OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

Date Issued: October 8, 2007 **IBA Report Number:** 07-95

City Council Docket Date: October 15, 2007

Item Number: N/A

Subject: Tourism Marketing District

OVERVIEW

The proposed Tourism Marketing District (TMD) would establish a program whereby certain lodging facilities within the City would self-impose a special assessment in order to secure a source of revenue for marketing and promotional programs. The assessment would be two percent of the daily room rate charged at hotels with 70 or more rooms, or 2.0-cents on every dollar. This assessment would be comparable in nature to the City's 10.5-cent Transient Occupancy Tax (TOT); however, revenue from the TMD assessment would be managed by the San Diego Tourism Promotion Corporation (SDTPC), a private non-profit entity, and would be allocated to various organizations and entities for marketing and promotion of the City based on a competitive application process.

The TMD is designed to benefit the lodging industry by providing a secure revenue source for marketing and promotion; however, it may also provide benefits for the City of San Diego. The primary and long-term benefit to the City is expected to be greater TOT receipts as a result of a strengthened tourism market. In addition, the TMD may also provide a more immediate benefit by alleviating current TOT allocations to various tourism-related organizations.

IBA report 07-47 (attached) posed a range of policy implications regarding establishment of the TMD. This report analyzes the potential benefit of the TMD for the City of San Diego, and highlights a few concerns with the TMD Management Plan. Overall, implementation of the TMD is expected to generate higher TOT receipts as a result of a stronger tourism market, and create savings by offsetting current TOT allocations. However, it is unclear how much the City will actually benefit in terms of greater TOT receipts, as such estimates are extremely difficult to quantify. In terms of the immediate benefit, the TMD may potentially free up more than $10 million on an annual basis, which could benefit the General Fund. However, current Municipal Code provisions regarding TOT allocations may restrict those savings unless amendments to the Municipal Code are made.

FISCAL/POLICY DISCUSSION

This section begins with a discussion of the primary and longer-term financial benefit to the City as it relates to increased TOT receipts. The second part analyzes the immediate savings that may result from offsetting current TOT allocations. Finally, several policy concerns with the proposed TMD Management Plan itself will be addressed.

However, in order to get a sense of magnitude, it is helpful to first take a look at the City's TOT revenue and the amount of revenue that may be generated by the 2.0-cent TMD assessment, projected over a five-year period. Total budgeted TOT revenue in FY 2008 is $162.6 million. Based on this projection, the 2-cent TMD assessment would generate approximately $29 million in FY 2008 if the TMD were implemented for the entire fiscal year[1]. The table below provides a five-year projection of the City's TOT revenue and the proposed 2.0-cent TMD assessment, as well as a projection of how much revenue the City would receive if the TOT rate were increased by 2.0-cents.

Table 1. Five-Year TOT Projection

	FY 2008 Budget	FY 2009 Projected	FY 2010 Projected	FY 2011 Projected	FY 2012 Projected	FY 2013 Projected
City TOT*	162,625,787	170,757,076	179,294,930	188,259,677	197,672,661	207,556,294
TMD 2-Cent	28,962,878	30,411,022	31,931,573	33,528,152	35,204,560	36,964,788
City 2-Cent	30,976,340	32,525,157	34,151,415	35,858,986	37,651,935	39,534,532

** Assumes 5% growth rate in all future years.*

In the above projection, City TOT revenue is assumed to grow by five percent in each year, consistent with the Mayor's Five-Year Financial Outlook. As the table shows, even with this modest growth rate, the 2-cent TMD assessment would generate nearly $37 million by 2013. If the City were to increase the TOT rate by 2.0-cents, it would generate approximately $39.5 million. The TMD assessment would generate slightly less revenue than a commensurate increase in the TOT rate since only hotels with 70 rooms or more will be subject to the TMD assessment.

Primary TMD Benefit: Increased TOT Receipts

The purpose of the TMD is to provide a secure source of revenue for the marketing and promotion of the City. Currently, the vast majority of funding for marketing and promotion of the City comes from City TOT allocations, via the Special Promotional Programs budget. However, these allocations have been gradually cut back over the past

[1] If the current proposal is implemented, assessment would not begin until January 2008, thereby reducing the amount of revenue generated in FY 2008. However, for purposes of simplicity, this analysis assumes full-year implementation.

several years due to General Fund budgetary constraints. Revenue generated from the TMD assessment would not be impacted by the City's budget, and therefore would be a more stable revenue stream for tourism marketing and promotion. In addition, the proposed assessment would generate significantly more revenue for these purposes than is currently being allocated by the City.

There is little question that increasing the amount of funding for marketing and promotion will strengthen the City's tourism and lodging industries, which in turn would provide greater TOT receipts for the City. The more pertinent question in this instance is by how much. Unfortunately, the impact of marketing dollars on TOT receipts is very difficult to quantify, and there does not appear to be any conclusive studies regarding the impact of tourism marketing districts, which are relatively new phenomena. In addition, academic research on the effectiveness of tourism marketing expenditures is limited. A brief review of the available academic literature does indicate that funding for destination marketing increases market share and has a positive return on investment. However, none of the studies reviewed were similar enough in scope to the present situation to offer conclusive guidance.

There are many factors that drive the choice of destination for travelers, such as local attractions, recreational opportunities, general economic conditions, visitor age and income, transportation costs and available alternatives. While marketing is surely one of these factors, it is very difficult to isolate its impact from that of the many others. Further research on the marginal impact of tourism marketing expenditures, and the point at which such expenditures hit diminishing returns would be beneficial.

Despite the lack of conclusive data on the impact TMDs or tourism marketing expenditures have on tourism, it is intuitive to believe that greater marketing expenditures will have a positive impact. What is clear is that implementation of the TMD will provide greater funding to the lodging industry for marketing and promotion of San Diego. A greater marketing effort will presumably result in stronger tourism and lodging industries, and benefit the City in terms of greater TOT receipts. From a policy perspective, this impact should be the prime motivation behind implementing the TMD.

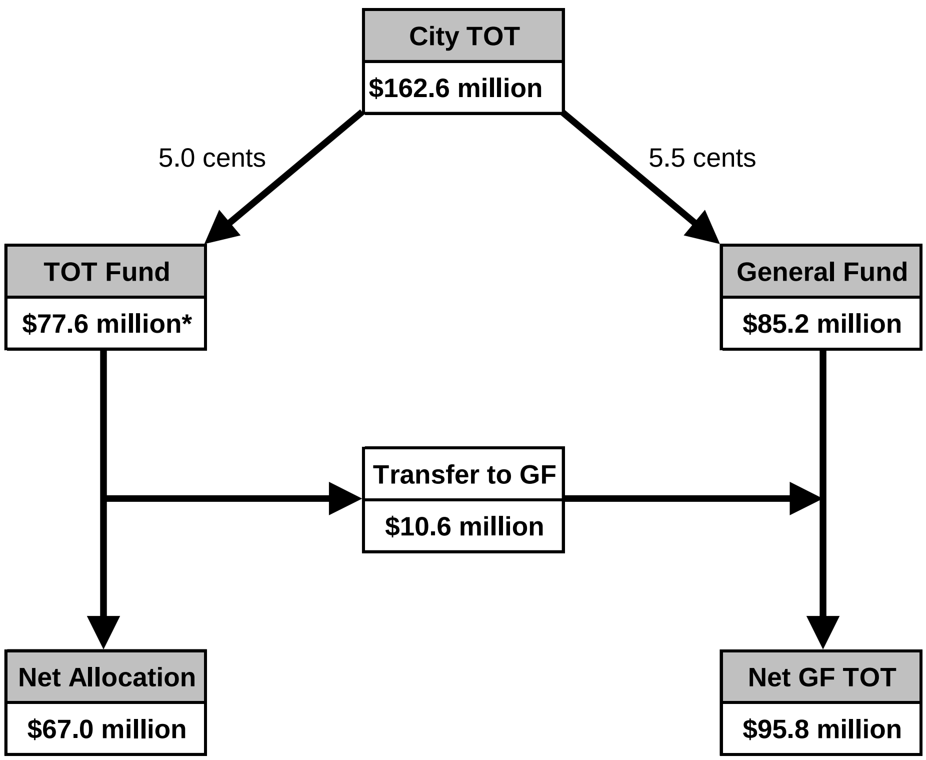
Immediate Benefit: Special Promotional Program Savings

Analysis of the potential immediate benefit of the TMD is broken into two parts: first, a description of how the City's TOT revenue is allocated via the Special Promotional Program, and how the City may realize short-term benefits from the TMD; and second, a discussion of how the potential short-term benefits may conflict with the Municipal Code.

TMD and Special Promotional Programs

The City's TOT revenue is allocated partially to the General Fund and partially to the TOT Fund to support the Special Promotional Programs (Special Promo) budget. The General Fund receives 5.5-cents of the 10.5-cent TOT levy, while Special Promo receives 5.0-cents. In FY 2008, Special Promo is budgeted to allocate approximately $77.6 million out of the TOT Fund. Of that total allocation, $10.6 million is returned to the General Fund, for general government purposes such as public safety, parks and libraries. The remaining funding is then allocated to various non-profit community groups, for debt service and to various other tourism-related organizations. In FY 2008, these allocations total $67.0 million. The allocation and flow of City TOT revenue is reflected in the figure below.

Figure 1. City TOT Revenue (FY 2008 Budget)



** Includes other minor revenues*

The proposed TMD would provide funding for certain tourism-related groups that are currently funded through this $67.0 million Special Promo allocation. These groups, and their FY 2008 allocations, are listed below.

Table 2. TMD-Funded Groups

SD Convention & Visitors Bureau	$ 8,830,411
SD Film Commission	661,817
Holiday Bowl	391,137
San Diego North ConVis	380,903
SD Intl Sports Council	145,800
Hall of Champions	75,000
Rock N Roll Marathon	19,519
California State Games	15,427
San Diego Crew Classic	4,648
TOTAL	**$ 10,524,662**

The TMD, if implemented, would initially assume funding for these groups, thereby alleviating the City's current funding obligation. This could result in an annual saving of approximately $10.5 million, which could be transferred back to the General Fund. However, it should be noted that in order to maintain this level of savings no further discretionary TOT allocations, or increases to any remaining allocations, can be made[2].

In addition, while the TMD guarantees funding to ConVis and North ConVis, funding for the other groups listed above would only be guaranteed for the first 12 months of operation (January – December, 2008). After that, those groups could apply for TMD funding according to the competitive application process. Should these groups not receive TMD funding, they may again seek funding from the City, which would decrease the potential savings if such funding is restored.

The table below reflects both the guaranteed savings that may be generated by implementation of the TMD, as well as the potential maximum savings. The guaranteed savings reflect the fixed TMD allocations to ConVis and North ConVis, as well as the committed funding for the other groups for the first 12 months of operation.

Table 3. Potential Savings from TMD

	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012	FY 2013
Guaranteed	5,262,331	9,867,988	9,211,314	9,211,314	9,211,314	4,605,657
Maximum	5,262,331	10,524,662	10,524,662	10,524,662	10,524,662	5,262,331

[2] This refers only to discretionary allocations. Allocations for debt service may increase over time; however, these allocations are not discretionary, and would occur regardless of the TMD.

The lower amounts in FY 2008 and FY 2013 reflect partial fiscal year savings, since the TMD is currently scheduled to be implemented beginning January 1, 2008 and last for a term of five years. However, the TMD may be extended for a longer term, which may increase the potential savings in FY 2013 and beyond. Again, it should be emphasized that the maximum potential savings as reflected in Table 3 would only be realized if no further discretionary TOT allocations are made or increased, and if current City allocations to the groups listed in Table 2 remain fully offset for the term of the TMD.

It should also be noted that while revenue from the TMD assessment will grow year over year, the maximum potential savings to the City would not increase, regardless of how much TOT revenue the City brings in. This is because it is only the *current* allocations to the groups listed in Table 2 that would be offset; it is not anticipated that any remaining allocations would be offset by the TMD in future years.

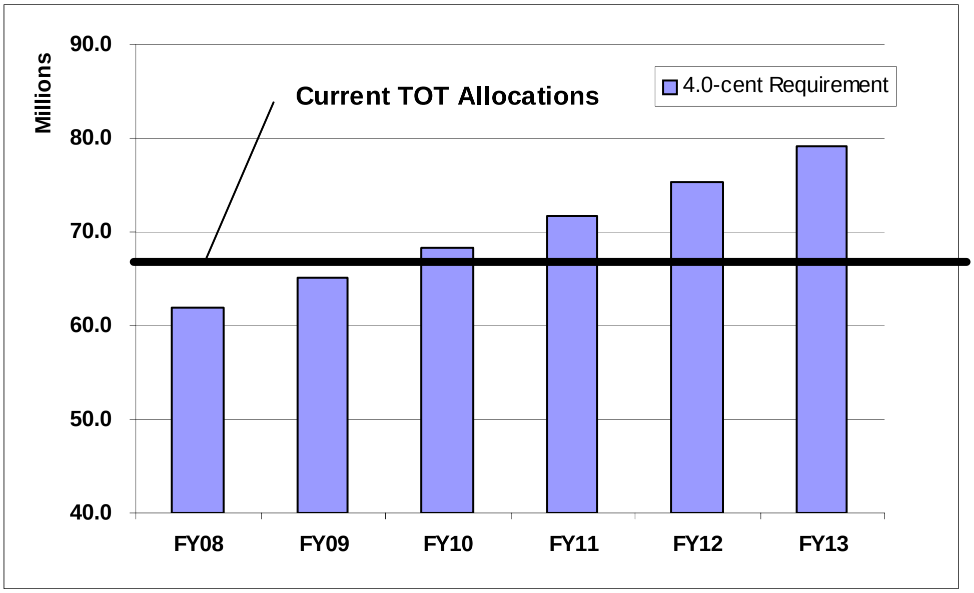
Municipal Code Restrictions

One of the complicating factors regarding these potential savings is the restriction placed on the use of City TOT revenue by the Municipal Code. Currently, the Municipal Code requires that 4.0-cents of the 10.5-cent TOT be used for the purpose of promoting the City. In previous years, TOT allocations were significantly large to easily comply with this requirement. However, due to the rapid growth in TOT revenue over the past several years, combined with reduced allocations, the 4.0-cent requirement may limit the amount of revenue that can be transferred back to the General Fund, and thus negate the potential savings in the Special Promotional Program.

Figure 1 (pg. 4) shows that the net TOT allocations in FY 2008 are $67.0 million. It is presumed that the TMD would reduce these allocations by an additional $10.5 million. However, based on budgeted TOT revenue in FY 2008, 4.0-cents of TOT is approximately $62.0 million. This means that the City could only reduce TOT allocations by approximately $5 million in FY 2008 in order to stay in compliance with Municipal Code requirements. As TOT revenue grows in future years, the amount of funding required by the 4.0-cent requirement will grow as well. The chart below reflects current net TOT allocations in contrast to the 4.0-cent requirement.

What is "Promotion"? In the past, there has been a flexible and somewhat vague notion of what constitutes promotion. Special Promotional Programs allocates TOT funding to groups that are clearly promotion-related, such as ConVis, but also for other purposes such as debt service on the PETCO Park bonds. Other activities such as park and beach maintenance have a nexus with promotion since visitors often come to San Diego to enjoy these resources, but are funded by the General Fund. In order to maximize the benefit of the TMD to the City, it may be necessary to clarify what constitutes promotion.

Figure 2. TOT Allocations v. 4.0-cent Requirement



The space between the solid line – reflecting current net TOT allocations – and the bars representing the 4.0-cent requirement is the potential savings for the City in each fiscal year, under current law. As the chart reflects, TOT allocations could only be reduced in FY 2008 and FY 2009, which may limit the amount of savings in those years. By FY 2010, even without the TMD, the City may need to *increase* TOT allocations in order to comply with the Municipal Code.

To realize the maximum potential savings in the Special Promotional Program as a result of the TMD and still comply with Municipal Code requirements, the City may need to more clearly define what constitutes promotion to include services that are currently funded by the General Fund. Services such as park and beach maintenance and lifeguard services, which are currently funded by the General Fund, would seem to have a clear nexus with tourism and promotion, as many visitors benefit from these resources. It is recommended that the City Attorney's Office examine this issue to determine what steps may need to be taken in order to realize maximum potential savings while still complying with the Municipal Code.

TMD Management Plan – Policy Implications

The TMD Management Plan is the key document detailing the administrative and operational guidelines for the proposed assessment district. It is also an informational document that participating lodging businesses will rely upon in deciding whether to support or oppose the proposed district. The City's role in supporting and administering the TMD are described in the Management Plan.

The Management Plan and a contract between the City and SDTPC are the controlling documents for TMD operation over the next five calendar years. The IBA has reviewed the TMD Management Plan and found it to be generally comprehensive and reasonable. There are, however, a few items that might warrant clarification, discussion or further consideration prior to adoption. These items are listed below, and may be addressed with minor amendments to the Management Plan or by incorporation in the subsequent contract with SDTPC.

- Page 5 indicates that the City will annually provide the SDTPC a statement detailing actual TOT revenues collected and describing the City's use of TOT revenues as it relates to the 4.0-cent Municipal Code requirement, including the "annual marketing subsidy as required by the San Diego Convention Center Corporation." It should be noted, however, that the annual marketing subsidy provided to the Convention Center Corporation is not required, but granted at Council's discretion in response to an application for funds submitted by the Corporation. The IBA suggests that the word "required" be changed to "requested."

- To ensure compliance with the Management Plan and to gauge the effectiveness of the TMD, the IBA recommends that the SDTPC annually provide the City with a summary of expenditures from the prior fiscal year, and the actual or expected return on investment associated with those expenditures.

- The Management Plan specifies that the City may be reimbursed for TMD administrative costs up $300,000 plus a 4.5% annual escalator. While this amount should be should be sufficient to reimburse the City for all normal expenses related to the TMD, it may not cover extraordinary or unforeseen costs. The IBA recommends that a provision be included in either the Management Plan or the subsequent contract with SDTPC that clarifies who will be responsible for covering the cost of extraordinary or unforeseen expenditures, including but not limited to possible legal proceedings.

- As previously described in this report, certain longstanding TOT recipient organizations (those marked with asterisks on page 13 of the Management Plan) are anticipated to receive funding from the TMD for the first 12 months of operation. Thereafter, these organizations can apply for additional funding from the TMD in accordance with the competitive application process described in Attachment 1 of the Management Plan. While City staff has indicated that these groups are guaranteed funding for the first 12 months, this provision is not written anywhere in the Management Plan. The IBA recommends that the funding commitment to these organizations be written into the Management Plan, as is the longer-term commitment to ConVis and North ConVis.

- Page 16 discusses City Treasurer administered penalty and appeal processes for TMD businesses failing to make timely payments. However, it is unclear whether the revenue from such penalties would go to the TMD or be retained by the City. The IBA recommends that the Management Plan clarify who retains the revenue from penalties.

CONCLUSION

Implementation of a Tourism Marketing District may have potential benefits for the City of San Diego. The primary and long-term benefit would be increased TOT revenue as a result of greater marketing and promotion efforts, as the TMD would secure greater funding for these purposes. However, this benefit is very difficult to quantify. While it may safely be presumed that increased funding for marketing and promotion will strengthen the tourism and lodging industries and lead to higher TOT receipts, the precise relationship between increased marketing expenditures and TOT revenues is unknown.

The TMD may also provide an immediate benefit by offsetting several TOT allocations currently made by the City. If maintained, these offset allocations may result in potential savings of up to $10.5 million per year. However, this level of savings assumes no further discretionary TOT allocations or increases to any remaining allocations. It also assumes that none of the groups initially funded by the TMD return to the City for funding in future years.

Finally, the Municipal Code currently requires that 4.0-cents of the 10.5-cent TOT be used for promotion of the City. This requirement may limit the potential savings that may result from implementation of the TMD. In order to realize the maximum potential savings, it may be necessary to clarify what constitutes promotion to include services currently funded by the General Fund, such as park and beach maintenance and lifeguard services.

[SIGNED]	[SIGNED]
Tom Haynes	APPROVED: Andrea Tevlin
Fiscal & Policy Analyst	Independent Budget Analyst

Attachment