PERSPECTIVE

No Room at the Inn? Prospects for the Lodging Tax

BY JUSTIN MARLOWE

Earlier this year a version of the headline, "Hotel vacancies are up, and so are hotel room rates" appeared in newspapers around the world. This seems to defy the basic laws of economics. If demand for hotel rooms is down, we would expect room rates to decrease. This trend, although quirky, could have a major impact on state and local finance.

There are two explanations for the rising rates-falling occupancy phenomenon. One is that hotel operators are willing to take losses today to keep their workers for tomorrow. As the Great Resignation grinds on, retaining workers is paramount even though the travel economy has not returned to pre-pandemic levels. That creates an odd dynamic where higher wages for workers are passed on to customers through higher room rates, even as lots of rooms sit vacant. Most travel industry experts see this as a short-term labor market disruption rather than a permanent shift.

A different and more durable explanation is that COVID sorted the travel economy into its elastic and inelastic components. Zoom is a permanent substitute for many in-person business meetings. That does not bode well for convention centers and downtown hotels in cities like Indianapolis, Indiana, Dallas, Texas, Kansas City, Missouri, and other traditional business travel destinations. On the other hand, this past spring proved that some people vacation, no matter what. They'll put up with packed airplanes, crowded beaches, and the risk of COVID just to get away. This should be no surprise, as the line between work and home is now erased for many workers. That strong demand met a constrained supply of rooms. Tourist hot spots like Honolulu, Hawaii, Palm Springs, California, and Orlando, Florida, saw record high room rates in late 2021 and early 2022 as a result.

All this suggests a new normal of weak demand for business travel but strong and consistent demand for leisure travel. To understand what that new normal means for state and local finance, it's useful to focus on state and local "lodging taxes."

Most jurisdictions collect an ad valorem tax on overnight stays in hotels, motels, and bed and breakfasts. Many also apply that tax to short-term rentals like AirBnB and VRBO. Some apply that tax through a special hotel tax or room tax. Some include lodging in their general sales tax. Some do both. A few states and localities also impose an excise tax collected per room or per night. These incremental taxes add up. In fact, a recent analysis by HVS Consulting shows the average combined state and local lodging tax rate is 14.13 percent.

But even with these eye-popping rates, lodging taxes are a small slice of total state and local revenues. In fact, the Census of Governments' state and local finance data doesn't list them as a distinct category. In the City of St. Louis, Missouri, they're a little more than two percent of total revenues. In the City of Nashville, Tennessee, they're a bit less than six percent. Even in a tourism-driven economy like Orlando, they make up approximately one-third of total city revenues.

This doesn't mean lodging taxes are unimportant. In fact, there are three reasons why this comparatively small tax has big implications for state and local finance.

First and foremost, they're a major share of the exportable tax base. Lodging taxes are paid primarily by out-of-town visitors, which makes them popular with politicians looking to minimize local tax burdens. In the City of Chicago, Illinois, for instance, lodging taxes make up only four percent of total corporate fund (or general fund) revenues, but roughly one-third of the city's total taxes aren't paid exclusively by residents. The same is true for many central cities. If lodging taxes in traditional business travel destinations dry up, an outsized share of those destinations' total local tax burden is likely to shift onto property taxes, utility taxes, and other taxes paid entirely by residents. With public trust in state and local government waning, and public skepticism toward taxes growing, this is a difficult prospect.

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Lodging taxes are also highly leveraged. Some jurisdictions use them for programming like destination marketing organizations, local cultural affairs departments, and seasonal attractions like arts festivals and outdoor concerts. But many have borrowed against them to finance convention centers, professional sports stadiums, community soccer complexes, historic district improvements, and other infrastructure that supports the travel economy. According to data from Refinitiv, today there are approximately $40 billion in municipal bonds scheduled to be repaid in part by lodging taxes over the next three decades.

Figures from the U.S. Travel Association suggest the pandemic has caused $34 billion in lost lodging tax revenue so far. Losses like these have affected and will continue to call into question the financial viability of lodging tax-backed projects. This is especially true for projects scheduled to open just as the pandemic took hold, like the refurbished Washington State Convention Center in Seattle. Without subsidies from other revenues and/or extensive refinancing, many of these projects will be a major drag on the credit quality of their issuer governments.

A third important implication is that lodging taxes support state and local government operations in areas far outside travel and tourism. Many jurisdictions use them to subsidize general operations in areas like parks, museums, and other cultural amenities. But without the lodging tax, those subsidies must come from other revenues. Competing for a larger share of stable or shrinking local revenues is a tough prospect for programs and services.

How can state and local finance leaders respond? One immediate task is to reconsider lodging taxes as a means of financing travel economy-focused infrastructure. At a minimum, jurisdictions that borrow against them will need much larger reserves to ride out the next pandemic-induced shutdown. More generally, now is the time to consider alternative approaches to providing many of the services paid for with lodging tax revenues. Is the travel and leisure sector amenable to new public-private partnerships? Are there new potential regional government approaches? These challenges will require new and creative approaches to financial leadership.

Justin Marlowe *is a research professor at the University of Chicago, Harris School of Public Policy, and a fellow of the National Academy of Public Administration.*