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F I S C A L   I M P A C T   R E P O R T

ORIGINAL DATE 01/26/10
SPONSOR Kintigh **LAST UPDATED** **HB** 52

SHORT TITLE Repeal Film Production Tax Credit **SB**

ANALYST White

REVENUE (dollars in thousands)

Estimated Revenue			Recurring or Non-Rec	Fund Affected
FY10	**FY11**	**FY12**		
$0.0	$ 71,500.0	$ 78,700.0	Recurring	General Fund

(Parenthesis ( ) Indicate Revenue Decreases)

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

	FY10	FY11	FY12	3 Year Total Cost	Recurring or Non-Rec	Fund Affected
Total	$0.0	$0.1	$0.1	$0.1	Recurring	SIC Operating Fund

(Parenthesis ( ) Indicate Expenditure Decreases)

SOURCES OF INFORMATION
LFC Files
New England Public Policy Center at the Federal Reserve Bank of Boston

Responses Received From
State Investment Council (SIC)
Taxation and Revenue Department (TRD)
Economic Development Department (EDD) – New Mexico Film Office

SUMMARY

Synopsis of Bill

House Bill 52 repeals all of Article 7-2F and parts of the severance tax bonding act relative to the film production tax credit and film production loans made from the severance tax permanent fund (STPF). The proposed legislation further replaces the repealed portion of the severance tax bonding act with language decreasing the amount of loans which may be made from the STPF to eligible film projects, from 6 percent of the market value of the fund to 3 percent of the market

value of the fund. The new language further eliminates the current cap of $15 million on the amount of money the STPF may invest at a market rate in any one film project, while simultaneously eliminating the zero-interest film guaranteed loan program. The proposed legislation also eliminates various due-diligence requirements related to STPF film investments such as:

- The project has posted a completion bond approved by the New Mexico Film Division;
- If the project has not posted a completion bond, that it has "obtained a full, unconditional, and irrevocable guarantee of repayment of the invested amount" in favor of the STPF:
    - From an entity rated investment grade by a national rating agency;
    - From a substantial subsidiary whose parent holds an investment grade rating from a national rating agency;
    - By providing a letter of credit from a U.S. bank with a credit rating of A or better by a national rating agency;
    - From a substantial and solvent entity as determined by the SIC
- If not guaranteed pursuant to those methods listed above, the project must have obtained no less than one-third of the estimated total production costs from other sources as approved by the State Investment Officer (SIO).

FISCAL IMPLICATIONS

The December 2009 consensus revenue forecast included $71.5 million in film production credits to be paid out in FY11 and $78.7 million to be paid out in FY12. The state paid out almost $80 million, or nearly a third of total corporate income tax receipts in FY09. Repealing the film production tax credit would therefore increase corporate income tax receipts by those amounts, but these increases would be partially offset by a probable decline in film activity that existed due to the credit.

Estimated GF Revenue Impacts (thousands)					
FY10	**FY11**	**FY12**	**FY13**	**FY14**	**FY10-FY14**
$ -	$ 71,500.0	$ 78,700.0	$ 86,500.0	$ 95,200.0	$ 331,900.0

Source: Taxation and Revenue Department

Note: After the release of its initial analysis, the Taxation and Revenue Department (TRD) revised its stance on the proposed legislation stating:

> "The estimate shows only the amount of film production credits disallowed, based on the December 2009 consensus revenue forecast, and assuming that the bill would disallow all credits that would have been paid starting July 1, 2010…The Film production tax credit has been instrumental in developing the film industry in New Mexico, and the attendant jobs, worker training and expertise, and investment in film-related facilities and equipment."

In its analysis of House Bill 52 the New Mexico Film Office indicates that it anticipates film industry direct spending of $150 million in FY11 yielding tax credits of $37.5 million. This number is just over half the $71.5 million estimated by the consensus revenue group, made up of economists from DFA, TRD, DOT, and LFC. Using the results of two studies on the benefits of New Mexico's film production tax credit program, the following general fund impacts can be estimated from using both projections.

GF Impacts Using Film Office Credit Estimates:

	Ernst & Young	Arrowhead Center
Direct Film Spending	$ 150.0	$ 150.0
Tax Credit	$ 37.5	$ 37.5
Revenue per $ of Credit	0.94	0.14
Revenue from Film Spending	$ 35.3	$ 5.25
Gain/(Loss) to the State	$ (2.3)	$ (32.25)

* Dollars in Millions

GF Impacts Using Consensus Revenue Group Credit Estimates:

	Ernst & Young	Arrowhead Center
Direct Film Spending	$ 286.0	$ 286.0
Tax Credit	$ 71.5	$ 71.5
Revenue per $ of Credit	0.94	0.14
Revenue from Film Spending	$ 67.2	$ 10.01
Gain/(Loss) to the State	$ (4.3)	$ (61.49)

* Dollars in Millions

Therefore, we can come to the conclusion that even in a best case scenario, using the Ernst & Young return per dollar of credit, the film production tax credit program is still expected to cost the state general fund tax revenue in FY11. In a worst case scenario, using the Arrowhead center return, these losses could be substantial. A more in-depth discussion and analysis of both of these studies is included in the significant issues section below.

Dynamic Analysis. The two studies that have been conducted on the potential economic impacts of the film industry in New Mexico are examples of "dynamic analysis" and are discussed in great detail in the significant issues section below. This type of analysis attempts to capture the full economic consequences of state tax policies, taking into consideration all of the potential actions and reactions of economic actors in the state. The wide disparity in results of the two studies illustrates how complex this analysis can be and also the difficulty of coming to a consensus on the correct assumptions and methods to use. Notwithstanding all the work done on these studies, they did not address a number of the important factors affecting economic impacts. These include the question of how the state's spending policies are affected by the proposed use of tax revenue, and whether the new workers employed in the film industry are from New Mexico or from another state. Because of the difficulty of deriving results that are reliable and also the difficulty of reaching a consensus on this type of analysis, the LFC has decided not to include dynamic analysis in FIR's. Although it could be argued that this means the LFC FIR's are biased, the alternative would be to introduce uncertainty and questionable results into the FIR's that would make them less reliable and more inconsistent.

SIC reports that there will not be significant fiscal impacts in the short term as the portfolio is reallocated to meet the 3 percent target in HB52 but that there is a concern that moving to "market rate" loans may create a higher risk of loan defaults. HB52 repeals the requirements regarding loan guarantors or letters of credit, and SIC is concerned that this would expose the fund to more loan defaults.

State Investment Council (SIC):

> As of 12/31/09, the current Film Investment Program has $213 Million capacity, with $142 Million outstanding or in closing. With 3% of the STPF, assuming a stable market value for the Fund, the SIC would require approximately $60MM in loans to be repaid prior to activating the new "market rate" program outlined in HB 52. The SIC has approximately $37MM coming due for repayment in calendar year 2010, and of course the program's capacity is largely dependent on the corpus of the STPF and whether we will see a recovery of investment values in the next few years. Conservatively, it will be the 4th quarter of CY 2010 at the earliest before the program created by HB 52 could be active and loaning money at a market rate to NM film or TV projects. At that time, fiscal impacts could be significant to the SIC…"

SIGNIFICANT ISSUES

Film Credit Repeal. The film production tax credit is a 25 percent refundable credit on most taxable expenditures made in the state. The credit is against either personal income tax or corporate income tax liability and any excess above liability is returned to the taxpayer. Most of the credit to date has been applied against corporate income tax liability.

Governor Gary Johnson in 2002 signed into law House Bill 118 from the 2002 session which created the 15 percent refundable film production tax credit. The credit was scored to cost $1.6 million annually according to the LFC fiscal impact report for HB118 in 2002. The credit was expanded in 2005 to include an additional 5 percent credit that was available through tax year 2008. At the time, TRD calculated the impact of the additional 5 percent credit at $250 thousand. In 2006, the credit was expanded to 20 percent and the additional 5 percent through 2008 and another credit, the filmmaker's tax credit, was repealed. TRD estimated that the cost would be $1.8 million annually. At the time the Film Office reported an economic multiplier of 4. In 2007, the credit was expanded again to 25 percent and made permanent. At that time the fiscal impact for the film credit program was estimated to be $33 million growing to $50 million by FY12. In FY09 the state paid out nearly $76.7 million in film production tax credits

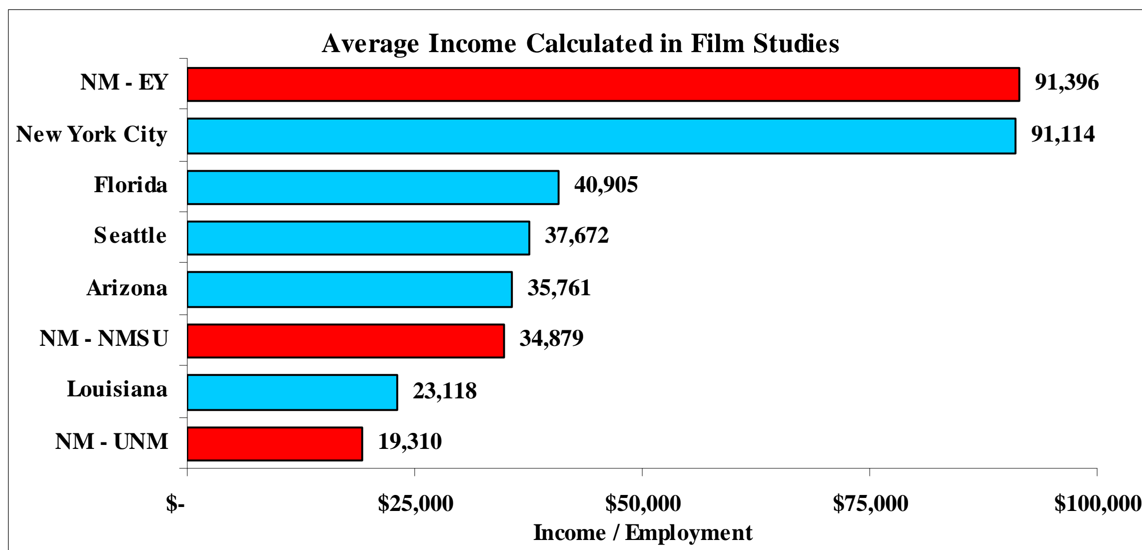
***Film Studies*.** In 2008, after repeated requests for the Film Office to study the impact of the credit on state revenues, the LFC contracted with the Arrowhead Center at New Mexico State University to analyze the impacts of the film credit and the return on the investment to the state. NMSU-Arrowhead looked at the film activity that was eligible for the credit and determined that the additional economic activity from film production generated 14.4 cents for every dollar of tax credit. The study was similar to other studies around the country in both methodology and results. NMSU has had significant experience estimating economic impacts of various industries in New Mexico.

In the fall of 2008, the New Mexico Film Office in conjunction with the SIC conducted a study of the film production tax credit program that included a survey of film industry participants and a survey by the Department of Tourism on film tourism impacts. This study, conducted by Ernst & Young in Washington, DC, showed only a slight negative return on the state's investment and including local governments a net positive return. According to the study, for each dollar of credit, the state received 94 cents back from the tax generated from additional economic activity and 56 cents went to the local governments.

Due to the significant differences between the Ernst and Young film study and a number of other studies performed throughout the country including the analysis done by the Arrowhead Center,

the New England Public Policy Center (NEPPC) at the Federal Reserve Bank of Boston published an analysis of the various studies in April of 2009. The analysis questions various aspects of Ernst and Young studies performed in New Mexico and New York, including model calibration, lack of a balanced budget assumption, the amount of economic activity actually attributable to the film-credit, questionable wage and salary assumptions, and lack of detail surrounding the compilation of tourism impacts. The analysis states that "although some of the methodological choices made by the E&Y authors are legitimate, there are several problems with the studies that lead us to question the accuracy of their findings." The summary also states that "… some of the decisions of the E&Y authors—such as the failure to include a balanced budget requirement—cannot be easily justified."

Several other states and cities have studied the film industry's impact on the local economy. The Ernst and Young study shows a much greater impact than any other readily available study. The key differences between the Ernst and Young study and other studies, including the other studies done by NMSU-Arrowhead and UNM-BBER are the assumptions regarding average wages, and the inclusion of capital expenditures and tourism. It is hard to compare the latter two components of the Ernst and Young study (tourism and capital expenditures) with other studies. The tourism component adds one-third of the return on investment making it a crucial piece of the conclusion that the credit nearly pays for itself. The comparable components are the assumptions about compensation. The chart below shows the assumptions about direct film production activity for various studies. The Ernst and Young study has an average income equivalent to New York City which seems incongruous with other studies particularly ones done by the in-state research groups, BBER and Arrowhead.



Based upon both studies results and methodologies, LFC staff compiled their own analysis of the two studies in 2009. The results of the analysis showed that a number of differences in assumptions and time periods were to blame for the rather wide discrepancies between the two studies. However the LFC analysis came to the primary conclusion that while the Ernst and Young study undoubtedly overstates the financial return to the state, the Arrowhead Center study most likely understates the financial benefit to the state. The 2009 LFC analysis came to the conclusion that on a purely apples to apples comparison of the two studies the actual return to the state from the film production tax credit was roughly 25 cents for every dollar.

The most important conclusion that can be made as a result of all of the various analyses performed by the NEPPC at the Boston Fed, Ernst and Young, the Arrowhead Center, and LFC staff, is that the overall financial return to the state is negative. Even using the most positive of all the studies performed the state is still losing 6 cents for every dollar it pays out in film credits. Therefore in order to validate the continued use of the film production tax credit as an economic development tool, significant positive externalities, or non-financial benefits, must be proven to accompany the film industry in New Mexico. This represents a conscious policy decision that must be made regarding whether or not the positive externalities provided to the state by the film industry outweigh the financial loss.

PERFORMANCE IMPLICATIONS

House Bill 52 eliminates various due-diligence requirements related to STPF film investments. These include the requirement of a completion bond, "unconditional and irrevocable guarantee of repayment" from a highly rated entity, or the obtainment of at least "one-third of the estimated total production costs from other sources."

State Investment Council (SIC):

> "Currently the SIC's film investment program has an extremely low risk profile and extensive protection of the principal, via the required irrevocable letter of credit from an A-rated domestic bank or corporate entity of similar standing. This guarantee has allowed for 100% return of principal on every film/TV project due to date, and is a very strong safety net for the state's money.
>
> Under HB 52, without a guarantor or letter of credit the state would not have any of the principal protection guarantees it currently does, though the SIC would see profit via interest it charges productions at a market rate. Potentially offsetting those profits due to interest, the SIC expects it would experience a typical amount of "market rate" loan defaults.
>
> In addition, due diligence would require additional staff or expertise to assess the creditworthiness of each applicant in an effort to limit the number of non-performing loans. This may require significant vetting of applicants, as well as foreign receivables expected through the required distribution deals HB 52 (and current law) hold in place. There is potential, depending on number of applicants for such loans, that without significant resources the administration of such a program may prove burdensome or even overwhelming to the agency."

TECHNICAL ISSUES

Taxation and Revenue Department (TRD):

> "It is not clear if the July 1, 2010, effective date is the date on which the credit stops completely and from which the Department (TRD) no longer processes any credits, or if it is the date until which we will accept application and then implement the new rules. It is not clear whether films currently being produced in the state would fall under the present law or if that determination would depend on the date of the application. The bill does not specify the treatment of a production company that has not submitted its claim or that is currently going through the approval process. In addition, credits that have

been approved but not refunded may be affected."

In order to address this technical concern it may be prudent to insert language into the proposed legislation clearly identifying that no credits may be awarded for any film production activity which takes place after the effective date of this legislation. Production activity having taken place prior to the effective date would then still be eligible for the credit.

New Mexico Film Office:

The bill's proposed changes to the Film Loan Program include the availability of loans from the STPF on advertising messages. Advertisements do not have a profit component and therefore would have no potential return on investment for the SIO.

ALTERNATIVES

Various other states have recently enacted various changes to their film production tax credit statutes in order to maximize benefits to their respective economies including:

- Prioritizing productions in poverty areas. Illinois provides an additional 15 percent credit for labor expenditures by the employment of residents in geographic areas with high unemployment and poverty. Texas provides an additional 2.5 percent for filming in underused or economically distressed areas. New Mexico could roll back the credit to 20 percent but provide a 5 percent incentive for productions in poverty areas, census tracts with high poverty, etc.

- Providing an incentive to a production that provides a "brand" or "image" to New Mexico. To someone outside the state, it may be difficult to know which movies were filmed in New Mexico. The tie to tourism would be improved. People visit Hollywood, because that has become a "brand" or 'image'. Georgia provides an additional 10% tax credit when productions place the Georgia logo (Georgia Peach) on movie trailers, posters, and credits of the film.

- Requiring a minimum percentage of the production occur in the state. Massachusetts and Maryland require that at east 50 percent of the production's filming must occur in the state in order to be eligible for the credit, Pennsylvania requires 60 percent, while Puerto Rico requires 50 percent of the principal photography OR if less than 50 percent, the production must spend at least one million dollars ($1M) in payment to Puerto Rico residents, Wisconsin requires 35 percent.

- Requiring productions to be "headquartered" in the state. Tennessee provides a rebate of 17 percent, however, if the production is headquartered in the state then an additional 15 percent is allowed, bringing the total credit to 32 percent.

- Capping the amount per production or a cap on the amount the state pays out annually. A cap per production may allow more productions to occur in the state, thereby employing more crew year round instead of blowing the whole annual cap on just a handful of productions.

- Prioritizing digital media, pre- and post production, and sound production. Build the industry vertically instead of just horizontally. Provide an additional incentive for local musicians, symphonies, etc.

WHAT WILL BE THE CONSEQUENCES OF NOT ENACTING THIS BILL

According to TRD, leaving the program in place will result in the General Fund paying out nearly $332 million in tax credits over the next 4 fiscal years resulting in significant costs to the state. Furthermore the SIC would still be permitted to use up to 6 percent of the STPF to make investments and zero-interest loans for eligible film projects.

DMW/mew