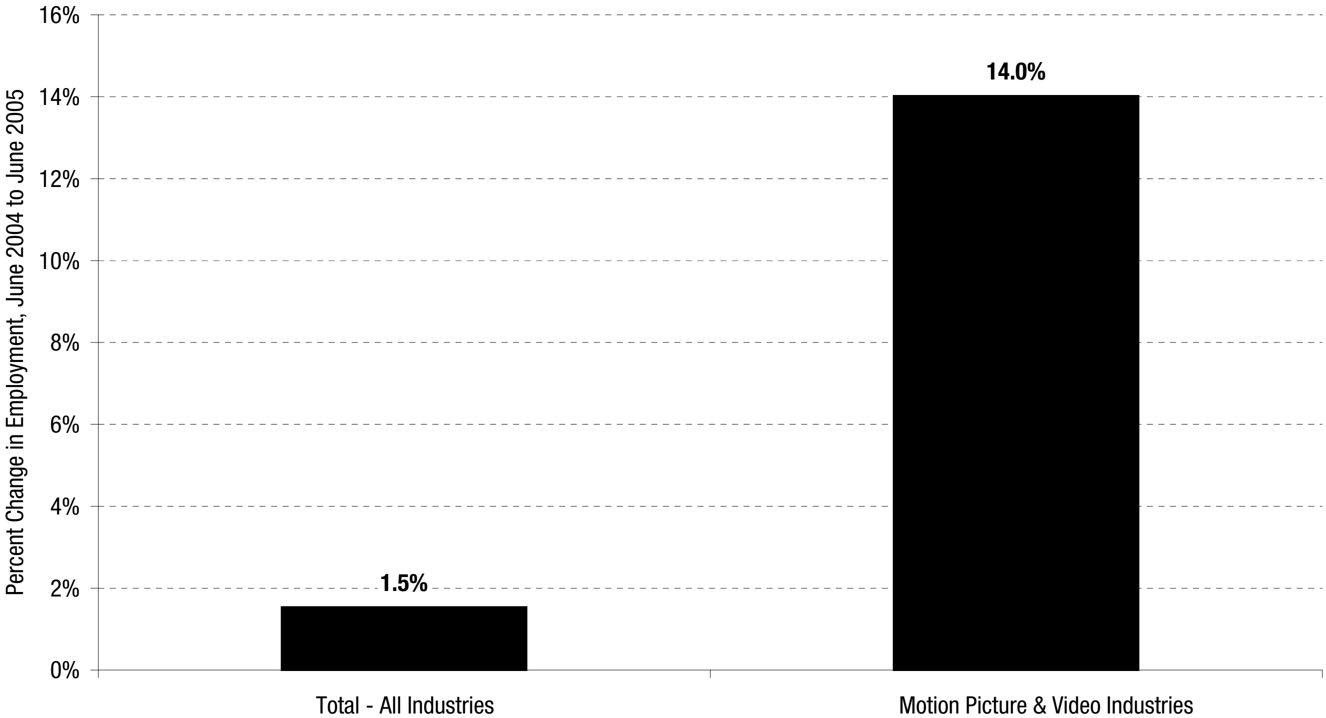
Employment Figures Do Not Support Claims Of Rising Runaway Production

Total motion picture and video employment in California increased by 35,400 (30.5 percent) between 1994 and 2004.[1] More recent data show that motion picture and video industries added 20,400 jobs between June 2004 and June 2005 - the most recent month for which employment data are available - an increase of 14.0 percent (Figure 1). In contrast, total employment in California rose by just 1.5 percent during the same period.

Some proponents of film tax credits attempt to support their claims by citing a fall in industry employment. While motion picture and video industry employment in California did fall from 141,600 in June 2001 to 131,800 in June 2003, by June 2004, employment had climbed back up to 145,500 and stood at 165,900 in June 2005 (Figure 2).

Moreover, some proponents and studies only look at parts of the film industry. The widely-cited 1999 Monitor Company study, for example, excludes animated films, commercials, daytime soap operas, documentaries, foreign films, foreign language television, game shows, infomercials, music videos, news programs, public access productions, religious programming, sports entertainment, training films, talk shows, and television specials.[2] Studies that exclude segments of the film industry risk missing shifts from certain production activities to others. This approach could

Figure 1: Motion Picture Employment Growth Far Surpassed Total Employment Growth in the Past Year



Source: Employment Development Department

overstate the economic impact of runaway production. An August 19, 2005 *Los Angeles Times* article, for example, noted that "Television's role as the driving job creator in Holloywood will be underscored today when local film officials release a study showing a near-tripling in onlocation TV activity over the last decade."[3]

Production Days in Los Angeles Peaked in 2004

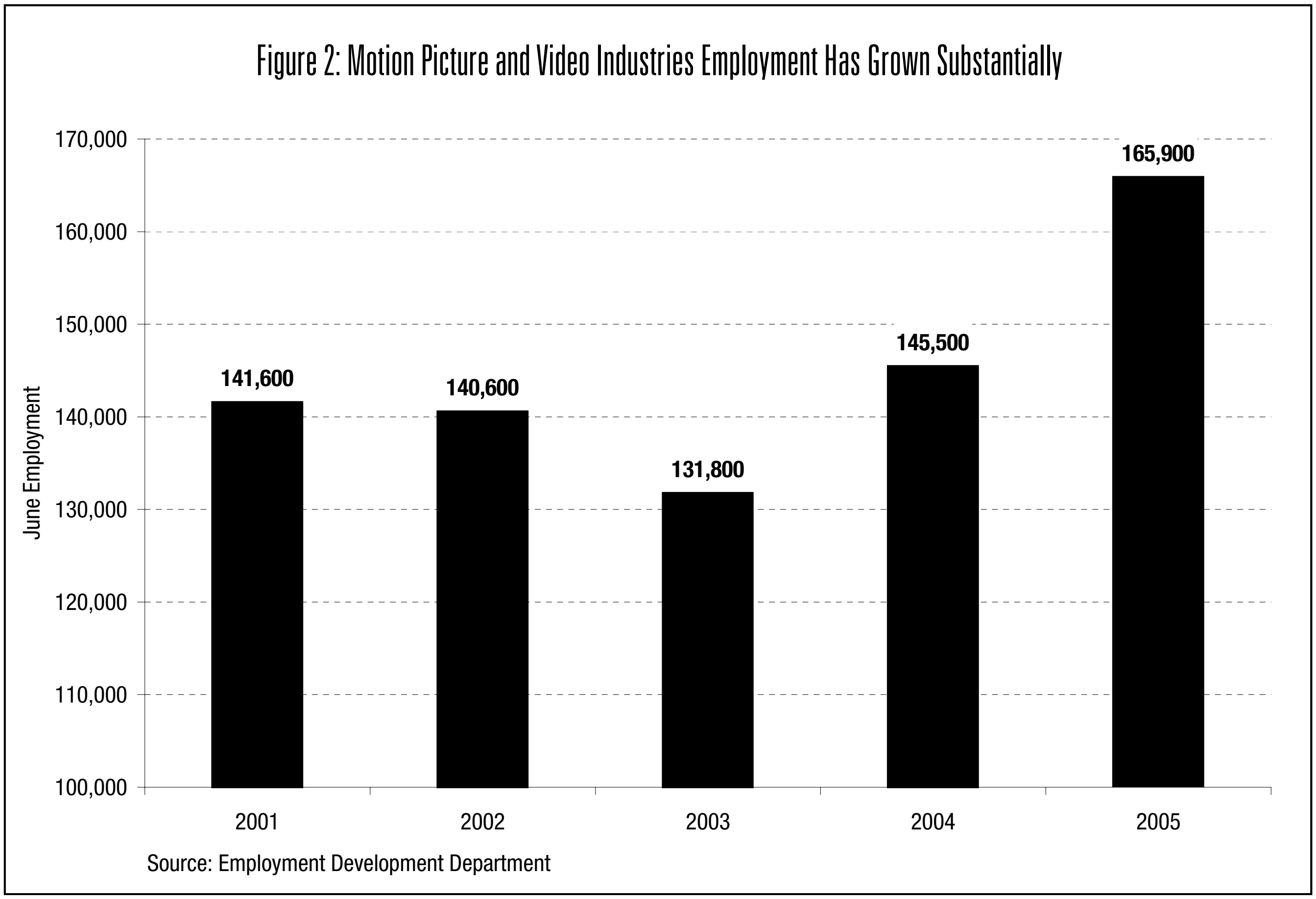
Proponents of tax subsidies point to the decline in features production days in Southern California since the late 1990s as a cause for concern. However, Los Angeles area production days for the entertainment industry overall have increased substantially. Total production days increased to 52,570 in 2004, up 18.9 percent from the prior year and 4,901 days above the prior peak of 47,669 in 1997 (Figure 3). Moreover, Los Angeles area features production days rose 24.9 percent during the first quarter of 2005 relative to the same period in 2004.[4] In addition, features production days increased 18.8 percent in 2004 relative to 2003. The number of production days for commercials, which would qualify for tax credits under the current proposal, has also increased – by over 1,000 between 2003 and 2004.[5] These data, which come from sources associated with the film industry, suggest that the industry is not in crisis.

Finally, it is critical to consider runaway production figures in relation to figures for overall production, and not just in absolute terms. One study shows that, while the share of US-developed productions that ran away for economic reasons increased from 1990 to 1998, the number of US-developed productions that were produced domestically also increased. For example, while the number of US-developed films that ran away increased from 44 in 1990 to 100 in 1998, the number of US-developed films produced domestically also increased from 223 to 363 over the same period.[6]

Why Have Some Productions Moved Abroad?

Numerous factors have led US film production to move abroad, including increasing worldwide demand for filmed entertainment, the formation of international production companies, the construction of new high-tech studios abroad, beneficial financing and tax incentives in foreign countries, and new technology that has aided the movement of high-quality film production to new locations and led to the replacement of some US film workers.[7]

In short, it is not just foreign tax incentives that are facilitating runaway production - as some imply - but a host of other factors as well. This suggests that solutions to runaway production



narrowly focused on tax incentives may well prove inadequate to counter the movement of production to locations abroad. As the Monitor Company noted in a study often cited by tax-subsidy proponents, "The solutions [to runaway production] will not be simple because the causes are several and very complex."[8]

How Much Does California Really Lose When Productions Run Away?

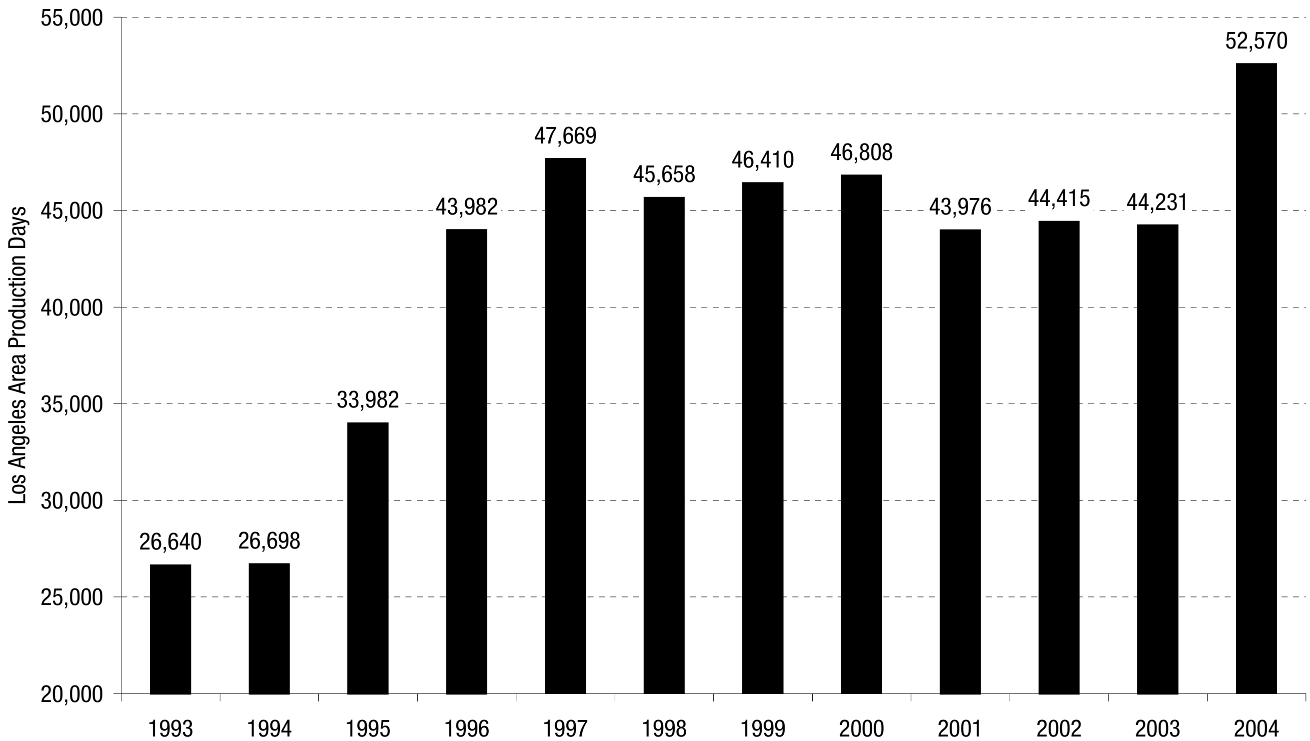
The industry's estimates of revenues and economic activity lost to California tend to be static estimates. That is, they assume that the capital, labor, and other assets that might have been employed in a runaway production remain idle when that production goes outside of California. As such, they do not account for the possibility that people are finding employment and suppliers are finding clients elsewhere, continuing to pay taxes on their earnings. For example, a catering company that might have worked for a movie of the week instead may be selling food to a firm producing music videos or increasing its sales to political fundraisers.

As noted above, one of the most widely cited studies of the economic impact of runaway production is the 1999 Monitor Company report. However, an October 2004 study commissioned by four Canadian industry organizations disputes the Monitor Company's findings. The study argues that the Monitor Company's report's estimate of the direct and indirect economic losses to the US were significantly exaggerated, as they included double counting and arithmetic errors. The Monitor Company estimated direct and indirect economic losses of $10.3 billion to the US in 1998. In contrast, the Canadian-industry report estimated a loss of approximately $1.7 billion during the same year.[9]

Why Do the Proponents of Film Subsidies Want a Refundable Credit?

Under standard film industry practice a partnership, corporation, or other ownership entity is often established for each production. Many of these companies do not make a profit and thus pay no corporate income taxes. Instead, many production companies pay out income received as executive salaries, and then sell the final production to a distributor who makes a profit from distributing the film. A traditional credit would be of no use in such cases, since the film companies pay no tax against which to claim the

Figure 3: Los Angeles Area Production Days Peaked in 2004



Source: Entertainment Industry Development Corporation

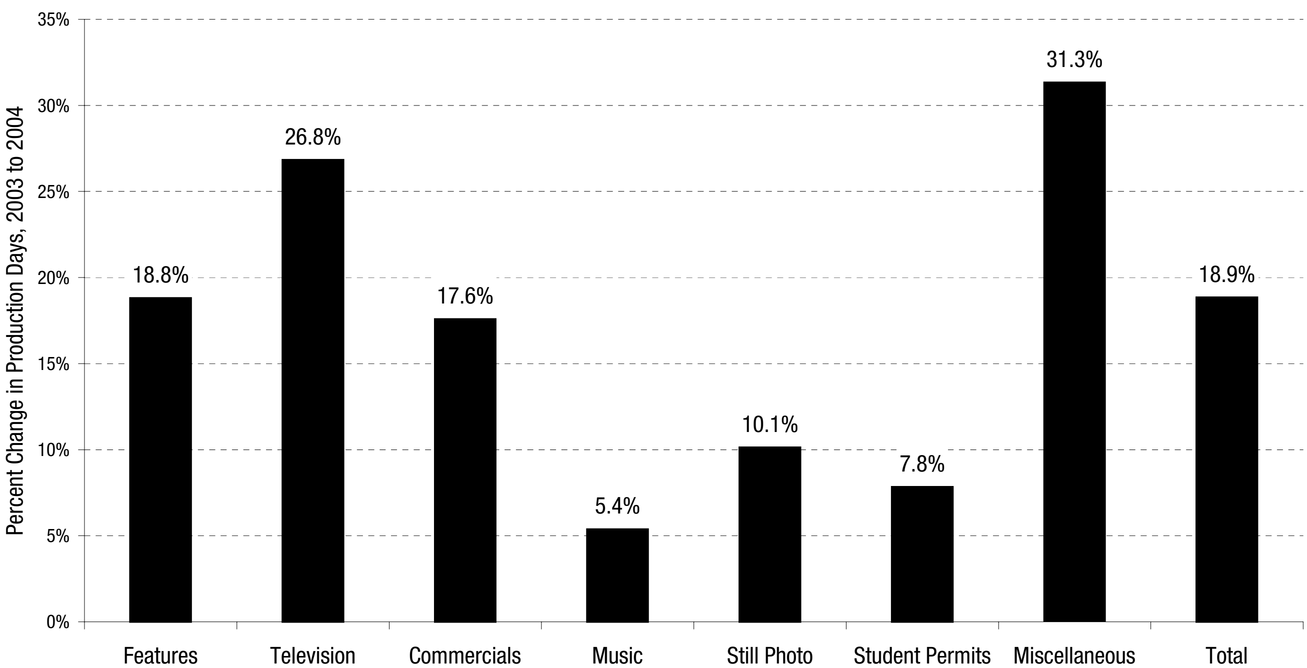
What Does the LAEDC Report Say About the Potential Impact of Film Industry Subsidies?

A new report prepared for the California Film Commission by the Los Angeles Economic Development Corporation (LAEDC) estimates the state tax revenues attributable to film and related production activities in California.[10] The LAEDC looks at direct employment – persons employed directly in production activities – as well as indirect employment of individuals and the amounts workers spend at shops, restaurants, and other businesses. The LAEDC report does not attempt to assess the impact that subsidies for the film industry would have on employment or state tax revenues. Specifically, the report does not address the impact of diverting tax dollars from other uses to provide film industry subsidies.

California faces a structural budget deficit – baseline spending that exceeds revenues – for the foreseeable future. Thus, dollars that are spent to provide subsidies to the film industry must come from reducing spending or increasing taxes on other businesses or individuals.[11] The "bottom line" impact on the California economy would be the sum of any positive impact on film industry employment and related tax revenues *minus* the loss of jobs and related tax revenues from cuts to state spending or higher taxes on other businesses and individuals needed to finance film subsidies. If, for example, school funding is cut by $100 million a year to provide funds for film industry subsidies, local school districts would receive fewer dollars and would employ fewer teachers, school bus drivers, or other staff (or pay their existing staff lower wages). In this example, film workers' gain would be school workers' loss. Similarly, if transportation funding is cut to provide funds for film industry tax credits, the state will employ fewer construction workers and they will have less money to spend in local communities. In short, the LAEDC study looks only at one half of the equation – the positive contribution made by film productions – and does not attempt to estimate the negative economic impact of the spending reductions needed to pay for the cost of the subsidies.

While some proponents of tax credits maintain that such subsidies will "pay for themselves" in added economic activity, there is no credible research that supports this supposition. In addition to the negative impact of lost revenues on services discussed above, it is important to note that some fraction – potentially a very large fraction - of the productions that would receive tax credits would have filmed in California in the absence of a subsidy. In these instances, the state will receive no benefits attributable to the subsidy from added economic activity. The current proposal makes only a minimal effort to direct credits to activities that are "new" to California. Given the cost disparities between California and other locales, the credit may not be sufficient to keep productions intent on filming in the lowest cost locale in California.

Figure 4: Los Angeles Area Production Days Posted Strong Gains in 2004 Across the Entertainment Industry



Source: Entertainment Industry Development Corporation

credit. At present, however, California has no refundable tax credits for businesses.

By creating a refundable credit for the film industry, California would establish a costly precedent for other industries. Historically, California has limited the use of tax credits to firms that pay taxes in California. The current proposal would provide subsidies in excess of any state income or sales tax liability.

Why Use Tax Credits to Assist Businesses That Pay Little to No Taxes?

Other alternatives for subsidizing California-based movie production are available. Options include grant or rebate programs that could be carefully crafted to apply only to productions that would have gone out-of-state in the absence of assistance. As a recent Senate Revenue and Taxation Committee bill analysis notes, a significant advantage of a grant program is that it may be administered in a way that focuses available funds on taxpayers whose behavior will most likely be affected by the grant.[12] However, many of the recent proposals would provide refundable credits even to those film producers that would have filmed their productions in California in the absence of the credit.

Should the State Subsidize Graphic Sex or Violence?

The current proposal raises a number of issues with regard to the types of content that might receive taxpayer-supported assistance. The current proposal would exclude productions that are subject to federal registration under provisions governing sexual exploitation and other abuse of children. However, the range of productions that would be excluded by this provision is narrow and the federal law referenced in the proposal states that it pertains only to "actual but not simulated conduct."[13] Nor does the exclusion apply to graphic violence or other conduct that many Californians might find offensive. While movies with graphic but not actual sex or actual violence would qualify for tax credits, news, documentary, and public affairs programming would not be eligible for subsidies.

Some suggest that even the minimum exclusion contained in this measure might be deemed to infringe on the freedom of speech protections offered by the First Amendment to the US Constitution. Such content provisions also may provoke controversy over what role the state should play in subsidizing productions with other potentially controversial content, such as extreme violence or politically sensitive issues.

What Types of Commercials Would Be Eligible?

This measure, unlike previous proposals, would provide tax credits for commercial advertising. The measure states that "qualified commercials" would not include "fundraising or political commercials…or a program produced by organization organized under Section 527 of the Internal Revenue Code."[14] It is unclear, however, what would qualify as political advertisement. Would, for example, an advertisement sponsored by the pharmaceutical industry touting a prescription drug discount plan qualify as political advertising? Would the same advertisement be considered political advertising if it aired during a hotly contested campaign over competing drug discount plan? Providing subsidies to some types of advertising, but not others, raising a number of issues regarding freedom of speech, as well as concerns over how decisions would be made as to what types of advertising does and does not qualify for subsidies.

Conclusions

The current proposal:

- Sets a costly precedent for California by providing refundable tax credits - cash subsidy payments – for motion picture production activities. Other industries central to the California economy are likely to advocate for similarly generous tax subsidies if this measure is successful.
- Comes at a time when entertainment industry production days and employment have posted strong growth.
- Would worsen the state's ongoing budget crisis. The Legislative Analyst's Office estimates that 2006-07 expenditures will exceed revenues by around $6.1 billion.[15]

Jean Ross prepared this Budget Brief. *The California Budget Project (CBP) was founded in 1994 to provide Californians with a source of timely, objective, and accessible expertise on state fiscal and economic policy issues. The CBP engages in independent fiscal and policy analysis and public education with the goal of improving public policies affecting the economic and social well-being of low- and middle-income Californians. General operating support for the CBP is provided by foundation grants, individual donations, and subscriptions. Please visit the CBP's web site at www.cbp.org.*

ENDNOTES

1 California average annual industry employment downloaded from Employment Development Department, Labor Market Information Division, at http://www.calmis.cahwnet.gov/file/indhist/cal$haw.xls on June 10, 2005.

2 Monitor Company, *U.S. Runaway Film and Television Production Study Report* (June 1999), p. 6.

3 Richard Verrier, *Movies, Shmovies – TV's Taking Over LA* (Los Angeles Times: August 19, 2005).

4 Entertainment Industry Development Corporation, *Productions Days: Features By Month & Percentage Change from Previous Year* downloaded from http://www.eidc.com/FeaturesHist.pdf on August 19, 2005.

5 Entertainment Industry Development Corporation downloaded from http://www.eidc.com/PDTotals.pdf on August 16, 2005.

6 Martha Jones, *Motion Picture Production in California* (California Research Bureau: March 2002), p. 36.

7 US Department of Commerce, *The Migration of U.S. Film and Television Production* (January 2001) downloaded from http://www.ita.doc.gov/media/migration11901.pdf on June 9, 2005, p 59.

8 Monitor Company, U.S. Runaway Film and Television Production Study Report (June 1999), p. 5.

9 Employment Development Department, *Report to the Legislature on the Motion Picture Industry in California* (June 2005), p. 6.

10 Gregory Freeman, et al., *What is the Cost of Run-Away Production? Jobs, Wages, Economic Output and State Tax Revenue at Risk When Motion Picture Productions Leave California* (August 2005), downloaded from http://www.film.ca.gov/ttca/pdfs/link_overview/cfc/California_Film_Commission_Study.pdf on August 23, 2005.

11 The state could borrow to finance film subsidies in the short term; however that would reduce funding available for public services in the long-term and would result in greater costs since the state would pay interest on amounts borrowed..

12 Senate Revenue and Taxation Committee, *Analysis of SB 58* (June 8, 2005).

13 So-called 527 organizations have sponsored independent political expenditures for candidates and issues.

14 Section 2257 of Title 18 if the US Codes, downloaded from frwebgate.access.gpo.gov on August 18, 2005.

15 Legislative Analyst's Office, *Major Features of the 2005 California Budget* (July 2005), p. 4