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

		ORIGINAL DATE	01/22/11		
SPONSOR	Kintigh	**LAST UPDATED**	01/27/11	**HB**	19
SHORT TITLE	Repeal Film Production Tax Credit and Limit STPF Investment in Film			**SB**	
				ANALYST	Golebiewski

REVENUE (dollars in thousands)

Estimated Revenue			Recurring or Non-Rec	Fund Affected
FY11	**FY12**	**FY13**		
$0.0	$ 59,762.5*	$ 62,737.5*	Recurring	General Fund

(Parenthesis ( ) Indicate Revenue Decreases)

***Please see Fiscal Implications and Technical Issues sections below.**

SOURCES OF INFORMATION
LFC Files

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

SUMMARY

Synopsis: House Bill 19 repeals the film production credit and reduces the allowable amount of the Severance Tax Permanent Fund (STPF) invested in New Mexico film and television productions from 6% to 3%. In addition, HB 19 requires loans to film entities to carry a market rate of interest. Currently, the SIC does not charge interest on these loans, in exchange for a negotiated share of a project’s post-break-even revenues and a letter of credit guaranteeing the principal loan amount.

HB 19 continues the current practice of requiring productions to have distribution contracts in place prior to receiving state funds.

FISCAL IMPLICATIONS

The state spent almost $66 million, or over half of total corporate income tax receipts, on film production credits in FY10. The December 2010 consensus revenue forecast estimated $65 million for FY11. Table 3 provides estimates of the film production tax credit for FY12-FY15.

Table 3. Estimated GF Revenue Impacts (thousands)					
FY11	**FY12**	**FY13**	**FY14**	**FY15**	**FY11-FY15**
$ -	$ 68,300.0	$ 71,700.0	$ 75,200.0	$ 79,000.0	$ 294,200.0

Source: Taxation and Revenue Department

The effect of repealing the film production tax credit on state revenue remains uncertain because it is unclear whether film companies would choose to produce in New Mexico in the absence of the credits. While the credits undoubtedly attract the film industry to New Mexico, the state also has other attractive features for film production companies. These include investments in workforce development, subsidized film facilities (like Santa Fe Studios), and natural assets such as scenery and culture.

The fiscal impact estimates reflect the film production credit estimates minus the effect of 50 percent of the film industry leaving New Mexico. The effect of 50 percent of the film industry choosing alternate locations is calculated using the 2009 LFC estimate of the film production credit's revenue benefits: 25 cents for every dollar of the credit (details of the film studies can be found below). In FY12, we estimate a gain from the repeal of the tax credit equal to $68.3 million minus the lost revenue of approximately $8.5 million.

Dynamic Analysis.

Two independent studies were performed in the past few years on the net benefits of the film production credit. The most favorable estimate of the net benefits of the film production tax credit program was produced in the Ernst and Young analysis, though even this estimate indicates the film credit is a net cost to the state. The Arrowhead Center's estimate of the effects of the film credit indicates more substantial net costs to the state. See attachment 1 for more information about the film studies.

Table 4. General Fund 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

Table 5. General Fund Impacts Using Consensus Revenue Group Credit Estimates:

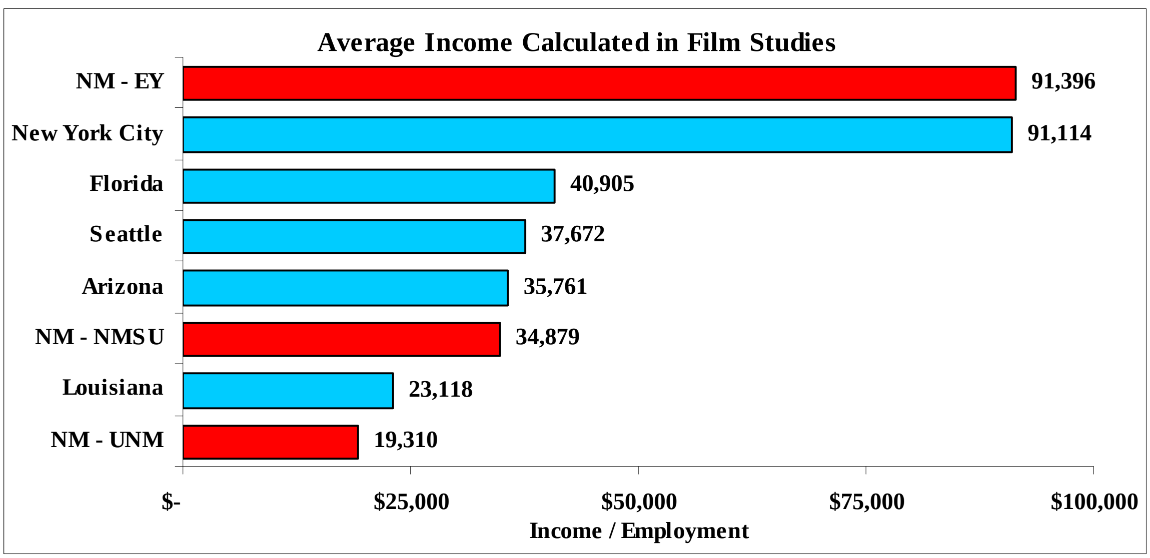
	Ernst & Young	Arrowhead Center
Direct Film Spending	$ 286.0	$ 286.0
Tax Credit	$ 71.5	$ 71.5
Revenue per $ of Credit	0.94	0.14
Revenue from Film Spending	$ 67.2	$ 10.01
Gain/(Loss) to the State	$ (4.3)	$ (61.49)

* Dollars in Millions

The two studies on the economic impacts of the New Mexico film industry are dynamic analyses, which consider both the costs and benefits (or net benefits) to the state of the film credit. That is, they attempt to capture the consequences of this state tax policy, taking into consideration all of the potential actions and reactions of the state's economic players. The wide disparity between the two studies' results illustrates the complexity of the analysis and the dependence of the results on the choice of assumptions and methods of analysis. In addition, some important questions were not examined by the studies: 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.

Due to the significant differences between the Ernst and Young film study and other studies performed throughout the country (including the analysis done by the Arrowhead Center), the New England Public Policy Center at the Federal Reserve Bank of Boston published an analysis of the various studies in April of 2009. The review identifies potential issues with the Ernst and Young studies in New Mexico and New York, including model calibration, lack of a balanced budget assumption, amount of economic activity attributable to the film-credit, questionable wage and salary assumptions, and lack of detail in tourism impacts.

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 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. 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 is inconsistent with other studies.



LFC staff compiled their own analysis of the two studies in 2009. The results of the analysis showed that differences in assumptions and time periods explained the rather wide discrepancies between the two studies. However, the LFC analysis came to the primary conclusion that while the Ernst and Young study overstates the financial return to the state, the Arrowhead Center study most likely understates the financial benefit to the state. The 2009 LFC analysis estimated the benefits to the state of the film production credit at approximately 25 cents on the dollar.

SIGNIFICANT ISSUES

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.

According to the Film Office of the Economic Development Department, film production companies would not film in New Mexico in the absence of the film production credit. They estimate that New Mexico would lose 2 thousand direct jobs in the film industry and potentially thousands of jobs indirectly. They note that between 8 thousand and 10 thousand students are currently enrolled in film programs in New Mexico, and they would have to leave the state to find jobs in the film industry. The Film Office also mentions the loss of income to New Mexico businesses that provide services to the film industry.

Film Production Credit History.

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 estimated to cost $1.6 million annually according to the LFC fiscal impact report for HB 118 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. Simultaneously, another credit, the filmmaker's tax credit, was repealed. TRD estimated the cost to 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 FY10, the state paid out nearly $66 million in film production tax credits.

PERFORMANCE IMPLICATIONS

The State Investment Office reports that current allocations of the STPF to film loans are below the 3 percent maximum stated in HB 19 but there is concern that at market rate of interest, there will be no demand for film loans. The SIC currently issues loans at zero percent interest.

According to the SIO, "Fiscal impact on the SIC will be dependent on industry appetite for market rate loans similar to those offered elsewhere. We believe it highly unlikely that there will be demand for such loans, especially should the state no longer offer a tax credit rebate. With 40 states currently offering some form of film incentives, it should be expected that fiscal realities would drive the vast majority of projects outside New Mexico. The loan program administered by the SIC has never brought a project to New Mexico on its own, but rather, has served as 'icing on the cake', the cake being the tax rebate on dollars spent here.

Further diminishing demand for such loans would be the fact that the Council has indicated it has little interest in making a non-secured loan without the current third-party letter of credit/guarantor. The risk involved in such an investment, for "market rate" returns is not attractive, and may in fact not comply with the Uniform Prudent Investor Act, due to the lack of a standard "market" for film project loans. Taking these factors into account, it is likely the terms the Council might require – either personal or corporate guarantees or a letter or credit –

compounded with an inflated rate of interest for this particular type of market, our estimate is the demand for such vehicles would essentially be nil."

In terms of investment return, the opportunity cost of making the loans between 2002, when the credit was first introduced into statute, and 2011 was calculated by the SIO to be approximately $27.2 million. This is the difference between the $898 thousand in total returns earned in film loan investments and the $28.1 million in returns that could have been achieved investing in Treasury securities. In fact, because the permanent funds can be illiquid, much higher investment returns would have likely been achieved.

This analysis may indicate that if market rates of interest drive demand for film loans to zero, STPF funds may be invested in other assets that produce higher returns, and if there is demand for film loans at the market rate of interest, then the STPF would benefit from the higher rate of return.

TECHNICAL ISSUES

Taxation and Revenue Department (TRD):

> "The implications of the effective date in this legislation are not entirely clear. The Department would probably interpret the effective date to mean that the credit would no longer apply to any expenditure on or after July 1, 2011. This would mean that some credit claims would continue to be processed from expenditures prior to that date. Alternative interpretations are possible, however so a clarification in the statute would make it easier to administer and also more predictable for credit."

This introduces additional uncertainty into our fiscal impact estimate for FY2012. If expenditures made in FY11 can be redeemed for tax credits in FY12, this reduces the estimate of fiscal impact. For example, if 25% of the FY12 film production tax credit estimate is attributable to eligible expenditures incurred prior to the effective date of the bill, then the FY12 fiscal impact would be reduced from $59.8 million to $42.7 million.

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.

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:

- <u>Prioritizing productions in poverty areas.</u> 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, bring 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

Continuing the program will result in the General Fund paying out approximately $294.2 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.

JAG/mew