An Economic Analysis of the GDAA Film Credit ROI Audit

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The audit report on the economic impact of the Georgia Film Tax Credit provides welcome hard numbers on the actual consequences of the credit. For too long, the discussion of the impact has been conjectural, with spending and multiplier numbers asserted with little or no external verification. The report shows that, for 2016, the state had a tax expenditure (the credit) of $667 million in support of $4.6 billion in additional economic activity that the state would not have realized but for the credit. This large return is a combination of direct spending by the film industry of $2.2 billion -- with a spending multiplier of 1.84 -- plus another $501 million from film tourism, and industry-related construction. In short, for every $1 spent by the state, Georgia's economy realizes an additional $7 in income in return.

Unfortunately, the audit report also contains several sections of analysis and assertions that are conceptually misguided or incomplete. More unfortunately, it highlights the results of those ill-conceived exercises as its major findings.

<u>The Report Contains Substantial Implicit Policy Commentary, Not Just Economic Analysis</u>: It misapplies the concept of opportunity cost to create a misleading "net" result.

The GDAA Audit finds that the $667 million in tax credits is instrumental in generating a net impact of $4.6 billion in additional income and an additional 29,006 jobs. This is the actual impact of the program. The audit report then takes the unusual step of saying that there may be alternative uses for those funds (opportunity costs of programs forgone), focuses on one of those alternative spending alternatives, and then calculates the impact of that other selected program and claims that the different return between those two programs is the "net" gain to the program selected (film credits). This is wrong. The difference in return between those two alternative spending plans is the marginal gain associated with one program over the other. Each program has some return associated with it. Noting the differences in return is useful for management, but the difference in return shouldn't be thought of as a net return to any one program, it is a measure of the differences between the programs.

To put this in a concrete example, consider the standard audit of a private firm. The firm did something that generated a return of $4.6 billion. Then the firm gets audited. The GDAA Audit finds that the firm made $4.6 billion on its operations, and that is usually the end of the story. In this case, however, the GDAA Audit notes that the firm was considering doing a different project, but they could only do one and chose the project that generated $4.6 billion. The GDAA Audit finds that the other project would have yielded $2.8 billion to the firm. This result would seem to support management's decision – it had at least two alternatives, and the one it chose had a much better return. But then the auditor's report goes on to say that since the firm could have done the project that yielded the lower amount, the true yield of the project undertaken should be reduced by the amount that the alternative project would have returned. This seems bizarre. One project yields $4.6 billion, the other $2.8 billion. The one project generates $1.8 billion more than the other. That is not the net gain from the project undertaken, it is the differential return between the two. And, to reiterate, the project undertaken generated $4.6 billion for the firm. Under the logic of the GDAA Audit, if the firm had adopted the second project, then the finding would be that the firm, net, lost $1.8 billion dollars, even though it actually made $2.8 billion by undertaking the less favorable project. This example just illustrates the misleading result that comes from this misapplication of the opportunity cost concept.

Moreover, the auditor is comparing the project undertaken with a project that management opted not to do. There are a virtually infinite number of alternative projects not undertaken. The auditor picked one. The GDAA Audit report assumes a specific alternative spending program involving education and healthcare would have been adopted. Maybe the legislature could have done what the auditor assumed but the legislature made the explicit decision to do what it did, which is not the strawman the auditor proposes. That's a decision for the policymakers. The marginal gain found by the auditor over its assumed alternative is a nice reinforcement of the decision to choose the path taken and not the auditor's alternative. But the auditor could have chosen a wide variety of alternatives, generating a wide variety of "net" return numbers, all of which are misleading in that they are comparisons of alternate marginal returns and not the actual return of the policy option selected. That is, the auditor could have easily chosen a different alternative and come up with a different net result. The net number is the result of choices made by the auditor, not the policymakers.

Opportunity costs are not unique to the film industry. Every spending decision involves tradeoffs. Those policy decisions are made by officials the voters elect, not by state employees. Our elected officials obviously make judgments about spending money with the recognition that the money must come from somewhere. The decreases in other state programs described by the audit report are the result of policy decisions that the author of the report is making, and are not, per se, a part of the economics of film. They are a part of the state budget process under the control of policymakers. The point of the audit, presumably, is to help policymakers understand the economics of the industry as a stand-alone proposition and that goal is thwarted by telling policymakers their choices are misguided rather than focusing on the economics alone. The audit contains useful economic data but chooses to focus primarily on a "net" number that would apply to any spending decision made by the state. The audit shows that, as the chosen policy option, the film industry is generating $4.6 billion in added income within Georgia at a cost of $667 million in tax credits.

Mischaracterization of Per-Job Expenditures: The second questionable component of the audit is the misuse of a cost-per-job number as a performance metric. You don't see cost-per-job used in the private sector for good reason: Often, the most profitable jobs are also particularly high cost. In evaluating a project, the question of the number of jobs created is rarely central to the discussion. If a project incurred costs of $667 million and returned $4.6 billion, the project would be deemed a success even if it created zero jobs! (To be clear: the audit shows a gain of 29,006 jobs.) The cost-per-job metric is often used in economic development because the project has not yet begun and there isn't a hard number on dollar return – the number of jobs to be created is somewhat less speculative and used in modeling even though it is not firm either. In other words, it is doubly imperfect but is sometimes all that is available. So, for many new projects, the only way to evaluate the relative merit of alternative projects is the relative cost-per-job across competing projects, even though it is far from ideal.

However, the data around the film credit is anything but uncertain, so we have much better options. A unique feature of the film tax credit is that there is nothing speculative at all about the potential spending by the project. The tax credit is based on the spending that actually takes place, so there is no potential risk of underperformance. It is hard to imagine many projects where the state (or anyone else) is in the enviable position of getting $4.6 billion in income generation now, at a cost of $667 million to be paid later. But that is the situation facing the state for the film credit. In this circumstance, the cost-per-job number doesn't seem relevant, as the preferred numbers are readily available.

Another cost-per-job problem the audit presents is mechanically related to the "net" numbers the audit uses as described above. The audit report shows that the film industry added a total of 29,006 jobs for the year. With a cost of $667 million, simple math calculates a tax expenditure of $23,000 per job, which is the outcome for the film industry by itself. This number has a much more favorable comparison to other incentives relative to the amount touted in the study, which is several times higher. And, this is the number that should be the one cited for policy-making purposes rather than the worst-case scenario figure the report presents.

<u>Failure to Include Marketing Benefit in ROI Calculations</u>: A significant part of the intent of the film credit is to establish Georgia's reputation as a leader in the world of artistic intellectual property creation, and to generally make Georgia much more visible worldwide. This is clearly established in the history of the credit since lawmakers assigned a third of the credit activity to actions that promote the state of Georgia and do not generate any immediate economic return. The film credit has put Georgia in front of billions of eyeballs worldwide by featuring our state as a primary component of a massive number of films, television productions, and other media. And, no one would argue that there is no real economic benefit to this. How to measure that economic benefit in the short run is difficult, but that is not a rational basis to ignore it and assign a zero value to it. Reputations and impressions take a long time to establish and spread. Clearly, the tax credit has put Georgia on the global map for film, video, and esports content creation. The GDAA audit essentially assigns zero economic value to this, which is very misrepresentative of both the intent of policymakers and the real-world economic reality.

<u>No Inclusion of Economic Impact from Removing Credit</u>: The film tax credit differs from most other economic credits in several ways. One of the biggest is that the production process is highly portable and Georgia's success in obtaining productions depends entirely on industry perceptions about the long-term stability of the credit. With content production increasingly moving towards long term productions of streaming series, major studios will be reluctant to make a multi-year commitment to a state where political uncertainty surrounds the underlying economics of production. While the GDAA audit uses some questionable calculations that inflate the cost of the credit, it makes no effort to understand the cost of cutting or eliminating the credit. Given the effort to produce the misguided net valuations, it would seem reasonable that some effort to measure downside risk if the credit were to be cut. Across Georgia, businesses large and small have relied on over a decade of assurances from our state government that the credit itself is a priority and would not be threatened. In turn, they have started businesses, borrowed money, built facilities, and hired vendors and employees. Those vendors and employees have bought homes, taken out loans, enrolled children in college and are actively paying taxes. This is true of not only direct film employers, but also firms in hospitality, food service, law, accounting, real estate development, construction, transportation, banking and other sectors who rely on a robust film industry for revenues and payroll. Threatening or removing the credit would destabilize several key sectors of our state's economy. Additionally, other industries that depend on a particular policy environment to profitably exist would question the past commitments and wonder about future stability. Understanding the degree of destabilization would require a significant amount of time and data, but ignoring it

altogether would clearly be both imprudent and inaccurate. One need look no further than recent events in other states around the country to understand the correlation between policy unpredictability and economic shrinkage. Simply put, removing or weakening the credit would lead to job losses, business closures, and layoffs. These things would then lead to a reduction in state and local tax revenues. Hence, any economic analysis of the value of the credit that might suggest the credit should be cut or eliminated should also consider the economic losses to state and local government and its citizens resulting from that choice. Otherwise, the picture presented by the audit is incomplete

In summary, the state auditor's economic impact report of the Georgia film tax credit makes a well-reasoned assessment of the tax credit's economic impact. And, the Department's work on improving the processes for administering the credit in a related audit represents exactly the kind of work product we should expect from an effective enterprise auditing function. However, the Department's second audit and its conclusions regarding the tax credit's fiscal impact are less well supported. The report relies on conclusions that require certain assumptions being made about how our state's policymakers would spend state revenues were it not for the film tax credit. This effort, while well-intentioned, provides helpful data in some areas (the economic impact assessment) but less than helpful conclusions in others (the net impact determination). A major role of government is to create an environment where the private sector can flourish. Policymakers in Georgia have a long record of doing just that by supporting a reasonable tax rate and using targeted incentives to grow our state's economy. The film tax credit is one such example.