Economic and Financial Issues of the Proposed Music City Center

August 31, 2006

William F. Fox, Director
LeAnn Luna, Research Assistant Professor
Center for Business and Economic Research
College of Business Administration
The University of Tennessee
804 Volunteer Boulevard
Temple Court, Suite 100
Knoxville, Tennessee
(865) 974-5441 – phone
(865) 974-3100 – fax
http://cber.bus.utk.edu

THE UNIVERSITY of TENNESSEE
Center for Business and Economic Research

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Introduction

The Center for Business and Economic Research at the University of Tennessee (CBER) has been asked by Mayor Bill Purcell to evaluate the financial and economic issues associated with the proposed Music City Center (MCC). This report summarizes our analysis of various elements of the proposed MCC. In preparing this report, we reviewed a number of documents including the studies performed by KPMG and the Music City Center Committee and met with a number of interested experts and individuals. However, we were not asked to perform another study that would allow us to independently verify the projections or conclusions reached in the earlier studies. Our approach is to analyze certain aspects of the proposed MCC and to raise several issues that are important in evaluating proposals for a new convention center and the proposed financing methods. We do not seek to answer the policy question of whether a new convention center should be built, and the comments that follow should not be viewed as a recommendation for or against the proposed convention center.

This report begins with a general discussion of the convention center market and follows with a discussion of the issues unique to this particular proposal. The specific issues addressed below include:

- Best use of Metro government's limited resources
- Impact of market conditions on convention centers in the U.S.
- Essential elements to a successful MCC
- Competition within Nashville
- Costs incurred in addition to the construction costs
- Use of tourism taxes to fund the MCC
- Distributional and economic effects of the specific funding options, which includes analysis of both the original funding plan and the evolving funding strategy

Opportunity Cost of Lost Alternatives

Taxes targeted for tourism or related activities have an important opportunity cost since money dedicated to a large long-term project such as the convention center is necessarily unavailable for other projects that might also provide lasting value. The question being considered now is whether a new convention center will best position Nashville as a desirable destination for both businesses and travelers in the coming decades. We believe that this question should be addressed in a broader context of what is the best use of Metro government's limited resources.

The MCC offers a number of potential benefits for the Nashville area. The MCC would in all likelihood generate significant economic benefits for the private sector that exceed the public sector's expenditures. The new MCC would also yield new tax revenues through the local sales tax and other sources and would provide intangible benefits such as greater civic pride. We did not undertake an economic impact study, but believe it is reasonable to anticipate that Davidson County will receive between $6.0-7.0 million annually in additional local sales taxes by fiscal year 2012, based on KPMG's conservative estimate of $223,530,000 of new spending in the area.[1] There could also be some additional property tax revenue, depending on the tax treatment of new investments such as a hotel and parking facility. While many of the benefits will be reaped in the area around the MCC, the additional spending from the new income created in the city should benefit all of Davidson County. Further, a significant downtown convention center may also be an essential element to a fully thriving downtown Nashville as it adds to the synergy resulting from the Gaylord Center, tourism activities in the area, enhanced downtown residential options and other downtown developments. But other alternatives exist, such as leaving tax revenues in the private sector, renovating the existing Nashville Convention Center (NCC), enhancing Opryland's convention center and others, and some of these may also result in important benefits. The MCC should be evaluated in the context of the broad set of options.

The financing options available for the MCC represent an annual stream of tax dollars that policymakers and citizens must allocate to the use that best serves Nashville's long-term interests. We conclude that much of the proposed revenues that would fund the MCC could be raised for purposes other than for the convention center, at least from an economic perspective. Setting aside the political issue of whether higher tax rates can be imposed, Metro should not assume that the revenue stream must be dedicated to tourism related activity instead of other economic development projects.

The next question that arises is how much public sector money should be spent in funding private sector developments. Three well-known issues arise in the context of public funding for development projects such as a convention center. First, publicly funding a venture intended to benefit private businesses effectively shifts the risk of the project from the private to the public sector. Taxpayers will primarily shoulder shortfalls, if they occur, with higher than expected general funding obligations. Second, without the discipline imposed by the free market, governments tend to overspend on large projects for political reasons. Finally, some distributional effects are likely, with non-conventioneers and some residents possibly incurring additional taxes. However, the net distributional losses to Nashville residents appear small since most residents will pay little of the taxes imposed for the MCC, and other residents will benefit by providing goods and services that support convention activities.

A decision for or against the new MCC should be made with full information about the total cost of the project. As discussed more fully below, the direct costs of building the MCC do not reflect the probable total cost to Nashville. The consensus is that a new convention hotel and additional parking will be necessary and will likely require some public assistance because restrictive financial structures, above-average capital costs, and revenue stream variability makes private capital very difficult to obtain (Standard and Poor's).[2] Further, public money is often necessary to ensure investment-grade bond

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[1] We believe that it is prudent to use conservative assumptions for analyzing projects that use significant public funding, particularly in cases like a convention center where it is difficult to project attendance and utilization.

[2] See Standard & Poor's, "Public–Private Partnerships in U.S. Public Finance," April, 2006.

ratings. Additional public resources are needed to fund anticipated annual operating deficits at the MCC, continue the existing NCC, and for public infrastructure to support a growing tourist economy. Further, use of the site for a convention center may forgo future property tax revenue that could result from substantial improvements at the site for other purposes such as high-density housing. The loss of future property tax revenue, to the extent it would happen, is a cost of the convention center. At a minimum, Metro should consider whether there are means of lessening the loss of future property tax revenue, such as an alternative convention center location in less desirable space. All of these costs are important components of the funding requirements and should be considered as a comprehensive package.

The existence and growth of privately owned comprehensive convention center complexes evidences that in many markets private money will find its way to desirable locations and projects. Metro government should consider if the considerable long-term public commitment is necessary and whether this is the best time to make the investment. The convention center competitive environment is uncertain, and Metro will be committing itself to supporting two publicly owned convention facilities.

Supply and Demand for Convention Centers Across the U.S.

Public capital spending on convention centers has doubled over the last decade, increasing convention center space by 50 percent. Even since 9/11, convention center space has increased 10 percent. According to a Brookings Institution report by Heywood Sanders, since 2000, 19 cities have opened new centers, 34 cities have expanded the size of their centers, and dozens more are currently planning expansions or constructing new centers.[3]

At the same time, demand for convention centers has fallen relative to available space. Even as the economy has steadily improved since 2002, total demand for convention center space has remained relatively flat (+0.8 percent). According to the HVS Journal, industry utilization rates of major exhibition events have decreased from an all time high of 21.63 percent in 1999 to 16.52 percent in 2004.[4,5] According to figures provided by the Nashville Visitors and Convention Bureau, the current NCC has a significantly higher utilization rate during the same time period, with utilization rates of 72.3 percent and 70.4 percent for fiscal years 2000 and 2005, respectively. Yet, the KPMG report shows that NCC convention and tradeshow attendance constituted approximately 40-50 percent of the total attendance between 2001 and 2003. While some of the usage may be for more localized events, these unusually high utilization rates are one indication that Nashville may have a need for increased convention center space in downtown Nashville.

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[3] See Tables 2 and 3 in "Space Available: The Realities of Convention Centers as Economic Development Strategy," by Heywood Sanders. The Brookings Institution, January 2005.

[4] See "Convention Centers: Is the Industry Overbuilt?" by Hans Detlefsen. HVS Journal 2005.

[5] The calculated utilization rate is computed by dividing the number of gross square feet days rented (demand) for major exhibition events by the number of gross square feet days available (supply). This utilization rate will be lower than the overall utilization rate because it does not include religious assemblies, graduation ceremonies, job fairs, sporting events and entertainment shows. However, the latter events do not generally generate significant economic effects since the participants are often local people.

Also, while the Brookings report focuses on the 200 largest conventions and tradeshows, it is difficult to find examples of convention centers that have been immune to the declines in demand. While many of the largest events would be too large for the MCC, the Brookings and HVS reports provide an overview of the current trends in the convention center market that suggests a basic pattern of decreasing convention center utilization.

We are not in a position to make an independent forecast of whether a strong rebound in convention center demand will take place and are only basing our comments on recent experience. Both technological advances and the events of September 11, 2001 contributed to the recent decline as many businesses began to reconsider how conventions fit into their education and networking goals. In addition, the increasing availability and affordability of broadband networks have encouraged substitutions for conventions, including teleconferences and online education seminars. Also, the Internet has permitted the buying and selling of goods without the cost and time of conventions.

The new MCC likely will open to an intensely competitive market since supply of convention centers has been growing much faster than demand and several major convention centers are scheduled to come on line in the next few years. But, according to *USA Today* (March 28, 2006), smaller cities are competing well with large cities and are reporting the fastest growth in convention center inquiries, largely due to improved meeting facilities and lower hotel room rates.[6] On the other hand, the KPMG study reports that as competition increases, convention centers in "first-tier" cities have begun to target smaller meetings that previously might have gone to second or third-tier sites. The inevitable result is many sites at all levels now offer incentives and "discounts" on various services, compounding the problem of covering operating costs.

Demand for Modern Facilities

Intense competition for convention business puts a premium on the most up-to-date and well-run facilities that can best accommodate the increasing demands of today's large events. Common amenities now include column-free exhibit space, high speed and wireless Internet connections, fiber optics, and the availability of a host of additional advanced communications infrastructure. Only fully modernized convention centers that best meet the needs of large conventions can hope to increase or even maintain their market share in the very competitive environment. The current NCC probably cannot compete in this environment, and Nashville must either renovate the existing facility or build a new one if it hopes to compete with a downtown convention center option.

In the current market, large conventions demand an adjacent or adjoining hotel that can accommodate large numbers of conventioneers. Currently, there are not enough convention-style hotel rooms in downtown Nashville, and everyone we spoke with believes that an anchor hotel and additional parking are critical to the success of the new MCC.[7] The MCC Committee report indicates that several hotel groups are interested in

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[6] "Smaller Cities Roll Out Red Carpet for Big Conventions," *USA Today*, March 28, 2006, pg. 6B.

[7] Knoxville recently constructed a new convention center without adding an anchor hotel, and there is general agreement that the convention center would be more successful if a hotel had been built.

forming a relationship with a new convention center. There is hope that the hotel and parking needs can be met solely through private sector funding. However, many cities have needed to provide at least some public support, such as tax concessions and tax increment financing, to those hotel partners, and in some cases the cities have chosen to entirely finance the convention hotel. Absent a firm commitment from one or more hotel partners to fully finance a hotel and parking, the public sector cost of such support must be estimated and factored into the financial analysis.

Competition Within Nashville

While we believe modern facilities and an anchor hotel are essential for a downtown convention center location, even with such amenities the MCC would face significant competition within Nashville. If the MCC is built, Nashville will effectively have three convention centers available: the current Nashville Convention Center, the Gaylord Opryland Resort and Convention Center, and the new MCC. A key issue is whether demand for convention center space in Nashville is sufficient to justify three convention centers.

Nashville has an existing commitment with the Renaissance Hotel to continue the current convention center for about 10 more years. The details of what this commitment entails are apparently not specific, but people at the Nashville Convention & Visitors Bureau believe that the commitment requires that from 1/3-1/2 of the current space must be available if the Renaissance Hotel is a participant in the new MCC. Greater use of the existing space may be required if the Renaissance is not a participant in the new hotel. Even if one-half or less of the space will be used for conventions, the issue of what to do with the unused space remains. Operating costs on the current NCC may not be significantly reduced even if some space goes unused, and any deficit at the NCC must be considered as one of the costs of the overall downtown convention center operation.

The Opryland Hotel and Convention Center already has the capability to accommodate many of the groups that will be targeted by the new MCC. Opryland and the MCC will both offer modern and attractive facilities with the capacity to accommodate a large percentage of the convention center market. However, as noted by KPMG and the MCC Committee, several cities have been successful in operating more than one convention site within the same city (e.g., Orlando, Dallas, and Las Vegas). For an extended period of time, Nashville will operate three convention centers, though the current NCC is a relatively small space. To our knowledge only a few cities operate three centers (e.g., Las Vegas, Miami), although certain geographic areas, such as southern California and central Florida, offer multiple convention centers in close proximity to one another. Is it feasible for Nashville to reach the scale of convention business necessary to support multiple convention centers?

It has been suggested that Nashville has two distinct markets – downtown with all it has to offer and a self-contained suburban destination in Opryland. This may be true to some extent, but at a minimum, these facilities will compete on the same level that Nashville now competes with other cities for convention center business. It is reasonable to expect that some of the expected tourism and revenue gains downtown may be offset by losses from Opryland visitors, and Opryland will attract some business that was also targeted by the MCC.

Estimation of the economic benefits provided by the MCC should only include those conventions and shows that would not otherwise come to the city. There is no new economic activity or tax revenue to the extent that the MCC takes business that otherwise would have been at the existing downtown convention center or Opryland.

Operating and Public Sector Costs

In addition to construction costs, Nashville will have to find ways to finance operating costs at the MCC and the existing downtown convention center and the additional costs of delivering public services. Almost every convention center in the country operates at a loss and is not able to fully recover ongoing operating expenses - personnel, maintenance, utilities, insurance, etc. – through the revenue sources directly attributable to them (e.g., rent, food and beverage, telecommunication services). At the same time discounting of stated rents is now necessary in many instances to attract convention business. KPMG reports that many convention groups have been able to secure long-term commitments at deeply discounted rates. The rental rate on public facilities must be weighed against the additional business that conventions bring to privately owned restaurants, hotels, tourist destinations, etc. Indeed, vertically integrated private convention centers are more flexible than public convention centers for negotiating convention business since losses in one area can be offset by higher rates in other areas. For the city as a whole, the same dynamics apply. Direct losses on the operations of the MCC could be offset by economic gains in the private sector, but there is no direct mechanism for covering the public sector (MCC) losses with the private gains.

In fact, the KPMG report estimates that a new MCC will run at an annual operating deficit of $2,854,000 in 2008 and $2,472,000 in 2012. We assume that these estimates apply to the MCC, and not the ongoing operating loss for the NCC. Conversations with the MCC Committee indicate that a portion of the debt service agreement requires a deposit of $90 million be placed in reserve and that interest on this deposit could fund the operating overruns, though the funding agreement would have to include this very important provision. However, this reserve is necessary to ensure against risk of default.

As described in more detail below, the revenue for financing the MCC is directly linked to the MCC and related activity. If tax revenues fall significantly below projections, this creates a compounding problem. Tax revenue shortfalls will force the convention center to dip into the reserve to make the debt payments. Second, any decrease in the reserve will reduce the principle amount that earns interest to fund the annual operating deficit. Finally, if convention attendance fails to reach expectations, then the operating deficit will exceed estimates because of the high fixed costs associated with a capital-intensive facility such as the convention center.

A successful MCC that achieves the goal of significantly increasing total tourism and related activity in Nashville will inevitably put pressure on a number of public services such as police, fire, and roads, just to name a few. The effects on public services have not been addressed in the two reports, but the public sector will need to finance these costs as well.

Use of Tourism Taxes to Fund the MCC

Economic research generally supports the notion that taxes on hotels and taxis are a good option for paying for convention centers because they are largely paid by visitors through higher prices for transportation and hotel stays and are generally not sensitive to modest tax rate increases. Two implications of this conclusion should be noted. First, this conclusion implies that hotels can simply raise their room rates and tourists would still come. Hotels would be expected to increase their room rates independent of taxes if they believe they can do so without affecting the number of visitors.[8] KPMG and HVS Journal indicate that total cost is a critical consideration when buyers decide on a convention center location. It must be assumed that these customers are highly sophisticated and consider taxes in their total cost estimates. Furthermore, the price sensitivity is largely dependent on the type of visitor (e.g., conventioneer, business traveler, leisure traveler). The MCC hotel will have to rely on tourism when the MCC utilization is low, and the leisure travelers may be more sensitive to prices (including the taxes) than other visitors might be. Second, it implies that Metro could impose higher taxes on tourists and use the funds for any important purpose, suggesting that the MCC decision can be made in the broader context of the best use of the resources.

An important issue is whether all hotels/motels, restaurants, etc. in Davidson County should help finance the MCC. Supporters of the MCC argue that non-convention center hotels should also pay the hotel/motel tax because they will benefit from the increase in visitors to the city. If the MCC succeeds in attracting large numbers of new visitors, then the beneficiaries will be broad based and include hotels, restaurants, tour operators, transportation companies, and a wide array of Nashville's service and retail economy. While it is true that some benefits will accrue to the broader Nashville area, much of the new economic activity will be focused on the businesses in a narrowly defined area surrounding the convention center, which of course may be an important policy goal for Nashville. That is, continuing to develop downtown Nashville may be a very important and separate goal from increasing the city's overall economic activity. The spillover of convention center benefits from the downtown area could support using general revenue sources to fund at least a portion of the convention center. Though the norm around the U.S. appears to be to finance convention centers with taxes on the tourism sector, to the extent that the benefits are diffused through Davidson County, an argument can be made that general taxation should finance part of the convention center rather than taxes targeting a single sector.

The hotel tax level is less important than location for many travelers, and except for hotels along the county's border, the tax rate should have a minimal effect on overall visitor levels. However, higher hotel taxes could have an effect on certain areas of

[8] A possible explanation is that the competitive environment within Davidson County makes it difficult for small hotels to raise their rates, unless other hotels follow suit. But, this explanation would not seem to preclude Gaylord from raising room rates on convention business at the Opryland Hotel, since it does not currently face the same competition in the Nashville market.

Davidson County. Hotels in the Cools Springs area, for example, could see a shift in demand of hotel rooms from Davidson County to Williamson County or, alternatively, downward pressure on room rates for those hotels in Davidson County near the border. Similar effects could be expected along borders with other counties, such as Rutherford and Sumner Counties.

Specific Funding Options

This report examines two sets of funding options. First, we consider the 10 funding sources that the MCC Committee initially identified. Second, we examine a revised funding plan.

Original 10 Funding Sources

A strength of the original funding sources from the perspective of financing the MCC is that they generally are not dependent on the number of increased visitors into the county as a result of the MCC, with the exception of the Tourism Development Zone increment tax (option 6). Thus, the ability to fund the debt service is not dependent on a high degree of success by the MCC. In almost every case, the revenues would be derived primarily from taxing activity that is already taking place in Nashville, including hotel room stays, restaurant meals, taxi rides and car rentals. The revenue estimates prepared by the MCC Committee generally appear reasonable and in total appear sufficient to fund the debt service for the $455 million facility. However, it is important to point out that the beneficiaries of the MCC are not the same as the taxpayers (most of whom will be non-residents) having to bear a significant portion of the costs. The tax sources are generally aimed at tourists, but most of these tourists will not directly benefit from the convention center.

Also, a significant increase in public sector costs, such as a publicly-financed hotel or parking facility, could mean insufficient revenue to fund the entire package. On the other hand, the analysis does not take growth in revenues into account, and increases in the tax bases during the 20 years of possible debt service should result in an even greater capacity to finance the required annual debt service.

The remainder of this section analyzes the 10 revenue sources in detail. The sources include a combination of new revenue bases and sources where the revenues are diverted from other uses.

1. 2 percentage points of current 5 percent hotel/motel tax. The proposal is to shift two percent of the existing 5 percent hotel/motel tax to finance the MCC rather than using the funds for other purposes. One percent is dedicated through June 2007 to repaying debt for the current convention center, so this continues use of this money for paying debt service on a convention center rather than some other use of the revenues. The other one percent is currently used to help fund the Nashville Zoo, the Adventure Science Center, the Country Music Hall of Fame and Museum, and the Nashville Sports Council. These organizations should all benefit from additional fee revenue generated by more tourist activity. However we did not investigate the individual entities' budget and revenue sources, and

cannot predict whether or not the additional visitors will produce a net revenue gain after all additional operating and long-term maintenance costs are deducted. If Nashville is an attractive convention site at least in part because these organizations are located in the downtown area, cutting funding from them may be problematic in the long term unless local leaders are confident additional revenue streams will make up for any shortfall from reduced dedicated tax money.

The MCC analysis assumed $8 million from this funding source. Rapid growth in the hotel/motel tax revenues has occurred during the past two years so that this source may provide closer to $9 million next year. Thus, the project could start with greater than anticipated revenue from this source. History suggests that the growth rate should be much slower over the longer term. We calculated the compounded growth rate using hotel occupancy tax revenues provided by the Department of Revenue and the Nashville Visitors and Convention Bureau. There has been little or no growth in this tax if 2000 is used as the base year. Using 2002 as our base year, at best we find a growth rate through 2005 and through the first half of FY 2006 of 3.67 percent and 3.89 percent, respectively. Longer-term growth rates at or exceeding 5.5 percent occur only when using a base year prior to 1995.

2. <u>Growth of hotel/motel tax at 5.9 percent.</u> Effectively, this source takes 5.9 percent of the 2006 hotel/motel tax revenue and dedicates it to debt service for the MCC. The MCC committee report estimates a growth rate of 5.9-6.0 percent in 2006 hotel/motel tax revenue, and the plan is to divert an amount equal to this growth rate from the hotel/motel tax for funding debt service. The actual growth rate appears to be higher, so this category should generate additional revenue. But, the revenue is taken from the growth in the hotel/motel tax, so this will reduce the amount of revenue under category 1 to some extent.

3. <u>Raising the hotel/motel tax by 1 percentage point.</u> The hotel/motel tax would be increased by one percent and all of the additional revenue would be dedicated to debt service. This new tax would be paid primarily by tourists visiting the Nashville area. Davidson County's current hotel/motel tax rate is 14.25 percent, just above the national median rate of 14 percent. An increase in the tax rate would clearly put Davidson County above the median. Previous studies have shown that a one percent increase in hotel/motel tax rates generally will have little effect on demand; however, demand may become more sensitive to rate changes as rates climb above the national average.

4. <u>$2 Nashville Convention Center flat fee per room.</u> A flat $2 tax would be levied on hotel and motel rooms and the revenues dedicated to debt service. Relatively few cities impose flat taxes on hotel rooms. Flat taxes fall relatively heavier on inexpensive rooms (the tax is a higher percentage of the total hotel cost), which will primarily be outside the Nashville downtown area (i.e. those that will see the

least direct benefit from the new convention center), rather than on hotels that are most likely to benefit from the MCC.

5. Redirection of state sales tax on hotel/motel rooms at 2 percentage points. The MCC Committee recommended that the State of Tennessee be asked to provide 2 percent of the 7 percent state sales tax on hotel/motel rooms as funding for the convention center. As with the other hotel/motel taxes, the revenue would come from all rooms in Davidson County, and not just those that are related to the MCC. The state would be transferring approximately $8 million annually plus the tax on additional rooms associated with the MCC to finance some of the debt service. Operation of a successful MCC would generate additional state sales tax revenues that could offset this revenue loss, but also means that the state would have less revenue to finance delivery of public services associated with the new economic activity. Using the KPMG conservative estimates of additional tourist spending, we believe the state would easily get much more than the $8 million that the state would divert for the MCC.

Total Taxes on Hotel/Motel Rooms for the MCC

In total, 50 percent of the hotel/motel tax revenues (equivalent to a three percent room tax) plus 5.9 percent of 2006 revenues, plus $2 per room, plus two percent of the state sales tax on hotels and motels would be used for debt service. These amounts to about $6.00[9] per room for an average room that costs about $75 per night, of which $2.75 would be new taxes imposed on the room rental.[10] The tax increases, which would raise Nashville's hotel taxes above the national median, will either make hotel rooms relatively more expensive compared with rooms in comparable cities or will require Nashville hotels to restrict their room rates. Alternatively, tourists may have fewer dollars to spend on other purposes in Nashville, such as souvenirs or restaurants, because of the taxes they must pay.

Over time, tax revenues from hotel/motel rooms will grow in various ways. The hotel/motel tax and state sales tax should grow and expand with the gross volume of hotel revenues (equal to the number of rooms sold times the average rate per room), the flat rate tax will rise with the number of occupied rooms in a year (since the tax is imposed on the number of rooms that is rented), and the 5.9 percent will remain a fixed number of dollars. Thus, the hotel/motel and sales tax revenue sources will grow much faster than the other sources.

6. Tourism Development Zone (TDZ) incremental tax. This source allocates state and local sales tax revenue growth in the zone around the MCC to finance the debt service. Specifically, sales tax revenue growth in the TDZ will be allocated to the MCC to the extent that the TDZ growth rate exceeds the county average. The revenue generated from this source will depend very heavily on success of the MCC and related hotels and parking and on the geographic definition of the

[9] An additional 0.05 percent state sales tax is also imposed in the Tourism Development Zone, as described in source 7.

[10] A total of $13.475 of sales and hotel/motel taxes will be paid on the $75.00 room.

TDZ. Metro should work very carefully with The Tennessee Department of Finance and Administration to ensure that the selected area will maximize the revenues for the MCC. In any event, the amount of revenue depends on activity at the MCC, which will phase in over several years. Revenues will probably be below the $3 million estimate in the beginning but should significantly exceed $3 million once the MCC is fully operational.[11] The amount of revenue depends on success of the MCC and hotel, meaning there is no guarantee, but could reach $8 million or more if the TDZ is properly designed and the MCC is successful.

7. Increase in sales tax in the Tourism Development Zone. An additional 0.5 percent local sales tax would be imposed in the TDZ. Conventioneers would pay the tax, but the revenue would still come primarily from local residents and other non-conventioneers. The tax is too small to have a dramatic effect on eating and shopping in the TDZ. With this increase, Davidson County's sales tax rate would be 2.75 percent in the TDZ, eliminating the County's *potential* to raise additional revenue inside the TDZ with a county-wide sales tax rate increase, since the area would be at the state imposed limit of 2.75 percent.

8. Rental car tax at 1 percent. A one percent tax (it would probably be levied as a fee) would be levied on all car rentals in Davidson County. Rental car taxes have become popular revenue sources around the country. *USA Today* reports that 80 car rental taxes have been imposed around the US and another 44 are pending.[12] Both tourists and local residents will pay this tax. The KPMG report shows that Nashville ranks among the highest for car rental costs and the tax would add to the already high levels. While the intent may be to have visitors bear the burden, local residents who rent cars while their personal vehicles are being repaired and for other purposes will also pay this tax. Furthermore, local residents may rent for longer periods of time, which will increase their relative share of the burden. In principle, the tax could be structured such that residents would pay a smaller portion by levying the tax only on rentals at the airport, but this would reduce the revenues from this tax.

9. Airport ground transportation fee. A $2 fee will be levied on every bus, taxi, or shuttle that leaves the airport. This fee will be paid more heavily by tourists but will also be paid by residents, such as when they return from trips.

10. 0.5 percent restaurant tax – countywide. An additional 0.5 percent tax could be imposed on all restaurant meals in Davidson County. Similar to the hotel/motel tax, this tax is probably paid by consumers in the form of higher costs for restaurant meals. Davidson County residents will pay most of this tax when they go out to eat, but conventioneers and other tourists will pay some of it.

[11] Other metro areas have had very mixed experiences with TDZs. Memphis raises considerable revenue from its TDZ, but the TDZ has not been very successful in either Chattanooga or Knoxville.
[12] "Eight Companies Join to Fight for Their Customers as Charges Pile Up," *USA Today*, April 18, 2006, p 5B.

Burden on Davidson County Residents

If the original funding plan was implemented, Davidson County residents would pay very little of the hotel/motel related taxes (sources 1 through 5), but would pay portions of the other five taxes (taxes association with the TDZ, rental car tax, airport ground transportation tax, and the restaurant tax). In all likelihood, Davidson County residents would pay a significant share of sources 6 through 10. In total this means that residents would probably pay something less than 20 percent of the total taxes that would be raised for debt service, since sources 1 through 5 (generally not paid by Davidson County residents) will generate most of the revenue. On the other hand, Davidson County would receive additional tax revenues resulting from conventioneers at the MCC, such as from the local option sales tax on meals, souvenirs, and hotels. We expect that the other taxes paid by tourists would exceed the taxes that Davidson County residents would pay even including the restaurant tax, so that Davidson County residents pay additional taxes that help fund the MCC, but non-residents add a greater amount to Metro's general fund. But of course, as tourism activity increases, Davidson County will need revenues to fund the additional demands on city services, such as police, fire, and infrastructure costs.

New Funding Strategy

Table 1 illustrates basic differences between the initial and new funding plans for the MCC once the MCC is fully operational. Funding for the MCC has been altered in two ways since the MCC Committee report was prepared. First, many of the funding sources that were initially identified, including diversion of two percent of the five percent hotel/motel tax revenue, diversion of hotel/motel tax revenue growth, a higher hotel/motel tax rate, a $2 per room hotel tax, the TDZ revenue growth, the rental car tax, and the airport ground transportation fee are the same for both plans but the potential amount of revenue has been changed in some cases. But, additional data are available on some funding sources that allow improved estimates of the revenue potential. Generally, more recent estimates indicate greater revenue than was initially anticipated. Strong hotel/motel tax revenue growth during Fiscal Years 2005 and 2006 have resulted in greater revenues from the related categories than had been anticipated (see Table 1). Also, the revenues available from excess sales tax revenue growth in the TDZ is likely to be greater than the original estimate included in the MCC report.

Second, discussions since the MCC report was prepared have altered the proposed funding strategy by eliminating three of the original 10 sources and adding one new source. Specifically, the 0.5 percent increase in the sales tax rate in the MCC area, the redirection of 2 percent of the state sales tax revenue on hotels and motels and the 0.5 percent restaurant tax were eliminated.[13]

On the other hand, the Tennessee General Assembly enacted legislation committing the state and local sales tax on all sales in the MCC, in up to two hotels associated with the MCC[14], and for parking specifically related to the MCC. Previous state legislation requires that 1.0 percent of the state's 7.0 percent tax go to the state's general fund and 0.5 percent go to the Basic Education Program. Therefore, the new statute allows a combined sales tax rate of 7.75 percent for the MCC, consisting of the state portion of 5.5 percent and the local portion of 2.25 percent. Further, the specific hotels and parking that would qualify must be agreed to by the state, but the legislation appears to allow relatively broad interpretation such that related sales, such as at a food court and shopping at the MCC and hotels, would be included. It should be noted that the state is effectively allowing Nashville/Davidson County to "double dip" since it is allocating **both** revenue associated with growth in the TDZ and all sales tax revenue at the site to the project.[15] Presumably much of the revenue growth in the TDZ comes from the MCC and the related hotel and parking, and this is the same revenue that is allocated under the new state statute.

[13] The revised plan allocates about $4.60 per night tax on a $75 room for the MCC.

[14] The hotel(s) must be new and either attached to the MCC or within one block of the MCC.

[15] Our revised estimate for the increase in the TDZ uses only the state sales tax as there is no additional revenue in Nashville/Davidson County to allow double dipping. A second allocation based on the same revenue would effectively come from Metro's general und. Further, we presume that there will be, at a minimum, the same level activity in the TDZ as in the MCC and hotel. This means the state portion of the two sources should be at least the same. Further we have assumed approximately an additional $20 million in taxable sales for any activity surrounding the MCC but within the TDZ.

Changes in the funding sources potentially affect the overall package in two ways. First, they alter the total amount of funding. The three eliminated sources were expected to provide $15.9 million and the replacement source will generate only about $5.8 million.[16] On the other hand, better growth in the other funding sources should offset some of the eliminated categories and should ultimately result in sufficient funding to meet the expected $37 million debt service for the MCC. In addition, if a second hotel locates at the MCC, more revenue will result.

Second, the package relies much more heavily on success of the MCC than the initial funding plan. The TDZ excess growth and allocation of the state sales tax at the site depend entirely on activity at the MCC. These categories are expected to raise about $11 million, and a poorly performing MCC could result in a revenue shortfall. Further, the revenues will only develop as activity at the MCC expands. This means that the funding sources will probably fail to generate sufficient revenue until the MCC is nearing operational capacity. KPMG estimated the MCC would not be fully operational until about 2012 because of the time necessary to attract conventioneers, develop contracts, and so forth. Thus, some subsidies from Metro's general funds are likely to be necessary in the early years, but there should be sufficient revenues once the MCC has reached the expected level of demand. For example, the subsidy necessary to finance debt service would be in the range of $5 million if the MCC were only operating at half capacity. Better revenue in later years could be used to repay the early subsidy.

Metro Nashville Davidson County's Department of Law provided us with an assessment of the legal authorization for the funding sources that have been identified for the MCC and it appears that Metro does not currently have the legislative authority to impose all sources (see Table 2). This opinion was confirmed through an evaluation prepared by the University of Tennessee's Municipal Technical Advisory Service (MTAS).[17] Uncertainly exists regarding the ability to impose some of the sources, and particularly regarding whether local action would be necessary. The reason is that the need for specific local action depends on the form of any legislation enacted by the Tennessee General Assembly. The legal staff believes that Metro is limited to a 5 percent hotel/motel tax rate so authorization would be necessary to increase the rate to 6 percent. The General Assembly would need authority to impose the $2 per room tax, since it would also take Metro above the 5 percent ceiling. Further, Metro believes that it does not have the authority to impose the airport departure tax or the rental car tax, and each would require specific legal authorization. In total this means that the General Assembly must enact legislation to authorize Metro to impose the taxes that raise $16.5 million of the total of $37.6 million listed in Table 1.

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[16]Projected sales tax revenue from the MCC consists of three pieces: MCC hotel rooms, hotel sales taxable activity, and other purchases relating to the MCC. For the MCC hotel rooms, we assume 1,000 rooms at an average rate of $150/night and an average occupancy rate of 68 percent. We use 50 percent of the hotel room activity as the sales taxable base of other hotel activity (e.g., restaurant, parking, and gift shop). For the other MCC purchases, we doubled the KPMG 2012 estimate of operating revenues to account for the additional MCC activity excluded from the operating revenues (e.g., restaurants, parking, and retail stores).
[17] Memorandum from Sid Hemsley, August 22, 2006.

Several caveats must be added. Dependence of the funding sources on the hotel, parking, and MCC performance also highlights the importance of considering any public funding of hotels and parking in assessing the funding plan. In an April 2006 study, Standard & Poor's points out that the riskiest period for a convention center hotel is the period from opening to stabilization. Most convention center hotels under perform relative to projections. The convention center hotels reviewed by S&P (Austin, San Antonio, and Baltimore) all needed explicit municipal financing to support investment grade bond ratings. For example, in the cases of San Antonio and Baltimore, municipal support allows the hotel project to withstand financial stress as citywide hotel occupancy taxes account for more than 100 percent of the debt service. We have assessed a plan with no public funding for either the hotel or parking, and the financing would need to be reconsidered if public funding is used for related projects. Also, additional funding may be necessary for the operating deficits at the MCC and NCC. Finally, the funding plan may need to be reconsidered if changes in construction costs or interest rates increase the debt service for the MCC.

Table 1: MCC Proposed Funding Options

Description of Possible Funding Source	MCC Estimate	Revised MCC Estimate*
2% of current 5% hotel/motel tax	$ 8,000,000	$ 9,000,000
Growth of hotel/motel tax at 5.9%	$ 1,000,000	$ 1,300,000
Raising hotel/motel tax by 1%	$ 4,000,000	$ 4,500,000
$2 Convention Center fee per room/per night, county-wide on all hotels/motels	$10,900,000	$10,900,000
Tourism Development Zone incremental tax	$ 3,000,000	$ 5,000,000
½¢ increase in states sales tax in Tourism Development Zone	$ 2,500,000	$ -
Rental car tax at 1%	$ 700,000	$ 700,000
Airport ground transportation departure fee	$ 400,000	$ 400,000
Redirection of state sales tax on hotel/motel rooms at 2%	$ 8,000,000	$ -
0.5% restaurant tax – countywide	$ 5,400,000	$ -
Sales tax revenue associated with the MCC	$ -	$ 5,800,000
Total	**$43,900,000**	**$37,600,000**

* Estimate based on CBER adjustments

Table 2: MCC Proposed Funding Options with Legislative Requirements

	Enabling Legislation Required	Local Legislation Required
2% of current 5% hotel/motel tax	POSSIBLY[a]	YES
Growth of hotel/motel tax at 5.9%	NO	NO
Raising hotel/motel tax by 1%	YES	YES
$2 Convention Center fee per room/per night, county-wide on all hotels/motels	YES	DEPENDS[b]
Tourism Development Zone increment tax	NO	YES If set up as a separate authority
Rental car tax at 1%	YES	DEPENDS[b]
Airport ground transportation departure fee	YES	DEPENDS[b]
Sales tax revenue associated with the MCC	NO	NO

(a) Current law may allow for diversion of 2% for construction of a new convention center, but it does not mention operation.
(b) Local legislation depends on the wording of the state law, whether it sets a tax itself or authorizes local governments to do so.

Summary

Nashville's Metro government faces difficult decisions as it plans strategies for long-term economic development and enhancement of the downtown. Many cities are offering new, expanded, or substantially renovated convention center facilities and this is certainly an important option for Nashville's Metro government to consider. The current NCC is becoming outdated, and its size prohibits attracting the most desirable events. Without action, Nashville can expect its downtown convention center business to decline. Nashville can expect greater convention business, new income in the city, and increased tax revenues if it constructs the MCC. Our primary conclusions of this report include:

- A modern downtown convention center would generate significant economic activity in Nashville and would contribute to an energized Nashville downtown. It would also result in additional sales tax revenues that are not linked to payment of the debt service or operating deficits.

- The long-term funding requirements for the MCC will necessarily divert funds from other *potential* uses that might benefit tourism and other local business activity. Other options exist for stimulating Nashville's growth, and these options should be considered as a decision is made on how to proceed.

- All costs should be considered in evaluating the project, including public resources for the MCC, a convention hotel, additional parking, anticipated operating deficits of the new MCC and current NCC, and additional public service delivery costs resulting from an increase in tourism.

- A new MCC will open to a mature and extremely competitive national convention center market. Recent increases in convention center space across the nation have exceeded growth in demand. At the same time, advancements in communications technology and increases in transportation costs have dampened the long-term growth potential of traditional face-to-face conventions. However, the MCC would help Nashville compete better in this competitive market for downtown conventions.

- If the MCC is built, Nashville will have three convention centers. Even if one accepts that Opryland and Downtown Nashville are distinct markets, they will be direct competitors just as those facilities must compete with a number of convention centers in other cities.

- If the MCC is unable to attract the expected convention center business, the annual operating deficits could exceed the KPMG estimates of approximately $2.5 million in 2012, and will also have negative implications for the expected parking facility and the affiliated hotel.

- Tourism taxes are effective ways to fund a convention center because visitors who are often not sensitive to modest tax rate increases largely pay them.

- The funding plan should generate sufficient revenue to fund the annual MCC debt service but only when the MCC attains the expected level of activity. However, the funding is not without risk because it depends on a successful MCC. Funding of the project under the initial plan was not highly dependent on success of the MCC because the tax options generally focused on tourism activity that is already in Nashville. The new plan shifts more of the funding to activity associated with the MCC, which means some government subsidy will probably be necessary in the beginning, but this potentially can be repaid with better revenues once the facility reaches operational levels. The funding plan should be reexamined if public financing is required for the related hotels or parking.

- Metro does not have the legal authority to impose taxes that would raise $16.5 million of the $37.6 million in recommended funding sources. The Tennessee General Assembly would need to enact enabling legislation if these funding sources are to be used in financing a convention center.

- Almost all of the tax burden will fall on non-conventioneer tourists and, to a lesser extent, conventioneers. Nashville residents will not pay a significant portion of the taxes under the revised funding plan.