



## THE CITY OF SAN DIEGO

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### OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

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Date Issued: October 13, 2023

IBA Report Number: 23-33

Budget & Government Efficiency Committee Meeting Date: October 18, 2023

Item Number: Item 3

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# Review of Proposed Changes to Council Policy 100-03 “Transient Occupancy Tax”

## OVERVIEW

On July 12, 2023, Council Districts 7 and 8 presented an item to the Economic Development & Intergovernmental Relations Committee (ED&IR) that would establish an annual legislative process for Councilmembers to express their intent for the use of the Council Discretionary component of Transient Occupancy Tax (TOT) to fund the Penny for the Arts goal. The ED&IR Committee accepted staff’s recommendation to forward the item to the Budget & Government Efficiency Committee (BGE) for consideration and requested that the City Attorney’s Office work with District 7 and District 8 offices to draft revisions to Council Policy 100-03 and provide other legal analysis.

The proposal being discussed at BGE has two main components: 1) it would establish a legislative process for the City Council to recommend the use of the Council Discretionary component of TOT to assist in the fulfillment of the TOT funding priorities outlined in [Council Policy 100-03, Transient Occupancy Tax](#), and 2) it would amend Council Policy 100-03 to, among other things, state Council’s continued support for meeting the Penny for the Arts goal. If approved, it is envisioned that this process would begin with the submission of budget priority memoranda in September 2024 for consideration in the development of the FY 2026 budget.

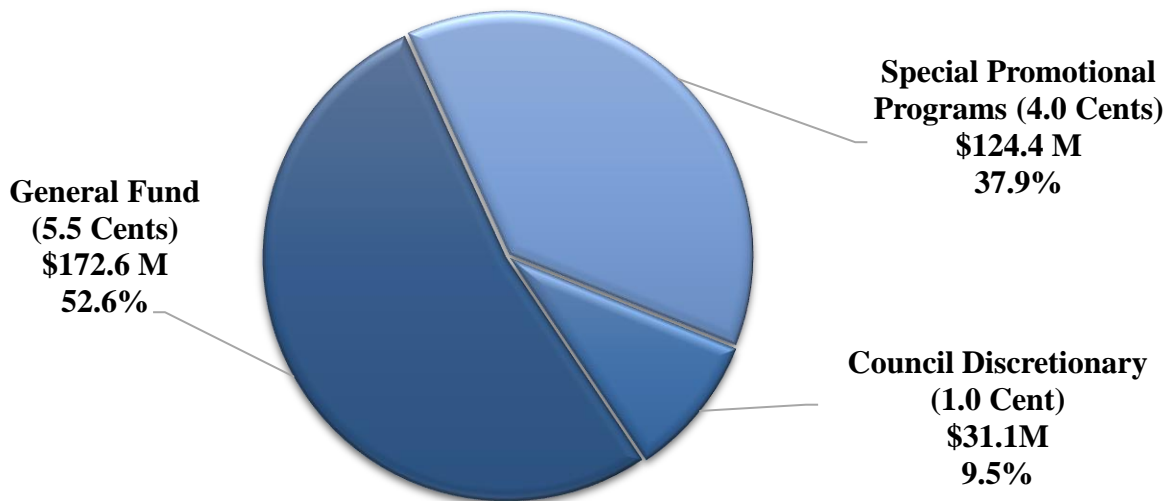
The purpose of this report is to provide background on Transient Occupancy Tax funding and the Penny for the Arts goal, the General Fund impacts of increasing funding to achieve the Penny for the Arts goal, and to raise issues for consideration to facilitate BGE Committee discussion.

# BACKGROUND

## Overview of Transient Occupancy Tax

Per the San Diego Municipal Code, there is a 10.5-cent Transient Occupancy Tax (TOT) on every one dollar spent on short-term stays in the City. The City’s TOT – or hotel tax – can be broken into three separate allocations – a General Fund allocation of 5.5 cents, an allocation for Special Promotional Programs of 4.0 cents and a 1.0 cent “Council Discretionary” allocation that ultimately ends up being allocated to the City’s General Fund. The estimated TOT revenue included in the FY 2024 Adopted Budget for all three components totals \$328.2 million, as broken down in the pie chart below.

**Components of Transient Occupancy Tax in the FY 2024 Adopted Budget**



### ***General Fund***

The General Fund component of TOT is 5.5 cents of the overall 10.5-cent TOT. This component of TOT is deposited directly into the General Fund. The General Fund is the City's main operating fund that pays for basic City services and has the most flexibility to fund various City services.

### ***Special Promotional Programs***

The Special Promotional Programs component of TOT is 4 cents of the overall 10.5-cent TOT. This component of TOT is deposited into the TOT Fund.<sup>1</sup> The Special Promotional Programs component of TOT supports the promotion of the City’s cultural amenities and natural attractions. Arts and culture expenditures (also referred to as funding that counts towards the Penny for the Arts goal) are currently funded from this component. Additionally, the Special Promotional Programs component funds debt service payments for visitor-related facilities, economic development programs, operating support for visitor-related facilities, and reimbursements for General Fund tourism and promotions-related expenses (see Table 1 on following page).

<sup>1</sup> As noted on the following table and further discussed below, the Council Discretionary component of TOT also flows through the TOT Fund before being transferred to the General Fund.

**TABLE 1: SUMMARY OF SPECIAL PROMOTIONAL PROGRAMS/TOT FUND BUDGET**

	<b>FY 2024 ADOPTED</b>
<b>Revenue</b>	
<i>Transient Occupancy Tax (TOT) - (5.0 cents)</i>	\$ 155,548,915
<i>Use of Fund Balance</i>	21,550,536
<i>Special Events Department</i>	120,000
<b>Total Revenue</b>	<b>\$ 177,219,451</b>

<b>Allocations</b>	
<b>Arts, Culture, and Community Festivals</b>	<b>\$ 18,255,651</b>
<i>Creative Communities San Diego</i>	2,040,912
<i>Organizational Support</i>	10,163,648
<i>Cultural Affairs Department (Arts &amp; Culture)*</i>	4,966,091
<i>Impact Pilot</i>	500,000
<i>ACCF - Mayoral / Council Allocations</i>	500,000
<i>Public Art Fund</i>	85,000
<b>Capital Improvements</b>	<b>\$ 22,120,300</b>
<i>Convention Center Debt Service</i>	12,092,175
<i>Mission Bay Park/Balboa Park Imps. Debt Service</i>	738,000
<i>PETCO Park Debt Service</i>	9,290,125
<b>Economic Development Programs</b>	<b>\$ 2,027,200</b>
<i>Economic Development &amp; Tourism Support (EDTS)</i>	1,000,000
<i>Business Expansion, Attraction, and Retention</i>	847,200
<i>Other Economic Development Program Admin.</i>	180,000
<b>Safety &amp; Maintenance of Visitor-related Facilities</b>	<b>\$ 46,597,454</b>
<i>Mission Bay Park/Balboa Park Imps. Operations</i>	709,826
<i>Convention Center</i>	8,984,045
<i>PETCO Park Operations</i>	4,638,463
<i>Special Events &amp; Filming Department</i>	1,426,338
<i>Discretionary TOT Support for General Fund Activities</i>	30,609,783
<i>Major Events Revolving Fund</i>	150,000
<i>Risk Management Fund</i>	79,000
<b>TOTAL ALLOCATIONS</b>	<b>\$ 89,000,605</b>

<b>General Fund Reimbursements</b>	
<i>Reimbursements for Homelessness Services</i>	\$ 31,000,000
<i>Reimbursements for Fire-Rescue (Lifeguards)</i>	30,000,000
<i>Reimbursements for Parks &amp; Recreation (Tourism Sup.)</i>	20,000,000
<i>Reimbursement for May Revise expenditures</i>	3,377,000
<i>Reimbursement for Storm Water (Street Sweeping)</i>	1,572,790
<i>Reimbursement for City Treasurer (TOT Fund Admin)</i>	1,250,000
<i>Reimbursement for Special Events (Public Safety)</i>	600,000
<i>Reimbursement for Facilities - Tourism Support</i>	300,000
<i>Reimbursement for Mission Bay Park Security Services</i>	78,000
<b>TOTAL ALLOCATIONS</b>	<b>\$ 88,177,790</b>

<b>TOTAL</b>	<b>\$ 177,219,451</b>
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\*Includes World Design Capital 2024

### ***Council Discretionary***

The Council Discretionary component of TOT, or the Council Discretionary 1 cent, is 1 cent of the overall 10.5-cent TOT. This component of TOT is deposited into the TOT Fund as reflected in the table above on the “Discretionary TOT Support for General Fund Activities” line. It is subsequently transferred to the General Fund to support General Fund expenditures, with the exception of \$500,000 that is appropriated for Mayoral and Council Arts, Culture, and Community Festivals (ACCF) allocations.

### **Penny for the Arts Goal**

On October 22, 2012, the City Council voted to approve a [“Penny for the Arts” funding blueprint](#). The goal was to increase arts and culture funding over a five-year period from the city’s Transient Occupancy Tax to equate to 1 cent out of the 10.5-cent TOT, which is sometimes referred to as 9.52% of overall TOT revenues (1 cent/10.5 cents = 9.52%). It is important to note that arts funding has historically been funded through the Special Promotional Programs component of TOT (not the Council Discretionary 1 cent). For FY 2024, the Penny for the Arts goal is \$31.1 million, while the aggregate amount of Arts, Culture, and Community Festivals funding within Special Promotional Programs included in the FY 2024 Adopted Budget is \$18.3 million (which includes \$3.0 million allocated for World Design Capital). This means the gap in funding for the Penny for the Arts goal in FY 2024 is \$12.9 million (or \$15.9 million if excluding funding for World Design Capital).

### **Summary of Proposal**

The proposal being discussed at BGE would establish a legislative process for the City Council to recommend use of the Council Discretionary 1 cent to assist in the fulfillment of TOT funding priorities outlined in Council Policy 100-03. Council Policy 100-03 describes five qualified priority areas for the distribution of TOT funds to individuals and entities for general operational support, as well as projects and events that build the social, artistic, cultural, recreational, and economic life of San Diego. These priorities include economic development; safety and maintenance as well as capital improvement of visitor-related facilities; arts, culture and community festivals; and major events. As shown in Table 1, these priorities are funded out of the Special Promotional 4.0 cent component of TOT. The staff report for the item at BGE notes that the Council Discretionary 1 cent could serve as a mechanism to bridge the funding gap for arts and culture.

The proposed legislative process would involve the ED&IR Committee establishing a recommendation on the use of the Council Discretionary 1 cent, which would then be forwarded to BGE to be approved or amended. Our Office would then incorporate the BGE recommendation into the budget priorities presented to the BGE Committee and City Council for consideration and adoption as the Budget Priorities Resolution. Our Office would also include in the budget priorities (and/or the Statement of Budgetary Principles) a request that the proposed use of the Council Discretionary 1 cent be presented by the Department of Finance during the Budget Review Committee and report on how it relates to meeting the goals of the Council Policy and the Council’s recommendation for this funding source. The recommendation, along with the other budget priorities receiving majority support by the Council, would be provided to the Mayor for consideration in the Proposed Budget. If the Council’s recommendation on the use of the Council Discretionary 1 cent is not met in the Proposed Budget, our Office could recommend modifications

to be budget based on available revenue, and would report whether the Penny for the Arts goal will be met.

## FISCAL/POLICY DISCUSSION

### **Fiscal Impacts of Proposal**

There are no *direct* fiscal impacts associated with establishing the Council’s *intent* for the use of the Council Discretionary 1 cent, which is to be incorporated into the Budget Priorities Resolution. As with any item included in the Budget Priorities Resolution, it may or may not be incorporated into the Mayor’s Proposed Budget. Similarly, the recommendation for the use of the Council Discretionary 1 cent established by this proposal would also be for the Mayor’s consideration since, as outlined in section 69 of the City Charter, the Mayor is responsible for proposing the annual budget. The City Council, in its authority to approve the budget, can modify a proposed budget in whole or in part, to include the Council Discretionary 1 cent recommendation, so long as the budget remains balanced.

However, there could be a General Fund impact related to the request that our Office recommend modifying the Proposed Budget, based on available revenues, if the recommended use of the Council Discretionary 1 cent is not included in the Proposed Budget, and the Council approves those modifications. The size of the fiscal impact depends on the recommendation from the Council outlined in the Budget Priorities Resolution, what the Mayor includes in the Proposed Budget, and available resources. Since these variables are unknown, we provide a discussion of the General Fund impact of increasing arts and culture using FY 2024 as a test year.

Historically, the Council Discretionary 1 cent has largely been used to support General Fund expenditures while the Special Promotional Programs allocation of TOT has funded arts and culture and other priorities outlined in Council Policy 100-03 (reflected in Table 1). To the extent that Council’s recommendation is to use the Council Discretionary 1 cent to further fund arts and culture – above what is currently being spent through the Special Promotional Programs – this would result in a reduction of ongoing General Fund resources available for other purposes.<sup>2</sup> A reduction in General Fund resources will come with tradeoffs such as decreasing other General Fund expenditures or not being able to fund *new* high-priority items. For context, fully funding the Penny for the Arts goal would have required an additional \$12.9 million in FY 2024, or \$15.9 million if excluding funding for World Design Capital.

It is important to note that there may be other ways to provide additional arts and culture funding when considering the budget as a whole, rather than focusing entirely on the Council Discretionary 1 cent. Full funding for the Penny for the Arts Goal could be met if other funding sources are used,

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<sup>2</sup> Although General Fund revenue is anticipated to grow, the City is currently facing a structural budget deficit where one-time resources are supporting about \$100 million in ongoing expenditures in the FY 2024 Adopted Budget. As General Fund revenue grows, it will be important to use it to backfill one-time resources that expire to continue supporting ongoing expenditures. Additionally, there is a projected deficit in FY 2025 as of the most recent Five-Year Financial Outlook, resulting in an anticipated need to rely on one-time General Fund balance (Excess Equity) to mitigate the deficit.

such as the Special Promotional component of TOT.<sup>3</sup> If additional arts and culture funding were to be provided by the Special Promotional component of TOT, there could be a similar, although indirect, General Fund impact as noted above. Given that the Special Promotional budget is also used to reimburse the General Fund for certain eligible expenses as shown in Table 1, if there is additional funding provided for arts and culture, beyond any increase in revenue, there may be fewer resources available to reimburse the General Fund for those expenditures.<sup>4</sup> For a more in-depth discussion of possible funding scenarios for the Penny for the Arts goal, which all reflect the same General Fund impact, please refer to Attachment 1.

## Issues for Consideration

Beyond the General Fund impacts, we offer a few other points for consideration. As described in Charter section 69 regarding the budget process, each Councilmember provides a memorandum to our Office setting forth their budget priorities for the upcoming fiscal year, regardless of funding source, which are sent to the Mayor for consideration in the proposed budget. This proposal creates a separate budget priority process for one General Fund revenue source – the Council Discretionary 1 cent – with the intent to use this source to support TOT priorities, namely arts and culture. **Although this proposal would set the Council’s intent only, it will likely apply pressure to restrict this specific funding source which would otherwise be available for any General Fund purpose.**

If the recommendation about the use of the Council Discretionary 1 cent is not included in the proposed budget, our Office would be requested to recommend modifications based on available revenue. Based on the [most recent Councilmember budget priorities](#) submitted to our office on September 27, six Councilmembers prioritized funding arts and culture at a level of 6.5% of TOT revenue in FY 2025, which is currently estimated to be \$22.2 million. This would require an additional \$6.9 million over what is provided in the FY 2024 Adopted Budget (excluding funding for World Design Capital). **This could consume a significant portion of funds available to support a variety of Council’s other budget priorities during final modification and adoption of the City’s budget.** For context, the Council modified the FY 2024 Proposed Budget by adding \$16.1 million in General Fund revenue and expenditures that funded numerous priorities. It is important to ensure that the final budget modifications recommended by our Office reflect the Council’s overall priorities.

Finally, under this proposal, the timing of when ED&IR and BGE would make its recommendation for use of the Council Discretionary 1 cent would be in September and October, respectively. Our Office’s recommended budget modifications report comes out in June, when the most updated revenue and expenditure estimates are available. The current budget process includes opportunities for Councilmembers to update their budget priorities (January) and provide our Office with desired final budget modifications (May). **Council may wish to consider including an opportunity to update the recommendation made by ED&IR and BGE at a date when a more accurate**

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<sup>3</sup> Reductions in other Special Promotional Programs expenditures could provide resources for the Penny for the Arts Goal, though it should be noted that a large proportion of Special Promotional Programs expenditures (that are not General Fund reimbursements) are associated with debt service or are otherwise relatively inflexible.

<sup>4</sup> Since the Special Promotional Programs budget has a structural deficit, it is anticipated that less funding will be available in FY 2025 despite anticipated growth in TOT revenue from FY 2024.

**picture of the City’s fiscal condition is available.** Alternatively, the Council could provide our Office updates in their final Budget Modification Memoranda if there is a desire to change the recommendation for the use of the Council Discretionary 1 cent.

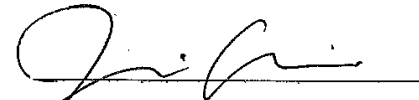
## CONCLUSION

This proposal changes the budget development process to create an opportunity for the Council to express its intent to use the Council Discretionary 1 cent to assist in fulfilling the TOT funding priorities outlined in Council Policy 100-03, *Transient Occupancy Tax*, which would be incorporated into the Budget Priorities Resolution. The staff report notes that this funding source could be used as a mechanism to bridge the funding gap for arts and culture.

There are no direct fiscal impacts associated with establishing the Council’s intent for the use of the Council Discretionary 1 cent, just as there are no fiscal impacts to the Budget Priorities Resolution. However, there could be fiscal impacts associated with the request that our Office, as part of our final recommended modifications to the proposed budget, determine whether the Council’s recommendation about the use of the Council Discretionary 1 cent has been met and, if not, recommend further modifications based on available revenue. Given the proposal’s intent to increase funding for arts and culture, this report discusses the fiscal impacts of increasing funding toward achieving the Penny for the Arts goal. Since there are finite resources to fund all the priorities of the Council, increasing funding for arts and culture will come with budgetary tradeoffs, and depending on the funding source, would likely have either a direct or indirect impact to the General Fund.



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Attachment 1: General Fund Impact of Fully Funding Penny for the Arts Goal

# Attachment 1: General Fund Impact of Fully Funding Penny for the Arts Goal

This attachment provides three different scenarios for funding the Penny for the Arts goal with TOT revenue, using FY 2024 as a test year. Note that in each scenario, the estimated General Fund impact remains \$12.9 million. While funding for the Penny for the Arts goal can come in a variety of packages, fully funding the goal will require the same amount of additional resources.

Current Funding Structure	Expenditures		
	To General Fund	Arts & Culture	Total
Funding Source (\$ in millions)			
Council Discretionary (1 cent)	\$ 30.6	\$ 0.5	\$ 31.1
Special Promotional Programs (4 cent)	\$ 88.2	\$ 17.8	\$ 106.0
Resources Total	\$ 118.8	\$ 18.3	\$ 137.1

Scenario 1	Expenditures		
	To General Fund	Arts & Culture	Total
Funding Source (\$ in millions)			
Council Discretionary (1 cent)	\$ 17.8	\$ 13.3	\$ 31.1
Special Promotional Programs (4 cent)	\$ 88.2	\$ 17.8	\$ 106.0
Total	\$ 106.0	\$ 31.1	\$ 137.1
General Fund Shortfall	\$ (12.9)		

Scenario 2	Expenditures		
	To General Fund	Arts & Culture	Total
Funding Source (\$ in millions)			
Council Discretionary (1 cent)	\$ -	\$ 31.1	\$ 31.1
Special Promotional Programs (4 cent)	\$ 106.0	\$ -	\$ 106.0
Total	\$ 106.0	\$ 31.1	\$ 137.1
General Fund Shortfall	\$ (12.9)		

Scenario 3	Expenditures		
	To General Fund	Arts & Culture	Total
Funding Source (\$ in millions)			
Council Discretionary (1 cent)	\$ 30.6	\$ 0.5	\$ 31.1
Special Promotional Programs (4 cent)	\$ 75.4	\$ 30.6	\$ 106.0
Total	\$ 106.0	\$ 31.1	\$ 137.1
General Fund Shortfall	\$ (12.9)		

## Scenario 1: Council Discretionary 1 cent is used to fund Penny for the Arts Gap

The FY 2024 Adopted Budget allocated \$18.3 million for arts and culture funding (including \$3.0 million for World Design Capital) within the Special Promotional Programs Budget. This leaves a \$12.9 million gap to fully fund the Penny for the Arts goal. Under this scenario, the incremental funding needed to support the goal would come from the Council Discretionary 1 cent. As stated



in the staff report, given that the Council Discretionary 1 cent has historically been used to support General Fund expenses, any amount that is diverted to fund arts and culture in addition to what is currently provided in the Special Promotional Programs Budget would require a corresponding decrease in General Fund expenses unless additional revenue is identified. Using FY 2024 as an example, if the Penny for the Arts goal had been fully funded by allocating Council Discretionary TOT to close the funding gap, a reduction of \$12.9 million in other General Fund expenditures would have been needed.

### **Scenario 2: Council Discretionary 1 cent is used to fund the *entire* Penny for the Art Goal**

Instead of using both the Special Promotional Budget and Council Discretionary to fund the Penny for the Arts gap, Scenario 2 assumes Council Discretionary would fund the entire goal. The General Fund impact would be equivalent to the increase in funding for Penny for the Arts above the current level, as long as other Special Promotional TOT expenditures remain at the same level.

Using FY 2024 as an example, if the full Penny for the Arts goal had been funded using Council Discretionary TOT instead of Special Promotional TOT, there would be an initial \$30.6 million decrease in General Fund resources. Within the TOT Fund, arts and culture funding currently budgeted in the Special Promotional Programs Budget of \$18.3 million would be freed up. To mitigate the impact on the General Fund, the City would likely try to identify additional General Fund expenses that could be reimbursed by TOT, like homelessness. This scenario assumes all freed up dollars would be used for General Fund reimbursements, ultimately resulting in the same \$12.9 million reduction to General Fund expenditures. However, there could be a finite amount of eligible expenditures that can be reimbursed to the General Fund by Special Promotional Programs budget. It is important to note that the freed-up expenditures in the Special Promotional Programs budget must be allocated to activities that have a nexus to tourism and promotion of the City, and therefore are restricted funds.

To summarize this scenario, the reduction of General Fund resources would be the same magnitude as the increase in funding for Penny for the Arts, or \$12.9 million in FY 2024.

### **Scenario 3: Special Promotional Budget is used to fund the *entire* Penny for the Arts Goal**

Since the proposal envisions flexibility to allow other resources besides Council Discretionary to fund the Penny for the Arts goal, Scenario 3 assumes the goal is fully funded by the Special Promotional Programs Budget. For FY 2024, instead of allocating the current \$18.3 million, \$30.6 million would be funded from the Special Promotional Budget, which is an increase of \$12.9 million. Although the Penny for the Arts goal would not be funded directly out of the General Fund, there would be indirect General Fund impacts, as the Special Promotional Programs component of TOT is used to reimburse the General Fund. In FY 2024, the Special Promotional Programs component of TOT was used to reimburse the General Fund for homelessness (\$31 million), Fire-Rescue lifeguards (\$30 million), Parks and Recreation (\$20 million), and other eligible expenditures, so if there is increased use of Special Promotional for arts and culture, beyond any increase in revenue, there will likely be fewer resources available to reimburse the General Fund for those expenditures.