# INTERNET TAX FREEDOM ACT: INTERNET TAX MORATORIUM

## HEARING

BEFORE THE

SUBCOMMITTEE ON
COMMERCIAL AND ADMINISTRATIVE LAW

OF THE

COMMITTEE ON THE JUDICIARY
HOUSE OF REPRESENTATIVES

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# INTERNET TAX FREEDOM ACT: INTERNET TAX MORATORIUM

**TUESDAY, MAY 22, 2007**

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON COMMERCIAL
AND ADMINISTRATIVE LAW,
COMMITTEE ON THE JUDICIARY,
*Washington, DC.*

The Subcommittee met, pursuant to notice, at 2:29 p.m., in Room 2141, Rayburn House Office Building, the Honorable Linda Sánchez (Chairwoman of the Subcommittee) presiding.

Present: Representatives Sánchez, Johnson, Delahunt, Watt, Cannon, and Jordan.

Ms. SÁNCHEZ. This hearing of the Committee on the Judiciary's Subcommittee on Commercial and Administrative Law will now come to order.

I will now recognize myself for a short statement.

In 2000, 2 years after the Internet Tax Freedom Act was first enacted, total e-commerce sales were estimated at $25.8 billion. In 2006, total e-commerce sales exploded to an estimated $108.7 billion. This astounding expansion of Internet commerce has changed our world.

Congress must now carefully consider Internet taxation so as to support the continued growth of e-commerce, while at the same time taking into account the revenue needs of State and local government.

During today's hearing, we will hear from a variety of experts with differing views on how Congress should address the quickly approaching expiration of the Internet tax moratorium on November 1, 2007.

The Internet Tax Freedom Act prevents State and local taxation of Internet access, ensures that multiple jurisdictions do not tax the same e-commerce transaction and protects e-commerce from discriminatory tax treatment.

Although commonly misunderstood as a moratorium on all taxes related to an Internet transaction, the Internet Tax Freedom Act does not prohibit States from requiring in-state consumers to pay sales and use taxes on goods purchased online, nor does it prevent States from requiring out-of-state sellers with a substantial physical presence in the State to collect and remit sales and use taxes.

As we consider different legislative approaches before the expiration of the moratorium, we must gain a deeper understanding of the critical issues in this debate. Congress must decide whether to

extend the moratorium permanently or temporarily, or to simply let it lapse.

If Congress does extend the moratorium, it should also consider whether to continue granting grandfather protection to certain States and localities that have imposed taxes on Internet access before the moratorium was enacted.

Furthermore, Congress could consider the current definitions in the Internet Tax Freedom Act that have been the source of some apprehension and legal uncertainty for State and local governments, Internet access service providers, telecommunications companies and other interested entities.

Specifically, the current definition of Internet access and the second clause of the definition of discriminatory tax have been subject to differing interpretations. Congress must also consider whether the rationales that justified passage of the Internet Tax Freedom Act in 1998 still hold true today.

One of those rationales was that the moratorium would protect the fledging Internet and e-commerce industry while accelerating the building of the Internet infrastructure into poor and rural communities.

To help us explore these issues, we have a distinguished witness panel with us this afternoon. We are pleased to have Dave Quam, director of Federal relations at the National Governors Association; Scott Mackey, a partner at Kimbell Sherman Ellis; Jerry Johnson, vice chairman of the Oklahoma Tax Commission; John Rutledge, senior fellow at The Heartland Institute; and Mark Murphy, a fiscal policy analyst for the American Federation of State, County and Municipal Employees.

Welcome to our witness panel.

I want to emphasize that today's oversight hearing is just the beginning of our consideration of issues related to State and local taxation of interstate commerce. While today we will only be generally discussing the Internet tax moratorium, the Subcommittee does plan to have a legislative hearing on the bills concerning this issue.

The challenge in our work is not just to determine the impact of the Internet moratorium up to now, but also its potential impact on the future. We have every reason to believe that this great age of innovation has many, many more years ahead.

Accordingly, I look forward to hearing today's testimony.

And at this time, I would now like to recognize my colleague, Mr. Cannon, the distinguished Ranking Member of the Subcommittee, for his opening remarks.

Mr. CANNON. Thank you, Madam Chair.

Today, we are considering the implications of extending the Internet tax moratorium. Almost 10 years ago, Congress made the decision to protect Internet access and trade from discriminatory taxes. That was a wise decision that has led to a prospering of e-commerce beyond what anyone could have imagined.

Now we have to ask ourselves whether it makes sense to continue that prosperity indefinitely. There are two bills, H.R. 743 and H.R. 1077, that would remove the sunset provisions of the Internet tax moratorium and forever prohibit States and localities from imposing discriminatory taxes on e-commerce.

Our witnesses today will help answer whether Congress should make these provisions permanent. Several of them will agree with me that a permanent end to the discriminatory taxes will only help ensure America's place as a leader of Internet commerce in the global economy.

I suspect other witnesses will disagree with that proposition and I look forward to hearing their views on how discriminatory taxes will improve America's competitiveness. Both of those would allow grandfather exceptions to the Internet moratorium to expire. One of those bills, H.R. 1077, would go further by eliminating the grandfather exceptions from the law entirely.

Should we allow these grandfather provisions to expire? Have the States that have taken advantage of these provisions had sufficient time to wean themselves from the revenue that their discriminatory Internet taxes bring? I imagine that many here on the dais—of course, we don't have them really on the dais, do we? An issue much more important than the presence on the dais would suggest.

And also on the witness panel believe that the answer to both of these questions is yes, but I suspect that we will hear differently from some of our witnesses. I also look forward to hearing these witnesses' testimony on the efforts of some States to impose taxes on some form of Internet access, notwithstanding the clear intent of Congress to the contrary.

I think it is important to learn whether Congress needs to amend the Internet Tax Freedom Act to make this point even clearer.

Madam Chair, keeping Internet commerce and access free from discriminatory taxes has been good for the American economy. I very much appreciate your efforts to hold this hearing today. However, given the importance of this issue and the fact that the current moratorium is expiring in just over 5 months, I hope that we can move quickly to address these issues in a markup.

I look forward to hearing from our witnesses.

Thank you, and I yield back.

Ms. SÁNCHEZ. Thank you. I thank the gentleman for his statement.

And, without objection, other Members' opening statements will be included in the record.

Without objection, the Chair will be authorized to declare a recess of the hearing.

And I would like to introduce our witnesses now, if we can.

We have just been called to vote. I do apologize. We have no control over the voting schedule. I will try to do your introductions, we will step across the street for votes, and then we will come back and go straight into the testimony. I know you have been very patient in waiting.

Our first witness is David Quam, director of the Office of Federal Relations for the National Governors Association. Mr. Quam manages NGA's legal and advocacy efforts, working closely with governors, Washington, DC, representatives, and NGA's standing committees to advance the association's legislative priorities. Prior to working at NGA, Mr. Quam served as counsel on the U.S. Senate Subcommittee on the Constitution, Federalism and Property Rights for the Committee on the Judiciary.

Welcome.

Our second witness is Scott Mackey. Mr. Mackey is a partner at Kimbell Sherman Ellis and assists clients in designing and implementing successful strategies in State capitals. Prior to joining KSE, Mr. Mackey was the National Conference of State Legislators' chief economist.

Welcome to you.

Our third witness is Jerry Johnson, vice chairman of the Oklahoma Tax Commission. Mr. Johnson was appointed vice chairman of the Oklahoma Tax Commission in August 1997 and reappointed to serve until his term expires on January 12, 2009. Mr. Johnson is also the first vice president of the Federation of Tax Administrators.

Our fourth witness is John Rutledge, senior fellow for economic growth and technology for The Heartland Institute. Mr. Rutledge is also a board member of the Progress and Freedom Foundation and a senior fellow at the Pacific Research Institute. Additionally, he is the chairman of Rutledge Capital, a private equity investment firm.

Our final witness is Mark Murphy, a fiscal policy analyst for the American Federation of State, County and Municipal Employees. Mr. Murphy analyzes State and local budget and tax policies, focusing on tax expenditures, contracting, revenue adequacy issues and the responses to budget deficits. Additionally, Mr. Murphy conducts financial analysis of State and local governments for collective bargaining.

Welcome to all of our panelists. We appreciate your willingness to participate in today's hearing.

Without objection, your written statements will be placed into the record, and we would ask that you limit your oral remarks to 5 minutes.

You will note that in front of you you have a lighting system. You will get the green light when your testimony begins. At 4 minutes, you will get a yellow light, which will warn you that you have got 1 minute left, and then you will get the red light. If you happen to notice that the red light is on, please try to summarize and wrap up your last sentence so we can move on to the next witness.

After each witness has presented his or her testimony, Subcommittee Members will be permitted to ask questions, subject to the 5-minute limit. And depending upon the number of questions that are asked, we may go to a second round of questioning as well.

With that, I think this is a natural place to break so that we can get across the street to vote, and when we come back we will jump straight into the testimony. So, thank you.

[Recess.]

Ms. SÁNCHEZ. The Committee will come to order. As I stated, we have Members trickling back from across the street, but we are going to go ahead and resume our hearing.

And, with that, I would like to invite Mr. Quam to begin his testimony.

**TESTIMONY OF DAVID C. QUAM, NATIONAL GOVERNORS ASSOCIATION, WASHINGTON, DC**

Mr. QUAM. Thank you, Madam Chairwoman, Mr. Cannon, Members of the Subcommittee. Thank you for inviting the National Governors Association to testify today.

My name is David Quam, and I am the director of Federal relations for the NGA. I am pleased to be here on behalf of the Nation's governors to discuss the organization's perspective on the Internet Tax Freedom Act, which expires this November 1st.

The bottom line for NGA is this: Although governors generally oppose Federal interference with State authority to develop and manage their revenue systems, NGA supports a temporary extension of the Internet Tax Freedom Act that clarifies the definition of Internet access and does not further limit State authority or revenues.

Since this is an oversight hearing, and as I heard you say there would be several hearings on this issue, or other hearings on this issue, NGA would urge the Committee to follow a few guidelines when looking at this issue.

First and foremost, be clear. Definitions matter. Because this is a bill that interferes with State and local revenues, it should be carefully tailored to meet a specific purpose. Second, remain flexible. A temporary solution is better than permanent confusion. Third, do no harm. Any extension of the moratorium should preserve existing State and local revenues.

I will address each of those in turn with regard to the current moratorium. First, be clear. The definition of Internet access is one of the top issues for the Nation's governors. That is because the definition was written back in 1998, a time I think everyone would agree when the Internet was much different than it is today.

The definition reads, the term Internet access means a service that enables users to access content, information, electronic mail or other services offered over the Internet. It continues by saying, and may also include access to proprietary content, information and other services as part of a package of services offered to users.

The definition is a problem really because of the second phrase. Exactly what does it mean to be able to package other services? Are there limits on what Congress meant by that phrase? Certainly in 1998, in a time of dial-up, the number of services and goods and products coming over the Internet was much different than it is today.

Today, services can be and will be delivered in an increasing fashion over the Internet, both telecommunications, television, other entertainment services, goods and products. In 2007, retail sales over the Internet are expected to exceed $252 billion. This is a much different Internet than 1998.

NGA believes that the unlimited ability of providers to bundle together content and other services into a single tax-free offering represents a loophole in the definition that Congress should close. Again, on the definitions, be clear.

Congress should be specific as to what is included. It is our position that Congress did not intend that just because a service is offered over the Internet that it should be tax-free. Rather, it is

Internet access, the ability of a user to get to the Internet, that is the key provision.

Second, stay flexible. Any extension should be temporary. This is obviously a very big issue. This law has been extended several times, but since 1998 and in every extension, the Internet has evolved and grown into something that was not considered during the last extension of this moratorium.

In 2004, the key issue was telecommunications, how to create parity between DSL and cable when there was not parity from a taxing standpoint. That bill addressed that issue. However, on the horizon with VOIP service, would voiceover Internet replace telecommunications, and could it be bundled under the definition and the loophole that we described?

Ultimately, Congress decided to exempt VOIP to address that issue. However, it has not solved the problem of the definition. A temporary moratorium allows Congress, industry and State and local governments another opportunity to review where this industry stands, how has the Internet developed and how is it being used?

This is one of the most dynamic industries in the United States. It is succeeding beyond anyone's imagination. The moratorium itself is not the cause of that growth. Rather, it is the innovation that comes with a new medium that is causing such explosive use of the Internet. Also, if a moratorium is made permanent, there is a slippery slope where other industries, seeking to preempt State and local taxes, will seek their own moratoriums, with their own preemptions of State laws.

It is very easy to try to come to Congress and ask for a one-stop shopping to preempt the States rather than going and dealing with those who have to make the decisions, State and local governments and local officials regarding the revenue systems.

Ms. SÁNCHEZ. Mr. Quam, I am sorry, but your time has expired. It goes quickly, I know.

Mr. QUAM. That is fine. Thank you.

[The prepared statement of Mr. Quam follows:]

PREPARED STATEMENT OF DAVID C. QUAM

Testimony of the National Governors Association
David C. Quam, Director of Federal Relations

Before the House Judiciary Committee
Subcommittee on Commercial and Administrative Law
U.S. House of Representatives

**Oversight Hearing on the *Internet Tax Freedom Act*: Internet Tax Moratorium**

May 22, 2007

Chairwoman Sanchez, Ranking Member Cannon, and members of the Subcommittee, thank you for inviting the National Governors Association (NGA) to testify today.

My name is David Quam, and I am the Director of Federal Relations for the NGA. I am pleased to be here on behalf of nation's governors to discuss the organization's perspective on the *Internet Tax Freedom Act (the "ITFA")*, which expires on November 1, 2007. The bottom line is this: although governors generally oppose federal interference with state authority develop and manage their revenue systems, NGA supports a temporary extension of the Internet Tax Freedom Act that clarifies the definition of Internet access and does not further limit state authority or revenues.

**Background**

Although the U.S. Constitution grants Congress broad authority to regulate interstate commerce, the federal government, historically, has been reluctant to interfere with states' ability to raise and regulate their own revenues. State tax sovereignty is a basic tenet of our federalist system and is fundamental to the inherent political independence and viability of states. For this reason governors generally oppose any federal legislation that would interfere with states' sovereign ability to craft and manage their own revenue systems.

The 1998 Internet Tax Freedom Act, which imposed a moratorium on state or local taxation of Internet access, is one exception to longstanding congressional forbearance when it comes to state tax issues. Designed to help stimulate this new technology by making access to the Internet tax free, the moratorium included three important restrictions to protect states:

1. The moratorium applied only to new taxes – existing taxes on Internet access were grandfathered;
2. The definition of "Internet access," while broad, excluded telecommunications services; and
3. The moratorium expired after two years to allow Congress, states and industry the opportunity to make adjustments for rapidly developing technologies and markets.

In 2000 the original moratorium expired, but was extended through November 1, 2003, with its protections for states still in place. In 2003, and 2004, Congress debated bills that targeted state protections by proposing to eliminate the grandfather provision, modify the telecommunications exclusion to address tax disparities between telecommunications broadband services and those of the cable industry, and make the moratorium permanent. Fortunately, the final bill retained several of the original state protections including the grandfather clause, an exception for taxes on voice-over-internet-protocol (VOIP) services, and an expiration date of November 1, 2007.

As Congress begins to consider changes to the ITFA, governors recommend that members examine the scope of the moratorium in light of technological advancements; update the ITFA's definitions to ensure they reflect congressional intent and do not unnecessarily interfere with state taxing authority; extend the moratorium on a temporary basis to respect state sovereignty and the ever-changing nature of the Internet; and retain the original grandfather clause to preserve existing state and local tax revenues.

**Congress Should Clarify the Definition of "Internet Access"**

A core concern for states is the potential breadth of the ITFA's definition of "Internet access." The current definition of Internet access states:

> "Internet access means a service that enables users to access content, information, electronic mail, or other services offered over the Internet, ***and may also include access to proprietary content, information, and other services as part of a package of services offered to users***. Such term does not include telecommunications services, except to the extent such services are purchased, used, or sold by a provider of Internet access to provide Internet access." *(Emphasis added)*

The first sentence of the definition has not changed since 1998 and allows a provider of Internet access to bundle "proprietary content, information, and other services" together

with access to make the entire offering tax free. NGA believes that the unlimited ability of providers to bundle together content and "other services" into a single, tax-free offering represents a loophole that could have the unintended effect of exempting content, information or services from otherwise applicable taxes merely because they are delivered over the Internet.

The risk of states losing significant revenues from this provision has grown significantly as broadband connections have become more common and companies have altered business plans to deliver more services over the Internet. Since 2001, the number of high speed lines in the United States has risen from more than 9 million to nearly 65 million with high-speed connections in the United States growing by 52 percent in 2006 alone.[1] Governors support the deployment of broadband services because they increase the ability of citizens to utilize the vast array of services and information available online and are critical to our nation's economic growth and competitiveness.

As more consumers move online, Internet protocol technology is also making more services available over the Internet. For example, a key issue of the 2004 ITFA debate centered on whether VOIP would become a viable alternative to traditional phone service. Unlike traditional telecommunications services, VOIP uses the Internet to transmit voice communications between computers, phones and other communications devices. Today, analysts project that VOIP subscriptions will top 18 million in 2009, a dramatic rise from VOIP's 150,000 customers in 2003.[2] The concern in 2004 was what would happen to the $23 billion state and local tax base for telecommunications services if VOIP replaces telecommunications services and were allowed to be bundled with Internet access into a tax-free offering. Congress' solution during the last ITFA extension was to specifically exempt VOIP from the moratorium. This solution, however, did not solve the problem of the underlying definition.

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[1] Response of Kevin J. Martin, Chairman, Federal Communications Commission, to pre-hearing questions asked by the House Committee on Energy and Commerce, February 7, 2007.
[2] Telecommunications Industry Association's 2006 Telecommunications Market Review and Forecast, February 27, 2006.

The next major service moving to the Internet is video programming. Known as Internet-protocol television (IPTV), this service represents another technological leap for industry and challenge for the ITFA. Worldwide, the annual growth rate of IPTV is projected to exceed 92 percent, rising from 3.9 million subscribers in 2006 to 103 million in 2011. The service brings together voice, Internet and entertainment services in a bundle marketed by some as a triple-play.[3] Much like VOIP in 2004, if a service like IPTV is packaged with Internet access and exempted from applicable taxes, it would create tax disparities for competitors offering similar services and undermine existing state and local revenues.

The emergence of services such as VOIP and IPTV underscore the need to clarify the definition of what constitutes "Internet access" so that the taxability of a good or service is not determined by whether it can be bundled with Internet access and delivered over the Internet. Although NGA supports having the moratorium apply to services related to providing access to the Internet such as email, Congress should close the bundling loophole by specifying that the definition of "Internet access" applies only to those services necessary to connect a user to the Internet.

**Any Extension Should be Temporary**

When the ITFA became law in 1998, it was passed as a temporary measure to assist and nurture the Internet in its commercial infancy. The Internet of 2007 is far different. It is a mainstream medium that has spawned innovation, created new industries and improved services. What started as primarily a dial-up service available through a handful of providers, today is available through thousands of internet service providers using technologies ranging from high-speed broadband cable or Digital Subscriber Line services, to wireless, satellite and even broadband Internet access over power lines.

Commercial transactions over the Internet have also exploded. A recent study by the National Retail Federation concluded that Internet sales grew from $176 billion in 2005

[3] Harris, Jan, "IPTV subscription to grow 92% year on year," Platinax Small Business News, April 10, 2007.

to $220 billion in 2006, a 25 percent jump that outpaced projections.[4] The survey projects online sales for 2007 will jump 18 percent to $259 billion. According to one of the survey's senior analysts, "[t]his strong growth is an indicator that online retail is years away from reaching a point of saturation."[5]

The rapid pace of innovation in the Internet and telecommunications industries makes it difficult to define accurately these complex and ever-changing services. Congress made the original moratorium temporary in part for this reason: to provide Congress, industry and state and local governments with the ability to revisit the issue and make adjustments where necessary to accommodate new technologies and market realities. With continued questions as to the scope of the moratorium, the ongoing evolution of the Internet and its developing role in commerce, a temporary extension of the moratorium remains the best way for Congress to avoid any unintended consequences that may arise from a permanent moratorium.

Another reason to support a temporary extension is that making the moratorium permanent would establish a troubling precedent that distorts the state-federal relationship. As mentioned previously, governors generally oppose federal efforts to interfere with state revenue systems because such interference undermines a states sovereign authority to provide government services. A more immediate consequence of a permanent ban on state taxes is the increased pressure Congress would receive from other industries seeking similar preemptions of state laws. Legislation to impose a moratorium on state and local cell phone taxes and efforts to dictate state nexus standards for business activity taxes are recent examples of the types of preemptions strongly opposed by state and local governments that would be bolstered by passage of a permanent moratorium.

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[4] *The State of Retailing Online 2007*, Shop.com/Forrester Research Study, May 14, 2007.
[5] *Online Clothing Sales Surpass Computers, According to Shop.org/Forrester Research Study, viewed at* www.nrf.com (May 17, 2007).

**Congress Should Maintain the Moratorium's "Grandfather" Clause**

NGA recommends that any extension of the moratorium preserve existing state and local revenues by continuing the so-called grandfather clause for taxes imposed prior to 1998. The grandfather clause serves two purposes; first, as a protection for existing state and local tax revenue; and second, as a means to preserve other state and local taxes not specifically mentioned by the ITFA.

Today only nine states have direct taxes on Internet access that qualify for the protection of the 1998 grandfather clause. Those states include Hawaii, New Hampshire, New Mexico, North Dakota, Ohio, South Dakota, Texas, Washington and Wisconsin. According to Congressional Budget Office estimates from the 2004 ITFA extension, eliminating the grandfather clause will cost those states between $80 million and $120 million annually. While these amounts may seem insignificant in terms of federal dollars, balanced budget requirements at the state level require that any unanticipated loss of revenues must be made up by either cutting services or raising revenues. These losses also are high enough to make the elimination of the grandfather clause an unfunded federal mandate under the Unfunded Mandate Reform Act. Any extension of the moratorium should therefore preserve the grandfather clause so as not to reduce existing state and local tax revenues.

The grandfather clause also serves as an important protection for all state and local taxes that indirectly affect providers of Internet access. Under the ITFA, a "tax on Internet access" means:

> [A] tax on Internet access, regardless of whether such tax is imposed on a provider of Internet access or a buyer of Internet access and regardless of the terminology used to describe the tax."

Because a tax on Internet access includes both taxes on users and Internet access service providers, some experts interpret the moratorium as applying to both direct taxes on Internet access and indirect taxes such as business taxes on a provider of Internet access. In fact, the pre-1998 versions of the moratorium expressly excluded

certain indirect taxes such as income and property taxes from the moratorium. That language was later dropped because the grandfather clause applies to all taxes on Internet access in force before October 1, 1998.[6] Although the 2004 extension does preserve the ability of states to impose a tax "levied upon or measured by net income, capitol stock, net worth, or property value," this list is not exhaustive. Preservation of the grandfather clause is important because it allows Congress to avoid having to define those direct taxes subject to the moratorium and any other taxes that lie outside the scope of the moratorium.

**Conclusion**

Governors remain steadfast in their insistence that decisions regarding state and local taxation should remain with state and local officials. The independent and sovereign authority of states to develop their own revenue systems is a basic tenet of self government and our federal system. As Congress considers whether to extend the ITFA, NGA urges members to honor state sovereignty by addressing the uncertainties inherent in the overly broad definition of Internet access and preserving the original grandfather clause as part of a temporary extension.

[6] Mazerov, Michael, "Making the Internet Tax Freedom Act permanent in the form currently proposed would lead to a substantial revenue loss for states and localities," Center on Budget and Policy Priorities, October, 20, 2003.

Ms. SÁNCHEZ. We will get at some of those issues, I am sure, in the questioning.

Mr. Mackey, would you please begin your testimony?

**TESTIMONY OF SCOTT MACKEY,**
**KIMBELL SHERMAN ELLIS, MONTPELIER, VT**

Mr. MACKEY. Thank you, Madam Chair, Mr. Cannon and Members of the Committee. My name is Scott Mackey. I have been working with the telecommunications companies, wireless companies, for the past 7 years at the State and local level to work on elimination and rolling back of some of the discriminatory taxes on telecommunications services.

Today, I am here to talk primarily about three things, first of all, the permanent extension of the moratorium's beneficial impact on investment; secondly, a permanent moratorium and its beneficial impact on continued efforts to try to close the digital divide and make sure we keep Internet access affordable and don't burden some of our lower-income families with excessive taxes; and, third, I would like to make a couple of comments about the 2004 amendments and what the intent was and what some of the results have been in the States, as some States have interpreted what Congress did back in 2004.

On the first issue of the impact on investment, I am not going to spend much time on it, because Dr. Rutledge is here and he knows a lot more about this than any of us in the room. Just a couple of quick points. The Internet tax moratorium, the success of that legislation and Congress's foresight really speaks for itself.

The U.S. has been a global leader in attracting investments, spurring high technology and innovation, both with applications providers and with the Internet backbone itself. And I guess the takeaway is that taxes do matter. You are going to hear that taxes don't matter, and I think that taxes do matter, and the other thing that matters, and the other reason why a permanent moratorium would be good for the U.S. economy is that stability matters to investors.

Investors need to know what the time horizon is going to be, and they need to know that there is going to be a stable tax policy going forward when they decide how to invest. And a permanent moratorium would provide that kind of stability and it would prevent the kind of thing that is happening, for instance, in Missouri, where local governments are coming after telecom providers and saying the tax that we have had for 50 years on local exchange service, you should have been collecting that on wireless and you should have been collecting it on other services. And they are actually making them go backwards in trying to get them to pay taxes that were never intended to be on those services, and that is the kind of instability that really hurts investment.

The second issue of the digital divide is one where we are finally seeing the benefits of competition bringing down prices for high-speed Internet access, and as a result we are seeing more and more lower-to moderate-income families being able to afford Internet access, which everyone is calling critical for our competitiveness in the 21st century.

So at a time when we are finally starting to make some progress there, to allow a moratorium to expire and have new taxes be imposed on Internet access—and what we are talking about here are not just sales taxes. We are talking about the excessive and discriminatory taxes that States have been imposing on the telecommunications industries for years, accused of being a monopoly.

There are ample examples of that happening, where States through interpretations in tax departments and through legislative decisionmaking could essentially impose these new discriminatory taxes on Internet access. And the studies that have been done in the late 1990's by The Heartland Institute show that those tax burdens are 2.5 times those imposed on sales taxes.

So there is a real threat if the moratorium were to expire that you would see these excessive new taxes be imposed on Internet access. And these are regressive taxes that hit low-income people the hardest. And, finally, let me just make a quick comment about the 2004 amendments where the Internet access definition was modernized to try to address really two issues.

First was to try to bring parity between DSL and wireless Internet access on the one hand and cable modem service on the other, where because there was a telecommunications exclusion, those services were being subject to tax by some States, where cable modem service wasn't. And I think that issue has primarily been addressed, but there was a second thing that Congress was trying to do by adding that language to the exclusion, and basically that is try to stop States from saying, okay, we are not going to tax the end user, we are going to essentially levy a backdoor tax on the wholesale Internet telecommunications services that are purchased, used or sold to provide Internet access.

And, therefore, the consumer wouldn't see a tax on his bill, but nonetheless they were being forced to pay and it was embedded in the price. And we think Congress intended to stop that. There are a handful of States who I think have interpreted it the way Congress intended, but there are a larger number of States who are interpreting as saying that we can still tax that telecommunications that is purchased, used or sold.

So I look forward to the question-and-answer. That is what I concentrated my prepared remarks on, and I again appreciate the opportunity to testify today. Thank you.

[The prepared statement of Mr. Mackey follows:]

PREPARED STATEMENT OF SCOTT MACKEY

Chairwoman Sánchez, Representative Cannon, and members of the subcommittee, thank you for this opportunity to testify on an issue of real importance to millions of consumers and businesses across the United States.

My name is Scott Mackey and I am an economist and partner at Kimbell Sherman Ellis LLP. Over the past seven years, I have worked as a consultant to major wireless telecommunications providers seeking to reduce or eliminate excessive and discriminatory taxes on communications services at the state and local level. I appear today on behalf of a broader coalition of Internet service providers, Internet "backbone" providers, and Internet application and content providers—the "Don't Tax Our Web" coalition—to support a permanent extension of the Internet tax moratorium.

Unless Congress acts, the Internet Tax Freedom Act will expire on November 1, 2007. I will focus on three important reasons why Congress should make the Internet tax moratorium permanent:

* First, at a time when state and local economic development experts are touting broadband as critical to economic competitiveness, new taxes on Internet access could have a chilling effect on broadband investment.

- Second, now that competition between different types of Internet access providers is lowering prices for consumers and making high-speed Internet access more accessible and affordable to lower income households, regressive new taxes on Internet access would create a new obstacle in efforts to close the "digital divide."
- Finally a number of states and localities are ignoring the will of Congress and Congress therefore needs to make it clear once and for all that the transport underlying the provision of Internet access and high speed Internet access is covered by the moratorium on taxes on Internet access service. Otherwise, the record is clear that states and localities will seek to avoid the moratorium on Internet access taxes by imposing taxes on the underlying transport and high speed Internet access. Recent studies of the taxation of telecommunications services suggest that such transport taxes could be excessive and discriminatory.

**(1) Taxes on Internet access could have a chilling effect on investment in broadband networks.**

The Internet Tax Freedom Act was adopted by the Congress and signed into law by President Clinton in 1998 to promote the availability of Internet access services by avoiding excessive and inconsistent taxation of these services. Congress was rightly concerned that high taxes and the administrative burdens of filing in thousands of taxing jurisdictions would impose undue burdens on consumers and impose a barrier to competitors and innovation.

The moratorium, by preventing the imposition of excessive telecommunications and other taxes on Internet access, has been instrumental in promoting the rapid development of high speed broadband networks and the web-based applications that use these networks. Congress' foresight in adopting the moratorium has benefited the entire US economy by improving the productivity of American businesses and lowering prices for consumers through competition.

For example, a recent study by the international technology consulting firm Ovum and Indepen found that as much as 80% of the productivity growth in the entire economy in 2003 and 2004 was due to just two sectors: communications and information technology.[1]

Economists strongly discourage policymakers from imposing taxes on investment. However, in the case of investments in the communications networks that make up the backbone of the Internet, tax policies that discourage investment are especially problematic because of the network benefits of advanced investments in the telecommunications infrastructure. Network benefits are the economic benefits provided by infrastructure investments—benefits that extend beyond the direct impact on the affected industry and enhance growth throughout the entire economy.

The data are clear: investments that increase the speed and reach of communications networks improve the productivity of the businesses that use these networks to conduct business every day. For this reason, tax policies that have the effect of reducing investment in telecommunications networks have negative consequences that extend far beyond the firms directly hit with the new taxes.

New taxes on Internet access, or discriminatory taxes on electronic commerce, would impose significant new costs on purchasers of Internet access and purchasers of goods and services that are delivered over the Internet. Higher prices for such services would reduce sales, reduce company revenues, and thus lower the rate of return on investments in communications networks and the applications provided over them. In addition, new taxes would increase the cost of doing business for US firms that increasingly rely on Internet-based applications and services as part of their operations.

Much has been written in the last few years about the investments that our economic competitors in China, India, and other nations are making in their communications networks. They recognize that broadband networks are crucial components of a successful strategy to compete in a global economy.

Here at home, the Congress, our governors, state legislators, and local officials also recognize the importance of broadband networks in an overall economic development strategy. In my home state of Vermont, the General Assembly has just

[1] Lewin, David and Roger Entner. "Impact of the US Wireless Telecom Industry on the US Economy," Ovum and Indepen, Boston, MA, September 2005.

agreed to a new program to borrow millions of dollars to expand broadband and wireless coverage statewide by 2010.

Unfortunately, in many states, state economic development policy and tax policy are not aligned. On the one hand, states subsidize broadband deployment while on the other hand they impose excessive property and sales taxes on the equipment necessary to provide broadband service. A review of current state tax policy suggests that, notwithstanding the good intentions of state and local governments, economic development priorities alone are not enough to prevent state and local governments from pursuing tax policies that are counterproductive to economic growth.

Congressional approval of a permanent moratorium would send a clear signal to the markets that long-term investment decisions will not be undermined by the imposition of new taxes on Internet access or discriminatory taxes on electronic commerce. Such a strong, pro-investment signal from the Congress would help ensure that these investments—which have had such an important role in US economic growth and productivity over the last decade—will continue to be encouraged and rewarded. It will send a signal to the markets to invest here, not abroad.

**(2) Regressive new taxes on Internet access would hurt efforts to close the "digital divide."**

The "convergence" that many in the industry have been touting for years is finally here. In more and more areas of the country, consumers have choices. They can get high-speed Internet access from a cable provider, DSL from a telecommunications company, or WIFI or "3G" service from a wireless provider. Other technologies on the horizon may provide even more competitive choices. The key to this consumer choice is the availability of competing networks that reach the consumer.

As a result of competition, the price of broadband Internet access service has fallen in many markets. In those areas that still lack competition, the key to bringing down prices for consumers is to get competing networks built and operating.

At the very time that the benefits of competition are coming to low- and moderate-income households, the imposition of new taxes on Internet access would increase prices and make broadband access less affordable. This would be especially problematic if excessive state and local telecommunications taxes were imposed on the service.

**(3) Congress should act to ensure that the moratorium is not undermined by state and local taxation**

The Internet Tax Freedom Act's moratorium on state and local taxes covers the transport purchased, used, and sold by Internet access service providers to provide Internet access and high speed Internet access. Nonetheless, some states and localities have persisted in imposing taxes on Internet transport and high speed Internet access. If left unchecked, such activities will undermine the moratorium. From an economic standpoint, taxes on the transport component of Internet access are indistinguishable from taxes on Internet access services. Both put the same upward pressure on end user rates, deterring the growth of Internet access subscribership.

The willingness of states and localities to tax communications services at excessive and discriminatory rates highlight the risk to consumers of indiscriminate new taxes if the moratorium is not extended and its applicability to Internet transport is not clarified once and for all.

In 1999, the Committee on State Taxation released a comprehensive study of the state and local tax burden on telecommunications services.[2] The study found that consumers of telecommunications services paid effective state/local tax rates that were more than twice those imposed on taxable goods sold by general business (13.74% vs. 6%). Including federal taxes, the tax burden was nearly three times higher than general business. In addition, due to the sheer number of different state and local taxes imposed in many jurisdictions, the typical communications service provider was required to file seven to eight times as many tax returns compared to those filed by typical businesses (63,879 vs. 8,951 annually).

Unfortunately, with the exception of Virginia, states with excessive and discriminatory taxes on telecommunications service have not reformed their taxes to reduce the level of taxation imposed on these services to the same level imposed on other competitive goods and services. The Heartland Institute released a new report this month that found that consumers of cable TV, wireless and wireline phone service paid an average of 13.5% in taxes, more than two times the 6.6% average sales tax rate. The study found that the average household would pay $125 less in taxes per

[2] Committee on State Taxation, "50-State Study and Report on Telecommunications Taxation." Washington, DC, 1999.

year if excessive taxes on cable TV and telecommunications were lowered to the sales tax rate. The failure of most State and local governments over the past decade to reduce excessive and discriminatory taxes on telecommunications services and the efforts by some states and localities to circumvent the moratorium by taxing telecommunications transport in blatant disregard of the moratorium heightens the risk that, absent the moratorium, these excessive and discriminatory could be extended to Internet access. The moratorium was enacted to prevent this from happening, and this threat is as real in 2007 as it was in 1998. It is time to make the moratorium permanent and to end the state grandfather clauses.

There is widespread agreement that, given the critical importance of education in the global economy, broadband access is not a luxury but a necessity for American families. Making the moratorium permanent and clarifying the scope of its applicability would ensure that regressive state and local taxes do not impose another obstacle on the ability of low-income families to prepare for and participate in the global economy, particularly since only 16 states specifically exempt Internet access from their sales or communications taxes.[3]

To summarize, making the Internet tax moratorium permanent will provide important social and economic benefits for American consumers and businesses. A permanent moratorium will send a strong, pro-investment signal to those entrepreneurs that are looking to improve communications and commerce over the Internet. It will prevent the imposition of expensive new taxes and administrative burdens on businesses that conduct interstate commerce over the Internet. It will ensure that regressive new tax burdens are not imposed on lower-income American families seeking to ensure that their kids are prepared for the global economy.

Madame Chair and members of the subcommittee, thank you again for the opportunity to testify on this important subject, and I respectfully urge you to pass a permanent extension of the moratorium.

Ms. SÁNCHEZ. Thank you. You came in right at the 5-minute mark. Very good.

Mr. Johnson, please begin.

## TESTIMONY OF JERRY JOHNSON, OKLAHOMA TAX COMMISSION, OKLAHOMA CITY, OK

Mr. JOHNSON. Thank you, Madam Chairwoman and Mr. Cannon.

My name is Jerry Johnson. I am the vice chairman of the Oklahoma Tax Commission. I am here today on behalf of the Federation of Tax Administrators. FTA is an organization that represents revenue departments in the 50 States, the District of Columbia, Puerto Rico and New York City.

The main point that I want to get across this afternoon is that we would urge this Committee to use extreme caution whenever you take action that infringes upon the rights of States to set their own tax policy. In the state of Oklahoma, I have served in a couple of capacities. For the past 10 years, I have been a member of the tax commission, and prior to that I worked for the appropriations staff of the State senate.

And, during my time working for the appropriations staff, I developed an appreciation for the demands that are placed on State government and local governments for providing services. And I know you are all aware of those demands at the Federal level, but those demands are growing at the State level. And my time on the tax commission, I have developed an appreciation for the demands placed on State revenue systems and the States' efforts to try to keep those systems fair and broad, but also for those systems to try to meet the needs of the services that are demanded in the States.

In Oklahoma, our governor and legislature recently made long-term multiyear commitments to increase funding for education and

[3] AL, AZ, CO, CT, DC, FL, IA, MD, MA, MI, MO, NY, NC, PA, UT, VA.

increase funding for roads. I think that is a very important thing for our State, but it is also a very important thing for our country that States are able to make those types of investments if we are to compete.

And a concern that the States have is if this definition and if this moratorium can be construed to greatly rolling back existing tax revenues that States won't have the revenues and the sources to make those kind of investments. In Oklahoma, for example, not only do we have a balanced budget amendment, but we have severe constitutional restrictions on the ability of the legislature to raise revenues.

There are two kind of fiscal problems I think that face the States. One is we have economic upturns and downturns that mean revenues go up and down. And I think States have done a very good job of trying to deal with those. We have rainy day funds. We use other one-time revenues to try to address those. But, to me, the most significant problem facing the States is the long-term erosion of the tax base.

As the economy changes and things shift to services or things shift to the Internet or through Federal preemption, if our tax base is eroded, then our ability to meet those demands is greatly diminished.

From the Federation perspective, as Congress continues the extension of the moratorium, we would ask you to consider three things: one, we believe that the definition needs to be revisited and reworked. We are very concerned that the definition goes beyond the original intent and that the definition could be construed to be much broader than intended and that would have serious consequences on the ability of State and local governments to fund necessary services.

The second thing is we think it is very appropriate to have a temporary extension. In most instances when we are dealing with Federal tax law, we have the IRS there or we have an executive agency there to monitor the implementation of the law, to write rules. That doesn't exist in this case, and so we are concerned that there needs to be that monitoring, that re-looking at the definition, and as technology changes that the definition be brought up to date to what was really intended by Congress.

And we think it is very appropriate for Congress to take that oversight role and for Congress to come back and revisit the definition and make sure things are working the way you intended, and so that is why we feel it should be temporary.

The third item is the grandfather clause. We think it is very important that the grandfather provision be retained because of possible other consequences on other taxes other than just access charges that relate to the grandfather clause.

But, again, I thank you very much for the opportunity to be here and look forward to answering questions.

[The prepared statement of Mr. Johnson follows:]

PREPARED STATEMENT OF JERRY JOHNSON

My name is Jerry Johnson. I am the Vice Chairman of the Oklahoma Tax Commission and am testifying today on behalf of the Federation of Tax Administrators of which I am First Vice President. The Federation is an association of the tax ad-

ministration agencies in each of the 50 states, the District of Columbia, Puerto Rico, and New York City. We are headquartered in Washington, D.C.

The Federation urges the Congress to refrain from enacting measures that abrogate, disrupt or otherwise restrict states from imposing taxes that are otherwise lawful under the U.S. Constitution. The current prohibition on the imposition of taxes on charges for Internet access as contained in the Internet Tax Nondiscrimination Act (the moratorium) is the type of law that should be avoided, especially on a permanent basis.

SUMMARY OF POSITION

The Federation urges Congress not to extend the Act because it is disruptive of and poses long-term dangers for state and local fiscal systems. Moreover, the General Accountability Office and other researchers have found that the moratorium is not effective in achieving its purported purpose of expanding the availability of Internet access to the American public and bridging what has been termed as the "digital divide."

If, however, Congress believes the Act should be extended we believe there are three principles that should be followed:

- The definition of "Internet access" in current law must be changed. As currently written, we believe that an Internet service provider could bundle virtually all types of Internet services, content and information (some of which may be currently taxable) into a package of "Internet access" and claim that the state would be preempted from taxing any part of that package. The danger to state and local fiscal systems over the long term from the current expansive definition is considerable.
- Any extension of the Act should be temporary in nature. The nature of the online world and the manner in which the public accesses and uses that world continues to change rapidly. The long-term impact on state and local finances is still evolving. Given what everyone acknowledges will be continuing rapid change, it seems only prudent that any extension be temporary and that Congress revisit the policy and its impact in a few years.
- The provision of the Act preserving those taxes on Internet access that were "generally imposed and actually enforced" prior to 1998 should be continued if the Act is extended. The intent when the original Internet Tax Freedom Act was passed in 1998 was not to disrupt existing practices and that commitment should be maintained.

IMPACT OF THE MORATORIUM

Congress was responding to several concerns when it originally passed the Internet Tax Freedom Act in 1998. Among these was that the Internet and electronic commerce were "fledgling industries" that should be protected from state and local taxation for fear that the taxes would be burdensome and complex and somehow prevent the growth and survival of the industry. In addition, there was a belief that preempting state and local taxation of charges for Internet access would provide a financial incentive to U.S. households to subscribe to Internet services and would encourage the Internet industry to deploy services to underserved areas.

While the goals are laudable, the economic evidence is that state taxation of Internet access charges has little or nothing to do with the adoption of Internet services by consumers or the deployment of services by industry. The Government Accountability Office (GAO) was required to perform a study on the deployment of broadband service in the United States when the Moratorium was last extended.[1] The key findings regarding taxes in their report reads as follows:

- "Finally, using our econometric model, we found that imposition of taxes was not a statistically significant factor influencing the deployment of broadband."
- "Using our model, we found that the imposition of the tax was not a statistically significant factor influencing the adoption [by consumers] of broadband service at the 5 percent level. It was statistically significant at the 10 percent level, perhaps suggesting that it was weakly significant factor. However, giving the nature of our model, it is unclear whether this finding is related to the tax or other characteristics of the states in which the households resided."

[1] Government Accountability Office, "Telecommunications—Broadband Deployment is Extensive throughout the United States, but It Is Difficult to Assess the Extent of Deployment Gaps in Rural Areas" (GAO-06-426). In the GAO study, the term "deployment" refers to the offering of broadband services by various types of providers and the term "adoption" refers to the use of broadband services by consumers.

GAO found that factors such as the education level of the head of a household and the income of the household influenced the purchase of broadband services. A household headed by a college graduate was 12 percentage points more likely to purchase broadband than those headed by a person who did not graduate from college. High-income households were 39 percent more likely to adopt broadband than lower-income households.

A study by economists at the University of Tennessee likewise found that taxation of Internet access had "no empirical evidence that Internet access rates are lower in state that have levied a tax on Internet access, all else being equal."[2]

Concern about the moratorium and its extension should not be interpreted as suggesting that states and localities do not recognize the importance of the Internet industry and the benefits improved service and utilization can provide to the citizens. The GAO report referenced earlier highlighted several examples of state and local programs aimed a providing assistance and incentives for the deployment of Internet technologies, including:

- The Texas Telecommunication Infrastructure Fund begun in 1996 that committed to spend $1 billion on telecommunications infrastructure.
- Connect Kentucky's an alliance of technology-focused businesses, government entities, and universities that work together to accelerate broadband deployment.
- Virginia Tobacco Indemnification and Community Revitalization Commission is designed to stimulate economic development opportunities by encouraging the creation of new technology-based business and industry.

DEFINITION OF INTERNET ACCESS

The current definition of Internet access was devised in large part in 1998 with "dial-up Internet access" in mind. It has not kept pace with the manner in which Internet technology and services and electronic commerce have evolved. While changes enacted in 2004 did much to remove discrimination among various types of Internet access providers, they did nothing to avoid a potential unintended erosion of state tax bases.

The current definition of "Internet access"[3] effectively allows a broad range of content, information and services to be bundled with Internet access and potentially be considered as protected under the prohibition on the imposition of taxes on Internet access. This results because the term "access" can be interpreted to mean a "right to use," meaning a "right to use" all the information, services and content on the Internet as part of a package of access. The range of content and service that can be bundled with Internet access is virtually unlimited. It includes all manner of electronic books, movies, music, photographs, services, databases, information services and the like.[4]

The current definition allows a growing proportion of the state and local tax base to be effectively put "off limits" by federal legislation with such a broad definition of Internet access. We do not believe this was the intent of Congress when it originally passed the Internet Tax Freedom Act nearly nine years ago.

If the current moratorium with the current definition of Internet access is made permanent it would lead widespread tax avoidance and litigation that today does not occur because it is temporary. The temporary nature of the moratorium deprives companies of the long-term financial inducements to "push the edge of the envelope" in interpreting the law to maximize their competitive advantage over "bricks and mortar" businesses. If the current definition of Internet access were made permanent there would be a considerable opportunity to gain a long-term competitive advantage over traditional businesses that cannot be realistically denied.

The current definition of Internet access poses an issue not only for state and local governments, but also for significant segments of the private sector. Firms that are providing content, video, or other services that compete with those provided by Internet service providers will face a discriminatory and unfair competitive situation

[2] See also Donald Bruce, John Deskins and William F. Fox, "Has Internet Access Taxation Affected Internet Use," State Tax Notes, May 17, 2004, pp. 519–526.

[3] Section 1105(5) of the original Internet Tax Freedom Act, at 47 U.S.C.A. § 1105(5), provides: "The term 'Internet access' means a service that enables users to access content, information, electronic mail, or other services offered over the Internet, and may also include access to proprietary content, information, and other services as part of a package of services offered to users. The term 'Internet access' does not include telecommunications services, except to the extent such services are purchased, used, or sold by a provider of Internet access to provide Internet access."

[4] The Moratorium's accounting rule for separating individual fees would not come into play because all of the bundled content would be considered "Internet access."

if those services when provided as part of Internet access are protected from state and local taxation, but services provided outside a bundle that includes access are subject to state and local taxes. The convergence of technologies and the consolidation in the communications industry suggest that this discrimination will be a real issue "sooner rather than later."

The Federation has worked and continues to work to develop a definition of Internet access that is acceptable to all parties and that is consistent with what we believe all parties actually understand the "intent" of the original bill to be. Our intent is to craft language that will allow Internet access packages consistent with those now offered to continue to be subject to the moratorium, but to avoid the bundling of other products and services into the package.

We have worked with Committee staff and have reached out to the Internet industry to develop such language. We look forward to continuing that effort if an extension of the moratorium moves forward.

TEMPORARY EXTENSION

If the Act is to be extended, it should be done on a temporary, short-term basis—even if the definition of Internet access is amended. A short-term extension would insure that the Moratorium's impact on state and local revenues is examined periodically and that unintended consequences are not occurring. This is necessary because of the continuing expansion of Internet availability and the expanding array of activities conducted on the Internet, which make it very difficult to predict the impact of restrictions. It is also desirable to insure that the industry has not changed in ways that somehow causes the moratorium to discriminate among Internet service providers. It was this sort of discrimination among providers that was, in fact, among the most contentious issues when the Act was last considered in 2003–2004. Finally, presuming a change in the definition of Internet access, it would be advisable to review the impact of that change in the near- to medium-term to insure that it is performing as intended.

PRESERVATION OF TAXES ON INTERNET ACCESS IMPOSED PRIOR TO 1998

Any extension of the Act should preserve the ability of those states currently imposing a tax on charges for Internet access to continue to do so if they so choose. The stated intent when the original Internet Tax Freedom Act was passed in 1998 was not to disrupt existing practices. Given the economic evidence that taxation of charges for Internet access has not impact on the availability or use of Internet access by households in these states, we see no reason that commitment should not be maintained.

Nine states currently impose taxes that are protected—Hawaii, New Hampshire, New Mexico, North Dakota, Ohio, South Dakota, Texas, Washington and Wisconsin. The Congressional Budget Office estimated that in 2003, these states collected on the order of $120 million from their taxes on charges for Internet access. Repealing the grandfathering protection would disrupt the revenue stream of these states—each of which must maintain a balanced budget. Repealing the preemption would constitute an intergovernmental mandate under the Unfunded Mandate Reform Act.

Preservation of the grandfather for pre-1998 taxes is an issue that is important not only to these states. The grandfather also covers a variety of general business taxes that may be imposed on a wide range of businesses (e.g., state and local gross receipts taxes, unemployment taxes, taxes on machinery and equipment purchases, real estate transfer taxes, etc.) that are not generally considered "taxes on Internet access" but would be subject to challenge under the Act if the grandfather clause is repealed.

CONCLUSION

We submit that the "fledgling industry" argument for Internet services in the United States is no longer relevant. Electronic commerce is a mature and important part of the U.S. and international economy. The continued moratorium on taxing charges for Internet access should be evaluated. In our estimation, there has been no showing that the purchase or supply of Internet access services in those states that tax the services has been adversely affected. Neither has there been a showing of an undue compliance burden on Internet service providers that would justify the preemption. Continuing the preemption simply provides a special position for this particular communications medium and unfairly shifts the burden of taxation on to other activities.

If the preferential treatment of Internet access continues, three matters should be addressed:

- The scope of the preferential tax treatment (definition of Internet access) needs to be limited to protect businesses that compete with Internet companies;
- The Act should be made temporary to insure periodic review of the Act and its consequences; and
- The original commitment to those states imposing taxes on Internet access should be continued.

Ms. SÁNCHEZ. Thank you, Mr. Johnson.

Mr. Rutledge?

**TESTIMONY OF JOHN RUTLEDGE, THE HEARTLAND INSTITUTE, CHICAGO, IL**

Mr. RUTLEDGE. I will have to talk even faster.

Madam Chairwoman, Representative Cannon, Members of the Committee, thank you for having me here to testify on this important issue.

My name is John Rutledge. I am an economist, chairman of Rutledge Capital, private equity investor in Greenwich, Connecticut. I am a senior research fellow at Heartland Institute and a number of other think tanks. I am also a professor at the Chinese Academy of Sciences and chief adviser to the governor of Haidian, which is China's Silicon Valley.

I was one of the authors of the U.S. Chamber of Commerce study on telecom reform year before last, and I am one of the authors of a study Heartland Institute released earlier this month on taxes and fees on communications services, which I have appended to my testimony.

Today, I want to focus on three simple things. First is that this issue is important for productivity and jobs and growth, second, that the key to jobs and growth is capital stock and the quality of the communications network and, third, that communications network capital is already heavily taxed. I will end up suggesting that the extension is a good idea, that permanent taxes are always better than temporary taxes, including this situation, that grandfather clauses be removed over time——

Ms. SÁNCHEZ. Pardon me, did you say permanent taxes or permanent moratoriums?

Mr. RUTLEDGE. Permanent taxes, permanent moratoriums, the same, but a permanent moratorium is better. And that suggests when the question comes up, what to tax, tax things that won't leave after you tax them. And what not to tax is the capital stock.

The communications network is not just a sector, it is the central nervous system for all the other businesses in the economy. It is what allows the workers to be productive and earn paychecks. America is the most productive economy in the world.

Three-quarters of the enormous productivity gains since 1995 are attributable to information technology and communication network investments, based on numerous studies. They all point to growth in jobs, incomes, productivity, from these investments, to lower costs that have helped keep inflation and interest rates in line, which helps people also buying homes and buying cars.

As an illustration we did for the U.S. Chamber of Commerce study, telecom reform, which in general is what has happened over the last year and a half, our results were that it would generate

about $50 billion of capital spending, which is about what we have gotten in the last 18 months, 212,000 jobs and $600 billion worth of new GDP.

Modern communications networks are also the key to competitiveness. We all know there is a Chinese delegation in town today, led by Vice Premier Wu Yi. They are here to talk about trade and competitiveness issues, but fighting over trade numbers, currencies and exports and imports of physical goods is yesterday's battle.

Today's battle is energy. There is not enough of it to feed the growing world economy. Tomorrow's battle is going to be technology. It will be fought with communications networks and information technology. The Internet tax moratorium has been a very positive influence on capital spending on networks.

It is important that we now make it permanent in order to keep investments in I.T. growing. Other countries are working hard on this issue. China, for example, has just released a plan that suggests that they can no longer deliver the 8 to 10 percent growth their people demand with manufacturing, so they are switching their investments over to information technology, communications equipment, software, advanced education, and they are doing a big job on it.

Communications and information technology is the only way countries can improve productivity and raise pay without fighting over energy. In the U.S., the sector is very heavily taxed. As you will see in the study from Heartland, the average family pays $250 a year of taxes. Tax rates on telecommunications and cable TV services are twice normal sales tax rates.

Tax rates vary widely across regions, across technologies and in some cases are higher than sin taxes, beer, alcohol, liquor, tobacco taxes. All of these happen during a period when the moratorium's been in place, so if you release the moratorium, I think you are going to have very major tax increases and I think that is something that would be detrimental to productivity and growth.

Thank you.

[The prepared statement of Mr. Rutledge follows:]

PREPARED STATEMENT OF JOHN RUTLEDGE

**OVERSIGHT HEARING ON THE**
**"INTERNET TAX FREEDOM ACT: INTERNET TAX MORATORIUM"**
**SUBCOMMITTEE ON COMMERICAL AND ADMINISTRATIVE LAW**
**U.S. HOUSE OF REPRESENTATIVE COMMITTEE ON THE JUDICIARY**
**MAY 22, 2007**

**TESTIMONY OF DR. JOHN RUTLEDGE**
Chairman, Rutledge Capital LLC, Cos Cob, Connecticut
Honorary Professor, Chinese Academy of Science, Beijing, China
Senior Fellow, Heartland Institute, Chicago, Illinois

Chairman Sánchez, Ranking Member Cannon, and members of the Subcommittee on Commercial and Administrative Law, thank you for the opportunity to testify on this issue of such importance to growth, jobs, productivity, and the competitiveness of U.S. workers and companies in the global economy.

My name is John Rutledge. I am an economist and Chairman of Rutledge Capital LLC, a private equity investment firm in Greenwich, Connecticut. I am a senior fellow at the Heartland Institute in Chicago, Illinois, and I am an Honorary Professor at the Chinese Academy of Sciences in Beijing, where I also advise the Governor of Haidian, China's Silicon Valley.

As further background on the subject of today's hearings, I was a coauthor of the 2005 U.S. Chamber of Commerce Study on Telecom Reform "Sending the Right Signals." I am also a coauthor of "Taxes and Fees on Communication Services," a research study released by the Heartland Institute earlier this month.

Today, I want to focus on three important reasons why I believe making the moratorium on internet taxes permanent would be extremely beneficial for U.S. productivity, jobs and growth and why doing so would help American workers and companies compete in the global economy.

- The communications network is the key to jobs and growth.
- The communications network is the key to competitiveness.
- The communications network and services are already overtaxed.

All of these are reasons to make the internet tax moratorium permanent.

The nation's communication network is not just another sector to be taxed and regulated. It is the Central Nervous System of the overall economy, allowing all workers and all businesses to share information that makes them more productive, improves the quality of our products and services, lowers costs, and speeds delivery.

More than 75% of the remarkable gain in productivity that has increased jobs and incomes since 1995 has been due to investment in communication networks and to the

information technology that is transported across them. These productivity gains have created jobs and increased real incomes for workers. They have also reduced costs and kept inflation and interest rates low, making it more affordable to buy a home or new car.

As an illustration of this impact, the U.S. Chamber of Commerce Study on Telecom Reform concluded that a broad set of reform designed to spur investment in new networks, many of which have now been implemented, would result in more than $50 billion of additional capital spending on communications networks. This increase in investment would have a huge impact on economic growth, adding 212,000 jobs and more than $600 billion of GDP and income over a five year period.

Modern high speed communications networks and innovative information technologies will determine the competitiveness of American workers and U.S. businesses in the 21st Century and Global Economy.

We all know that a high level Chinese delegation, led by Vice Premier Wu Yi, is in Washington today to discuss trade and competitive issues. Fighting over trade numbers dominated by exports and imports of physical goods is yesterday's battle.

Today's battle is over energy. There is not enough energy to supply the needs of a rapidly growing world.

Tomorrow's battle will be over technology. It will be fought with communications networks and information technology. The country with the fastest, highest quality communications network and the most innovative information technologies will win the most jobs and the highest paychecks.

The internet tax moratorium has been a positive influence on U.S. investment. It is important that we now make it permanent to keep investment high and keep American capital at home where it can be used to create jobs and paychecks for American workers.

Other countries are working hard to pass us. China, for example, has decided they will no longer be able to deliver the 8-10% annual growth their people demand without running out of oil, gas and coal and without furthering fouling the air and water. Their strategy, as revealed in their most recent plan, is to invest heavily in communications networks, communications equipment, information technology, software, and advanced education to train their people for tomorrow's jobs.

Communications and information technology are the only way to improve productivity fast enough to create jobs and rising incomes without coming into conflict with other nations over scarce supplies of energy and other resources

In the U.S., the communication network is already overtaxed. Ending the internet tax moratorium, would result in further major increases in communications taxes with extremely negative impact on investment and growth.

The Heartland Institute study "Taxes and Fees on Communication Services," which I helped write, examined taxes and fees on communications services in 59 cities across America. The study found that:

- The average household pays $250 per year in taxes on communications services, including landline, wireless, VOIP, cable and internet access.
- The average tax rates on communications services is 13.5%, more than twice the average rate of 6.6% of all other goods and services.
- If communications tax rates were no higher than general tax rates applied to other goods, the average household would save $10.48 per month or $125.79 per year.
- The total annual tax burden is $37 billion dollars.
- Tax rates impose a major burden on low income households, which pay 10 times as much in communication taxes as high income households as a share of income.
- Tax rates vary widely across technologies and across the country even for the same services.
- Some communications tax rates exceed "sin" tax rates. In Jacksonville, Florida, for example, households pay 33.24% wireless taxes, higher than beer (19%), liquor (23%) or tobacco (28%).
- All of the above has taken place during the period when the internet tax moratorium has keep state authorities from taxing internet access or imposing multiples or discriminatory taxes on internet services.

For these reasons, I support making the internet tax moratorium permanent and removing grandfathered tax authority over a reasonable period.

Thank you very much.

John Rutledge

**Executive Summary**

# Taxes and Fees on Communication Services

A new study by David Tuerck, Paul Bachman, Steven Titch, and John Rutledge finds taxes and fees imposed on cable TV and phone services in 59 U.S. cities cost the average household approximately $250 a year. Communication services are taxed at twice the average rate of other products and impose a major burden on consumers and low-income households in particular. Taxes also vary considerably from state to state, from service to service, and according to the technology used to deliver otherwise-similar services. Local, state, and national governments can take actions to make communication taxes lower and more uniform.

## 1. Communication services are heavily taxed.

Communication services today consist of voice, video, and Internet access services delivered over telephone wires, cable TV lines, or wirelessly (via point-to-point signal transmission or satellite). Consumers of voice and video services pay substantial taxes and fees. This study found:

- **The total average monthly cost** of taxes and fees on cable TV and phone calls (wireline and wireless) for the 59 cities studied for this report is $20.51, an effective rate of 13.52 percent. The burden on all communication services (including Internet access) ranges from a low of $10.93 (5.81 percent) in Lansing, Michigan to a high of $34.27 (18.22 percent) in Jacksonville, Florida.
- **Cable video subscribers** pay, on average, $6.12 a month in taxes and fees, an effective rate of 11.69 percent. Lansing, Michigan and Carson City, Nevada impose the lowest burdens while cable subscribers in Charlotte, North Carolina and Tallahassee, Florida pay the highest rates.
- **Wireline telephone subscribers** pay, on average, $8.50 per month in taxes and fees, or 17.23 percent. Subscribers in Billings, Montana experience the lowest burdens while those in Jacksonville, Florida pay the highest rates.
- **Wireless telephone subscribers** pay, on average, $5.89 per month in taxes and fees, a rate of 11.78 percent. The lowest burdens are in Carson City, Nevada and the highest are in Omaha, Nebraska.
- **Broadband Internet subscribers** pay, on average, $0.29 a month in taxes and fees if they use a Digital Subscriber Line (DSL) and $0.23 a month if they use a cable modem to access the Internet, for an effective tax rate of 0.71 percent on both types of service.

## 2. The methodology used for this study.

The Heartland Institute contracted with the Beacon Hill Institute (BHI) at Suffolk University in Boston, Massachusetts to collect data for the 50 largest cities in the U.S., measured by population, and the nation's 50 state capital cities. BHI was able to collect complete data for 59 of these cities. BHI identified the taxes and fees, calculated the dollar value and effective tax rates for each, and summed the values by service (video, voice, and Internet access) and technological platform (cable, wireline, and wireless). Data on prices and monthly bills for cable, wireline, and wireless phone services came from Federal Communications Commission reports. Data regarding cable video services were collected by BHI from local officials and franchise agreements.

BHI's data source for taxes and fees applied to wireline telephone services was a 2004 study by the Council on State Taxation (COST) updated using proprietary information provided by the Coalition to Reform and Reduce Excessive Communication Taxes (CORRECT), a group of major companies from the wireline, wireless, and cable communication industries.

## 3. Taxes and fees on communication services vary considerably.

Taxes and fees on communication services vary greatly from city to city, from one communication service to another, and depending on the technology used to deliver otherwise-similar services. A typical phone call placed with a wireline phone is taxed at 17.23 percent, while a call placed over a cell phone and billed at the same rate is taxed at 11.78 percent. If placed using a Voice over Internet Protocol (VoIP) service like Vonage (the "digital phone" services increasingly offered by cable companies), the call in most states isn't taxed at all.

Taxes and fees on communication services vary greatly from city to city, from one communication service to another, and depending on the technology used to deliver otherwise-similar services.

A typical pay-per-view movie ordered through a cable TV box is taxed at 11.69 percent, while the same movie downloaded over the Internet using a service such as Vongo is not taxed. The new video services being offered by wireline phone companies will probably be taxed at 5 or 6 percent.

Time spent on the Internet using a broadband connection is not taxed, except in the eight states with grandfathered taxes, but the same amount of time spent on the Internet using a wireline dial-up connection is taxed as heavily as a wireline phone call, an average of 17.23 percent.

The seeming absurdity of the current tax and fee regime is growing worse over time as people increasingly watch videos on their cell phones, place calls using their cable modems, and connect to the Internet with devices ranging from personal computers to cell phones to iPods.

## 4. Communication taxes are twice as high as taxes on other goods.

According to the Tax Foundation, the national average retail sales tax rate (combining local, county, and state sales taxes, weighted by personal income) is 6.61 percent. Taxes and fees on cable TV and telephone subscribers average 13.52 percent, twice as high. In other words, telephone calls and cable services are taxed at two times the rate as clothing, sporting goods, and other household products.

The average household in the U.S. pays $20.51 per month ($246.10 a year) in taxes and fees on cable TV and telephone services. If communication taxes and fees were no higher than the general sales tax applied to other goods, the average household would pay only $10.03 per month ($120.30 a year) in communication taxes and fees, for a savings of $10.48 a month ($125.79 a year).

A closer examination of taxes and fees in 11 major cities confirms the disparity: Taxes and fees on cable TV and telephone calls in those cities average 14.77 percent while sales taxes imposed on most goods and services averaged only 7.58 percent, about half as high. Communication taxes and fees in those cities are 164 times as high as taxes on medicine and about 13 times as high as taxes on food.

In several cities, even so-called "sin taxes" are lower than communication taxes and fees. In Jacksonville, Florida, taxes and fees on wireline phone service (33.24 percent) are higher than taxes on beer (19 percent), liquor (23 percent), and even tobacco products (28 percent). In Chicago and Los Angeles, taxes and fees on wireline phone service also are higher than taxes on beer and liquor, though not tobacco products.

## 5. Communication taxes and fees impose a heavy burden on consumers.

Taxes and fees on communication services impose a heavy burden on consumers and distort consumer choices and investment decisions, resulting in large and unnecessary social costs. In addition, excessive taxes and fees reduce capital spending on the country's communications network, which reduces productivity, output, and employment.

- **A $37 billion annual burden:** The national annual burden on cable TV and telephone customers (estimated by multiplying average monthly taxes by 12 and then by the numbers of franchise cable, wireline, and wireless customers in the U.S.) is approximately $37 billion. This is a massive redistribution of wealth from consumers to government treasuries.

> The national annual burden on cable TV and telephone consumers is approximately $37 billion. This is a massive redistribution of wealth from consumers to government treasuries.

- **The poor pay more:** Communication taxes and fees are regressive with respect to income: Their rate as a percent of household income declines as household income rises. Taxes and fees on cable TV and telephone services consume about 1 percent of the annual income of low-income households, 0.5 percent of median-income households, and only 0.1 percent of incomes of households in the top income quintile.

- **Distortion of cousumer choices and investment decisions:** Taxes and fees on cable television services reduce consumer demand for cable television by between 17.5 percent and 35 percent. Taxes and fees on wireless telephone services reduce the number of wireless phone customers by between 5.1 and 8.4 percent and the number of minutes used by between 13.3 and 15.3 percent. Taxes and fees cause an annual "deadweight loss" to society of more than $11 billion.

## 6. Policymakers can act to protect consumers.

Policymakers at the local, state, and national levels have opportunities to reduce taxes and fees on communication services and make them more uniform.

- **Local reforms:** Repealing local cable franchise rules would benefit consumers. According to the Government Accountability Office, basic service cable fees "were approximately 16 percent lower in areas where a second cable company – known as an overbuilder – provides service." The net annual social benefit of competition in cable markets nationwide would total $2.9 billion

- **State reforms:** States can replace, reform, or eliminate video franchise laws, following the example of such states as Texas, which in August 2005 became the first state to pass legislation creating statewide franchising. Since then, nine more states (Arizona, California, Indiana, Kansas, Michigan, New Jersey, North Carolina, South Carolina, and Virginia) have passed similar legislation. States also can follow the lead of Virginia and Ohio by adopting legislation that lowers and streamlines communication taxes.

> States can follow the lead of Florida and Ohio by adopting legislation that lowers and streamlines communication taxes.

- **National reforms:** In March 2007, the FCC issued an order requiring local governments to decide on video franchise applications within 90 days and prohibiting build-out requirements and other nonprice concessions that may block or delay entry by competitors. This is a good start. Bills to federally preempt local franchising authority have been introduced in Congress. The national government can adopt legislation prohibiting discriminatory sales, use, or business taxes on communication services and can reform the Federal Universal Service Fund, which unnecessarily costs consumers billions of dollars a year.

## 7. Conclusion

Taxes and fees imposed on cable television and telephone subscribers in the U.S. are twice as high as general sales taxes on other goods and they vary significantly from city to city, by type of service, and by the type of technology used to access otherwise-similar services. These taxes impose a heavy burden on consumers both directly – $37 billion a year in taxes collected – and also indirectly – a "deadweight loss" to society of more than $11 billion a year.

High and discriminatory taxes and fees are legacies of earlier technology and public policy choices. Policymakers should bring public policy up-to-date with the changes that have transformed the communication arena. To reflect today's technological and market realities, communication taxes ought to be cut, simplified, and made uniform across different technology platforms. Some states have already taken the lead in enacting needed reforms; other states should follow.

The national government has started to act in this arena, with the FCC ruling that local cable franchise policies should not discourage entry by new competitors in the video marketplace. But it also could do more. It could preempt local and/or state video franchising authority and forbid national, state, and local governments from imposing taxes on communication services higher than they impose on other goods and services.

Based on David Tuerck, Paul Bachman, Steven Titch, and John Rutledge, "Taxes and Fees on Communication Services," *Heartland Policy Study* #113 (Chicago, IL: The Heartland Institute, May 2007). Copies of the 45-page study are available for $20 each. Permission is granted to reprint or quote from this *Executive Summary*, provided appropriate credit is given.

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May 2007

# Taxes and Fees on Communication Services

**By David Tuerck, Ph.D., Paul Bachman, Steven Titch, and John Rutledge, Ph.D.**[1]

## 1. Introduction

Communication services today consist of voice, video, and Internet access services delivered over telephone wires, cable TV lines, or wirelessly (via point-to-point signal transmission or satellite). In the past, each service relied on a different technology, allowing it to be purchased, regulated, and taxed separately. Today, all three can be delivered via all three technological platforms and are often offered in packages combining several different services using one or more platforms.

Cable television and telephone subscribers pay hefty taxes and fees on these services, while Internet access is largely untaxed. The burden on telephone and cable subscribers in 59 cities for which complete data are available is 13.52 percent. (See Figure 1.) This is more than twice the average general sales tax paid on other goods (6.61 percent). This report documents taxes and fees on communication services, describes their destructive consequences, and calls for tax and regulatory reform.

**Figure 1**
**Average Monthly Bill, Taxes Paid, and Tax Rate on Communication Services**

| Service | Average Monthly Bill | Average Tax Rate | Average Tax Paid |
|---|---|---|---|
| Cable TV | $52.36 | 11.69% | $6.12 |
| Wireline Phone | $49.33 | 17.23% | $8.50 |
| Wireless Phone | $49.98 | 11.78% | $5.89 |
| *Subtotal* | $151.67 | 13.52% | $20.51 |
| Internet Access | $36.50 | 0.71% | $0.26 |
| Total | $188.17 | 11.04% | $20.77 |

Taxes and fees on communication services also vary greatly from city to city, from one communication service to another, and

[1] David Tuerck, Ph.D., is executive director of the Beacon Hill Institute (BHI) and professor and chairman of the Department of Economics at Suffolk University in Boston, Massachusetts; Paul Bachman is director of research at the Beacon Hill Institute; Steven Titch is a senior fellow of The Heartland Institute and managing editor of *IT&T News;* John Rutledge, Ph.D., is a senior fellow of The Heartland Institute and chairman of Rutledge Capital, a private equity investment firm.

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depending on the technology used to deliver otherwise-similar services. These variations make little sense and often are the legacy of tax and regulatory decisions made before the advent of modern communication technologies.

Some taxes and fees are imposed *only* on communication services. The principal ones are listed in Figure 2. Most states and cities also impose general sales taxes and other taxes and fees on voice and video communication services, but not on broadband Internet access.

**Figure 2**
**Principal Taxes and Fees Imposed Only on Communication Services**

**Video**
Franchise Fee
Access Fee
FCC User Fee

**Voice**
Federal Universal Service Fund
911 Tax
City Telecom Tax
TDD (deaf tax)
State Universal Service

This study did not take into account corporate income or property taxes, even though communication companies pay those as well. Also excluded are nonprice concessions, such as non-repeating capital grants paid by cable companies and the cost of radio spectrum licenses paid by wireless companies. The 3 percent federal excise tax is excluded from wireless phone bills entirely and from the long distance portion of wireline phone bills. Part 2 of this report summarizes these and other methodological issues.

Parts 3 - 6 of this report documents the taxes and fees paid by communication service subscribers for each of 59 cities for which data were available. The entire database is available on two Web sites, www.heartland.org and www.beaconhill.org.[2] Some highlights include:

- **Cable television subscribers** pay, on average, $6.12 a month in taxes and fees, or 11.69 percent of the average monthly subscription cost. Lansing, Michigan and Carson City, Nevada impose the lowest burdens while cable subscribers in Charlotte, North Carolina and Tallahassee, Florida pay the highest rates.

- **Wireline telephone subscribers** pay, on average, $8.50 a month in taxes and fees, or 17.23 percent of the average monthly telephone bill. Subscribers in Columbus, Ohio pay the least in taxes and fees while those in Jacksonville, Florida pay the highest rates.

- **Wireless telephone subscribers** pay, on average, $5.89 a month in taxes and fees, or 11.78 percent of the average monthly bill. The lowest burdens are in Carson City, Nevada and the highest are in Omaha, Nebraska.

- **Broadband Internet subscribers** pay, on average, $0.29 a month in taxes and fees if they use a Digital Subscriber Line (DSL) or $0.23 a month if they use a cable modem to access the Internet, for an imputed rate of 0.71 percent for both types of service. State and local taxes on Internet access are banned by the Internet Tax Freedom Act in all but eight states and some cities in Colorado, where preexisting Internet access taxes were "grandfathered."

[2] The authors plan to update data in the tables frequently and to issue new editions of this report occasionally. Persons with new information are invited to contact the authors at the email addresses provided at the end of this report.

- **The total average monthly cost** of taxes and fees paid by household with cable TV, wireline and wireless phone, and Internet access is $20.77, or 11.04 percent of the average monthly bill. The burden ranges from a low of $10.93 (5.81 percent) in Billings, Montana to a high of $34.27 (18.22 percent) in Jacksonville, Florida. Because broadband Internet access is rarely taxed, removing it from our calculations lowers the average monthly burden only slightly, to $20.51, but raises the effective rate to 13.52 percent.

Part 7 shows how taxes and fees on communication services vary considerably by type of service and choice of electronic device used to receive the service. For example, average taxes and fees on wireline voice service are *twenty times higher* than taxes and fees paid on Voice over Internet Protocol (VoIP) service. Taxes and fees on video service from a cable company are likely to be more than double the taxes and fees on the same video service offered by telephone companies over their new fiber-optic and IP video networks.

Part 7 also finds communication taxes and fees are very high compared with general sales taxes imposed on other goods. The average general sales tax on other products is 6.61 percent, less than half the 13.52 percent paid on cable television and phone calls. The average household would save $125.76 a year if taxes and fees on cable television and phone calls were the same as average general sales taxes on clothing, sporting goods, and household products.

Taxes and fees on telephone calls and cable TV often approach and even exceed taxes on liquor and tobacco. For example, taxes and fees paid by the average wireline telephone subscriber in a sample of 11 cities is higher than the average tax on beer. In Jacksonville, Florida, taxes on beer, liquor, and tobacco are all lower than taxes and fees on wireline phone service.

The average household would save $125.76 a year if taxes and fees on cable television and phone calls were the same as general sales taxes on clothing, sporting goods, and household products.

Part 8 examines the negative impact of high and discriminatory communication taxes and fees, and finds they pose a heavy burden on consumers and distort consumer choices and investment decisions. Consumers pay approximately $37 billion a year in communication taxes and fees. Low-income families pay ten times as much as upper-income families do as a percentage of their annual incomes.

Part 9 discusses what policymakers can do to improve the situation. Local and state governments can repeal, reform, or replace cable franchise laws that restrict competition and consumer choice; states can reduce and streamline taxes on communication services; and the national government can preempt state and local franchising authority, ban discriminatory taxes on communication services, and reform the Federal Universal Service Fund to reduce its cost.

Part 10 contains brief concluding remarks. Appendix 1 presents more detail on methodology, and Appendix 2 contains data used to calculate the national average general sales tax rate. Finally, at the end of the study are biographies of the authors, acknowledgment of persons who participated in the peer review process, and descriptions of the sponsoring organizations.

## 2. Methodology

The Heartland Institute commissioned the Beacon Hill Institute at Suffolk University (BHI) to conduct a survey of taxes and fees imposed by federal, state, and local governments on cable, wireline, and wireless communication service subscribers for a sample of U.S. cities. Figure 3 shows the nine sets of services and representative devices covered in this report.

**Figure 3**
**Selected Types of Communication Services and Devices**

| | Voice | Video | Internet Access |
|---|---|---|---|
| **Wireline** | Traditional telephone (PSTN-public-switched telephone network)<br>Voice over Internet Protocol (VoIP) | Internet Protocol TV (IPTV), FiOS (Verizon), and U-verse (AT&T) | Dial-up (not broadband)<br>Digital Subscriber Line (DSL)<br>Broadband over Power Lines (BPL) |
| **Wireless** | Cellular phone<br>Voice over Internet Protocol (VoIP) over Wi-Fi<br>Satellite (mostly specialized government and commercial applications) | Direct Broadcast Satellite (DBS) TV<br>Mobile Video<br>Multichannel Multipoint Distribution Service (MMDS) | Satellite Internet<br>Wi-Fi<br>MMDS (Clearwire)<br>Cellular (EV-DO, GSM)<br>Wi-Max (in development) |
| **Cable** | Voice over Internet Protocol (VoIP) | Multi-channel Cable TV | Cable Modem |

BHI sought data for the 50 largest cities in the U.S., measured by population, and the nation's 50 state capital cities.[3] BHI was able to collect complete data for 59 of these cities.

BHI identified the taxes and fees, calculated the dollar value and effective tax rates for each, and summed the values by service (video, voice, and Internet access) and technological platform (cable, wireline, and wireless). Data on prices and monthly bills for cable, wireline, and wireless phone services came from Federal Communications Commission reports.[4]

Data regarding cable video services were collected by BHI from local officials and franchise agreements. Generally the data are for the year 2005.

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[3] The cities were chosen to take advantage of databases created by previous research and to encompass a large percentage of the nation's population while also capturing the situation in smaller cities.

[4] FCC, "Annual Report and Analysis of Competitive Market Conditions With Respect to Commercial Mobile Services," 11th Report, September 29, 2006, p. 69 and Table 10 on p. 106, http://hraunfoss.fcc.gov/edocs_public/attachmatch/FCC-06-142A1.pdf [accessed March 17, 2007]; FCC, *Report on Cable Industry Prices*, February 4, 2005, http://hraunfoss.fcc.gov/edocs_public/attachmatch/FCC-05-12A1.pdf [accessed July 28, 2006], and FCC, *Statistics of the Long Distance Telecommunications Industry Report*, May 14, 2003, http://www.fcc.gov/Bureaus/Common_Carrier/Reports/FCC-State_Link/IAD/ldrpt103.pdf [accessed July 28, 2006].

BHI's data source for taxes and fees applied to wireline telephone services was a 2004 study by the Council on State Taxation (COST)[5] updated using proprietary information provided by the Coalition to Reform and Reduce Excessive Communication Taxes (CORRECT), a group of major companies from the wireline, wireless, and cable communication industries. The coalition's members separately compiled tax and fee information relevant to their own circumstances, and then estimated the projected taxes and fees paid by other communication service providers in their segments of the industry. This information was submitted to counsel for the coalition under a claim of privilege and aggregated by counsel to produce a database that was then given to BHI researchers under a confidentiality agreement. These data are generally for the 2004 and 2005 tax years.

The authors took into account criticisms of the COST study made by a coalition of local government associations,[6] as explained in Appendix 1.

Additional data on taxes and fees imposed on wireless service were taken from a 2004 study on wireless communication service by Scott Mackey,[7] who provided updated numbers for 2005. Those numbers, in turn, were verified by local and state officials contacted by BHI researchers.

This study and its complete data set are posted on the Web sites of The Heartland Institute (www.heartland.org) and the Beacon Hill Institute (www.beaconhill.org).

Paul Bachman and David Tuerck of BHI then worked with two Heartland senior fellows, Steven Titch and John Rutledge, to produce this summary and interpretation of the BHI database. The study then was edited and put through peer review by Heartland's president, Joseph Bast. Persons who participated in the peer review are identified on pages 43-44. This study and its complete data set are posted on the Web sites of The Heartland Institute (www.heartland.org) and the Beacon Hill Institute (www.beaconhill.org).

## 3. Cable Video Services

Franchise fees, access fees, and initial capital grants are the three most prominent industry-specific fees imposed on cable companies offering video service. In addition, state and local sales taxes, public utility taxes, and other transactional taxes often apply to these companies. Cable franchise agreements often are long documents that require additional perks and benefits to local governments and nonprofit organizations such as cash grants, free studios, free

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[5] Telecommunications Tax Task Force of the Council on State Taxation, "2004 State Study and Report on Telecommunications Taxation," Washington, DC, March 2005.

[6] "Local Government Perspective on Telecommunications Taxes: A Response to Industry's 2004 COST Study," Summer 2006, http://www.gfoa.org/documents/TelecomTaxBriefing_FullReport.pdf.

[7] Scott Mackey, "The Excessive State and Local Tax Burden On Wireless Telecommunications Service," *State Tax Notes* (July 2004): 181-194.

equipment, or free services.

The original intent of cable franchise fees was to impose a fee on cable companies for the use of public rights-of-way. Over time, franchise fees became a significant source of general revenues for many cities. The rationale for these fees is discussed in Part 9 of this report.

The 5 percent franchise fee "acts as an excise tax on services sold by companies that hold cable franchises" and is passed through to consumers the same way other transactional taxes are.

To protect cable customers from high and discriminatory taxes imposed by local governments, the Federal Communications Commission (FCC) established a formula for determining franchise fees based on a percentage of "gross video revenues" derived from the franchise area. The fees are capped at 5 percent, but some local franchising authorities define "gross video revenues" expansively to include local advertising revenue and commissions paid to cable operators from home shopping networks.

The 5 percent franchise fee "acts as an excise tax on services sold by companies that hold cable franchises"[8] and is passed through to consumers the same way other transactional taxes are. Fees that genuinely reflect costs incurred by municipalities due to the use of public rights-of-way should not be counted as taxes, and when so identified were removed from these totals.

Capital grants and other nonprice concessions significantly raise prices and impose other costs on consumers. A study done in the 1980s estimated nonprice concessions accounted for 26 percent of the cost of building cable networks and 11 percent of operating expenses.[9] The FCC recently determined that such concessions are large and pose "undue burdens upon potential cable providers."[10] The estimated welfare loss caused by taxes, fees, and capital grants and other nonprice concessions imposed on cable companies is addressed in Part 8.

Methodological problems, however, prevent the authors from including capital grants and other nonprice concessions in estimates of monthly taxes and fees paid by consumers. Grants and other nonprice concessions tend to act as sunk costs, which cannot be avoided and do not vary with output. Sunk costs are not *entirely* passed through to consumers in the form of higher prices. Some of the cost is absorbed by cable firms in the form of lower profits, and some takes

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[8] Jerry Ellig and Jerry Brito, "Video Killed the Franchise Star: The Consumer Cost of Cable Franchising and Proposed Policy Alternatives," *Working Paper in Regulatory Studies*, Mercatus Center, February 2006, p. 14.

[9] See Mark A. Zupan, "The Efficacy of Franchise Bidding Schemes in the Case of Cable Television: Some Systematic Evidence," *Journal of Law and Economics*, 1989, Vol. 32, pp. 401-405.

[10] "The record demonstrates that LFA [local franchise authority] demands unrelated to cable service typically are not counted toward the statutory 5 percent cap on franchise fees, but rather imposed on franchisees in addition to assessed franchise fees. Based on this record evidence, we are convinced that LFA requests for unreasonable concessions are not isolated, and that these requests impose undue burdens upon potential cable providers." FCC, "Report and Order and Further Notice of Proposed Rulemaking," FCC 06-180, March 5, 2007, p. 23.

the form of reduced investment and output. The effect on consumers is also likely to occur in time periods different than the one covered by this study.

These problems, which do not dispute or contradict the fact that consumers ultimately pay for capital grants and nonprice concessions, led the authors to exclude capital grants and other nonprice concessions from the estimate of monthly taxes and fees. This decision is discussed in more detail in Appendix 1. Because these costs are very large, leaving them out means our estimates are very conservative.

Figure 4 presents data for the average monthly taxes and fees paid by cable video subscribers in 59 cities. The average for these cities is $6.12 per subscriber a month, or 11.69 percent of an average monthly bill of $52.36. Lansing, Michigan, Carson City, Nevada, Baltimore, Maryland, and Colorado Springs, Colorado impose the lightest burdens on their cable subscribers, taking from $1.63 to $2.78 a month, or effective rates of 3.11 percent to 5.31 percent.

Cable subscribers with the highest burdens are in Raleigh, North Carolina, Charlotte, North Carolina, and Tallahassee, Florida, where rates exceed 20 percent.

Cable subscribers with the highest burdens are in Raleigh, North Carolina, Charlotte, North Carolina, and Tallahassee, Florida, where rates exceed 20 percent. These subscribers pay taxes and fees that are about 80 percent higher than the sample average.

Figure 4 also reveals substantial variation in the level of taxes and fees on cable subscribers between the largest and capital cities within the same state. Baltimore subscribers paid $2.71 a month, for example, while Annapolis subscribers paid $7.61. The intrastate variation is the consequence of local authorities granting cable franchises, whereas, for example, wireless licenses are auctioned by the national government and therefore are the same from state to state.

Cable video service providers compete directly with Direct Broadcast Satellite (DBS) providers and multimedia multipoint distribution service (MMDS) providers such as Clearwire, that are not subject to franchise fees and nonprice concessions. Satellite companies have increased their U.S. subscribers by nearly 25 million over the past 10 years, causing cable's share of the market to fall by more than 20 percent.[11]

[11] Tim Feran, "The sky's the limit, satellite TV gives cable a run for its money," *The Columbus Dispatch*, November 27, 2006.

**Figure 4**
**Monthly Taxes and Fees and Imputed Rate**
**Paid by Average Subscribers to Cable Video Services**

| City | Tax | Tax Rate | City | Tax | Tax Rate |
|---|---|---|---|---|---|
| Lansing, MI | $1.63 | 3.11% | Dallas, TX | $6.72 | 12.84% |
| Carson City, NV | $2.28 | 4.36% | Madison, WI | $6.81 | 12.99% |
| Baltimore, MD | $2.71 | 5.18% | Memphis, TN | $6.90 | 13.18% |
| Colorado Springs, CO | $2.78 | 5.31% | Santa Fe, NM | $6.96 | 13.28% |
| Portland, OR | $2.80 | 5.34% | Fort Smith, AR | $7.00 | 13.36% |
| Billings, MT | $2.91 | 5.56% | Philadelphia, PA | $7.03 | 13.42% |
| Salt Lake City, UT | $3.05 | 5.82% | Omaha, NE | $7.07 | 13.50% |
| Las Vegas, NV | $3.19 | 6.09% | Huntington, WV | $7.08 | 13.52% |
| Los Angeles, CA | $3.26 | 6.22% | St. Paul, MN | $7.10 | 13.56% |
| Wilmington, DE | $3.28 | 6.26% | Augusta, ME | $7.11 | 13.58% |
| Columbus, OH | $3.33 | 6.35% | Jefferson City, MO | $7.17 | 13.69% |
| Casper, WY | $3.72 | 7.10% | Atlanta, GA | $7.27 | 13.88% |
| Chicago, IL | $3.75 | 7.16% | Davenport, IA | $7.42 | 14.17% |
| Boston, MA | $4.04 | 7.71% | Cheyenne, WY | $7.44 | 14.22% |
| Springfield, IL | $4.15 | 7.92% | Charleston, SC | $7.51 | 14.34% |
| Minneapolis, MN | $4.22 | 8.06% | Little Rock, AR | $7.57 | 14.45% |
| Sioux Falls, SD | $4.68 | 8.93% | Annapolis, MD | $7.61 | 14.53% |
| Seattle, WA | $4.80 | 9.17% | Portland, ME | $7.69 | 14.68% |
| Milwaukee, WI | $5.29 | 10.10% | Montgomery, AL | $7.73 | 14.75% |
| Des Moines, IA | $5.39 | 10.29% | Tucson, AZ | $7.85 | 14.99% |
| Denver, CO | $5.51 | 10.52% | Manchester, NH | $7.87 | 15.03% |
| Gulfport, MS | $5.71 | 10.91% | Wichita, KS | $7.90 | 15.08% |
| Dover, DE | $5.73 | 10.94% | Birmingham, AL | $8.53 | 16.29% |
| Indianapolis, IN | $5.85 | 11.17% | Concord, NH | $8.53 | 16.29% |
| Fort Wayne, IN | $6.08 | 11.61% | Jacksonville, FL | $8.65 | 16.53% |
| Fargo, ND | $6.24 | 11.91% | Kansas City, MO | $9.19 | 17.55% |
| Phoenix, AZ | $6.45 | 12.31% | Raleigh, NC | $10.96 | 20.92% |
| Bismarck, ND | $6.56 | 12.52% | Charlotte, NC | $10.97 | 20.94% |
| Austin, TX | $6.61 | 12.62% | Tallahassee, FL | $11.07 | 21.14% |
| Sacramento, CA | $6.63 | 12.65% | **Average for 59 cities** | **$6.12** | **11.69%** |

## 4. Wireline Voice Services

Voice (or telephone) services can be provided by traditional wireline, wireless (cell phones), or cable networks. Cable networks may use the public switched telephone network (PSTN) via leased telephone lines or the newer Voice over Internet Protocol (VoIP). When voice services are provided by a wireline phone company or a cable company using the PSTN, one set of taxes and fees applies. Wireless calls are subject to a different set of taxes and fees, and calls placed using VoIP are very lightly taxed or not taxed at all.

Prominent taxes and fees that apply to wireline and cable PSTN voice services at the national and state levels include the Federal Universal Service Fund fee (a percentage of interstate end-user revenues that is reformulated each quarter, but for this analysis was set at 2.48 percent[12]), state sales taxes, and 911 fees. Local taxes include 911 fees, general sales taxes, excise taxes, and public utility taxes.

A 3 percent national excise tax on all wireless and on wireline long-distance calls was being phased out as this report was written, with tax collections ending on August 1, 2006. The tax was originally intended to apply to local service and long-distance service sold with prices that vary by time and distance (WATS service at the time the law was enacted). Even though the tax was still being collected by many phone companies during the time period chosen for this study, we have excluded the tax from all but local wireline calls so the results more accurately reflect tax burdens in 2007.

A 3 percent national excise tax on all wireless and on wireline long-distance calls was being phased out as this report was written, with tax collections ending on August 1, 2006.

Figure 5 displays the total taxes and fees paid per month by the average wireline and cable PSTN voice service customer in 59 cities, and the imputed average rate. The average for all cities studied is $8.50 a month, or 17.23 percent of the average monthly bill of $49.33. Subscribers in Lansing, Michigan, Billings, Montana, Augusta, Maine, and Dover and Wilmington, Delaware experience the lightest burdens, between $4.32 (8.76 percent) in Billings and $4.82 (9.77 percent) in Wilmington.

Consumers in Kansas City, Missouri, Dallas, Texas, Los Angeles, California, and Jacksonville, Florida fare the worst. Their telephone bills carry taxes and fees ranging from 29.10 percent to 33.24 percent, with burdens ranging from $14.35 to $16.39 a month. Jacksonville consumers pay tax rates that are nearly double the sample average.

Figure 5 also shows there is less variance in intrastate tax and fee rates on wireline and cable telephone services than on video services offered by cable companies. For example, households in Dover, Delaware face nearly the same average burden a month, $4.62, as households in

[12] The latest rate is 10 percent on the interstate portion of a phone bill, which is about 25 percent of the total bill. See http://hraunfoss.fcc.gov/edocs_public/attachmatch/DA-05-2454A1.pdf.

Wilmington, Delaware, at $4.82. This pattern demonstrates the majority of taxes and fees levied on wireline and cable voice services are administered at the national and state levels.

**Figure 5**
**Average Monthly Taxes and Fees and Imputed Rate**
**by Average Subscribers to Wireline Telephone Service**

| City | Tax | Tax Rate | City | Tax | Tax Rate |
|---|---|---|---|---|---|
| Billings, MT | $4.32 | 8.76% | Bismarck, ND | $7.90 | 16.02% |
| Dover, DE | $4.62 | 9.37% | Charlotte, NC | $7.95 | 16.12% |
| Lansing, MI | $4.77 | 9.67% | Fargo, ND | $8.15 | 16.53% |
| Augusta, ME | $4.80 | 9.73% | Philadelphia, PA | $8.16 | 16.55% |
| Wilmington, DE | $4.82 | 9.77% | Salt Lake City, UT | $8.44 | 17.12% |
| Boston, MA | $5.11 | 10.36% | Fort Smith, AR | $8.49 | 17.22% |
| Madison, WI | $5.20 | 10.55% | Tucson, AZ | $8.68 | 17.60% |
| Columbus, OH | $5.29 | 10.73% | Colorado Springs, CO | $9.07 | 18.39% |
| Charleston, SC | $5.30 | 10.75% | Phoenix, AZ | $9.08 | 18.41% |
| Milwaukee, WI | $5.40 | 10.95% | Portland, OR | $9.10 | 18.45% |
| Casper, WY | $5.57 | 11.30% | Jefferson City, MO | $9.42 | 19.10% |
| Concord, NH | $5.58 | 11.32% | Little Rock, AR | $9.81 | 19.89% |
| Manchester, NH | $5.58 | 11.32% | Huntington, WV | $9.90 | 20.08% |
| Minneapolis, MN | $5.62 | 11.40% | Baltimore, MD | $10.27 | 20.83% |
| Portland, ME | $5.79 | 11.74% | Annapolis, MD | $10.55 | 21.40% |
| Seattle, WA | $6.06 | 12.29% | Wichita, KS | $10.88 | 22.06% |
| Indianapolis, IN | $6.09 | 12.35% | Sante Fe, NM | $10.94 | 22.19% |
| Davenport, IA | $6.12 | 12.41% | Denver, CO | $11.52 | 23.36% |
| Fort Wayne, IN | $6.15 | 12.47% | Omaha, NE | $11.95 | 24.23% |
| Gulfport, MS | $6.27 | 12.72% | Sacramento, CA | $12.53 | 25.41% |
| St. Paul, MN | $6.41 | 13.00% | Tallahassee, FL | $13.52 | 27.42% |
| Cheyenne, WY | $6.55 | 13.28% | Austin, TX | $13.55 | 27.48% |
| Montgomery, AL | $6.63 | 13.45% | Springfield, IL | $13.70 | 27.78% |
| Des Moines, IA | $7.06 | 14.32% | Chicago, IL | $13.70 | 27.78% |
| Birmingham, AL | $7.35 | 14.91% | Memphis, TN | $14.02 | 28.43% |
| Las Vegas, NV | $7.36 | 14.93% | Kansas City, MO | $14.35 | 29.10% |
| Carson City, NV | $7.38 | 14.97% | Dallas, TX | $14.42 | 29.24% |
| Sioux Falls, SD | $7.53 | 15.27% | Los Angeles, CA | $14.99 | 30.40% |
| Atlanta, GA | $7.58 | 15.37% | Jacksonville, FL | $16.39 | 33.24% |
| Raleigh, NC | $7.63 | 15.47% | **Average for 59 cities** | **$8.50** | **17.23%** |

## 5. Wireless Voice Services

As with wireline and cable voice services, the main taxes and fees that apply to wireless telephone services (or more technically, Commercial Mobile Radio Service carriers) are national and state universal service fund taxes, state and local sales or excise taxes, and 911 fees. Once again the 3 percent national excise tax has been excluded from our analysis.

Wireless voice service has been the target of specific discriminatory city and state excise taxes across the country.

Wireless voice service has been the target of specific discriminatory city and state excise taxes across the country. In 2004, Baltimore imposed a $3.50 a month tax on cell phone users, and Pennsylvania imposed a 5 percent gross receipts tax on top of the existing 6 percent sales tax. Municipal efforts to impose new taxes on cell phone users in two Oregon cities were turned back only after organized opposition emerged. According to a trade association for the wireless telephone industry, "between January 2003 and April 2004, wireless taxes grew nine times faster than that of general business."[13]

Wireless telephone companies also pay the national government to license the radio spectrum they use to reach their customers. By one estimate, these payments, which total some $20.6 billion to date, work out to about $1.4 billion a year (in 2001), equivalent to a tax of about 2.1 percent of revenues.[14] These payments clearly have an effect on consumer welfare, but like the capital grants and nonprice concessions paid by cable companies, they cannot easily be translated into the equivalent of a monthly fee or tax paid by consumers. For this reason, these fees are not included in the current analysis. The decision to exclude these fees is described in more detail in Appendix 1.

Figure 6 presents the monthly taxes and fees paid and the imputed rates for 59 cities. On average, wireless telephone service subscribers pay $5.89 in taxes and fees per month, or 11.78 percent of an average monthly bill of $49.98.

Wireless telephone customers in Carson City and Las Vegas, Nevada, Portland, Oregon, Billings, Montana, and Dover, Delaware pay the lowest taxes and fees on their wireless telephone services. Wireless customers in Seattle, Washington, Jacksonville, Florida, Chicago, Illinois, Tallahassee, Florida, and Omaha, Nebraska pay the most, between $3.25 and $4.78 a month more than the national average wireless customer.

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[13] Jim Schuler, CTIA assistant vice president-policy, quoted in Mary Lou Jay, "Taking Their Toll: Is Excessive Taxation Penalizing Wireless Consumers for Embracing Technology?" *Wireless News*, n.d., accessed December 1, 2006, http://transcoder.usablenet.com:8080/tt/www.ctia.org/news_media/index.cfm/AID/10253.

[14] Scott R. Mackey, "Wireless Carriers and Right-of-Way Fees," August 2002, unpublished manuscript provided to the authors.

**Figure 6**
**Monthly Taxes and Fees and Imputed Rate Paid by Average Subscribers to Wireless Telephone Service**

| City | Tax | Tax Rate | City | Tax | Tax Rate |
|---|---|---|---|---|---|
| Carson City, NV | $1.81 | 3.62% | Minneapolis, MN | $5.51 | 11.02% |
| Las Vegas, NV | $1.81 | 3.62% | St. Paul, MN | $5.52 | 11.04% |
| Portland, OR | $2.09 | 4.18% | Santa Fe, NM | $5.57 | 11.14% |
| Billings, MT | $3.71 | 7.42% | Atlanta, GA | $5.62 | 11.24% |
| Dover, DE | $3.96 | 7.92% | Fort Wayne, IN | $5.68 | 11.36% |
| Wilmington, DE | $3.96 | 7.92% | Gulfport, MS | $5.74 | 11.48% |
| Milwaukee, WI | $3.99 | 7.98% | Springfield, IL | $5.99 | 11.98% |
| Madison, WI | $4.01 | 8.02% | Indianapolis, IN | $6.01 | 12.02% |
| Boston, MA | $4.04 | 8.08% | Little Rock, AR | $6.34 | 12.69% |
| Davenport, IA | $4.27 | 8.54% | Bismarck, ND | $6.54 | 13.09% |
| Jefferson City, MO | $4.37 | 8.74% | Denver, CO | $6.74 | 13.49% |
| Lansing, MI | $4.53 | 9.06% | Fargo, ND | $6.77 | 13.55% |
| Casper, WY | $4.55 | 9.10% | Wichita, KS | $6.93 | 13.87% |
| Columbus, OH | $4.68 | 9.36% | Memphis, TN | $6.99 | 13.99% |
| Annapolis, MD | $4.74 | 9.48% | Fort Smith, AR | $7.08 | 14.17% |
| Des Moines, IA | $4.77 | 9.54% | Phoenix, AZ | $7.11 | 14.23% |
| Augusta, ME | $4.89 | 9.78% | Sioux Falls, SD | $7.17 | 14.35% |
| Portland, ME | $4.89 | 9.78% | Salt Lake City, UT | $7.84 | 15.69% |
| Birmingham, AL | $4.94 | 9.88% | Baltimore, MD | $8.24 | 16.49% |
| Montgomery, AL | $4.94 | 9.88% | Philadelphia, PA | $8.24 | 16.49% |
| Charlotte, NC | $5.04 | 10.08% | Sacramento, CA | $8.53 | 17.07% |
| Raleigh, NC | $5.04 | 10.08% | Austin, TX | $8.79 | 17.59% |
| Kansas City, MO | $5.07 | 10.14% | Dallas, TX | $8.79 | 17.59% |
| Concord, NH | $5.16 | 10.32% | Los Angeles, CA | $8.91 | 17.83% |
| Manchester, NH | $5.16 | 10.32% | Seattle, WA | $9.14 | 18.29% |
| Charleston, SC | $5.24 | 10.48% | Jacksonville, FL | $9.23 | 18.47% |
| Huntington, WV | $5.24 | 10.48% | Chicago, IL | $9.24 | 18.49% |
| Cheyenne, WY | $5.37 | 10.74% | Tallahassee, FL | $9.33 | 18.67% |
| Colorado Springs, CO | $5.39 | 10.78% | Omaha, NE | $10.67 | 21.35% |
| Tucson, AZ | $5.41 | 10.82% | **Average for 59 cities** | $5.89 | 11.78% |

## 6. Broadband Internet Access

Consumers can access the Internet using traditional telephone lines via either dial-up or Digital Subscriber Line (DSL); wireless phones, using EV-DO or GSM technology; satellite using services provided by DirecTV and EchoStar; cable lines using cable modems; fiber-optic lines typically offered by cable companies and increasingly by telephone companies; and wireless transmission services such as Wi-Fi, Multimedia Multipoint Distribution Service (MMDS), or coming soon, Wi-Max. Wireless broadband Internet access is growing rapidly, accounting for 58 percent of the 11 million new broadband subscribers who signed up in the first half of 2006.[15]

State and local governments are generally prohibited from taxing Internet service by the Internet Tax Freedom Act (ITFA), passed in 2004, although the act allows eight states and some cities in Colorado to collect taxes imposed and enforced prior to November 1, 2005. One might think the ITFA means nearly all Internet access is untaxed, but the reality is complicated by changing state and federal rulings on what constitutes "Internet access" and what parts of a phone or cable bill might still be subject to tax. Once again, tax policies differ according to the technology used:

One might think the ITFA means nearly all Internet access is untaxed, but the reality is complicated by changing state and federal rulings on what constitutes "Internet access" and what parts of a phone or cable bill might still be subject to tax.

- Accessing the Internet via **cable modem, Wi-Fi, and satellite services** is generally exempt from state and local taxes and franchise fees, as well as national Universal Service Fund (USF) fees.
- Accessing the Internet via **wireline dial-up (not broadband) service** is taxed at the same rate as wireline phone calls, although the Internet Service Provider's monthly charge is exempt from taxation in most states.
- Accessing the Internet using **digital subscriber line (DSL) service** was exempted from national USF fees when the FCC ruled it was a data service and not a telecommunication service. The Internet Tax Freedom Act clarified that both the DSL service fee and the telecommunication service used to provide the service are to be exempt from state taxes under national law, except for those states with taxes grandfathered under the act.
- Finally, accessing the Internet via **wireless devices** may or may not be taxed depending upon how it is provided and billed. In most states, stand-alone Blackberry services or monthly Internet access plans ("air cards") are exempt. However, if the service is bundled with a voice service plan for a fixed price, the service may be taxable depending upon whether the provider separately states the charge or has the capability to identify the non-taxable part of the bundle in its "books and records."

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[15] As reported in "Broadband Breakout," *The Wall Street Journal*, February 22, 2007.

Wireless Internet access was too recent a development, and the rules too complex, for our database to capture any data that could be extrapolated to a national average. In the course of researching this paper, the authors came across many anecdotal accounts of taxes being applied to the Internet portion of a phone or cable bill, but presumably this is no longer commonplace as the FCC and IRS have clarified their policies on taxing Internet access. Consequently, the only Internet taxes included in the current study are those "grandfathered" under the ITFA.

In the course of researching this paper, the authors came across many anecdotal accounts of taxes being applied to the Internet portion of a phone or cable bill, but presumably this is no longer commonplace.

Figure 7 shows average taxes paid and tax rates for the nine cities in this study that are known to tax Internet access. Their rates range from 0.88 percent to 6 percent. Averaged across all of the states in this study, the "grandfathered" states are responsible for a national mean average monthly tax of $0.29 for telephone company digital subscriber line (DSL) subscribers (0.71 percent of the average monthly bill of $32.00) and $0.23 for cable modem subscribers (0.71 percent of the average monthly bill of $41.00).

Since the tax rates on the two Internet services are the same, from this point forward we simplify the analysis by assuming an average monthly bill of $36.50, an average monthly tax of $0.26, and a national average tax rate on Internet access of 0.71 percent. We acknowledge this is not precise, since the market is not evenly split between DSL and cable modem, but we doubt any further adjustments we could make would add any precision to what is, after all, a very small part of the tax burden on communication services.

**Figure 7**
**Monthly Taxes and Fees and Imputed Rate Paid by Average Subscribers to Broadband Internet Service**

| City | Tax | Tax Rate | City | Tax | Tax Rate |
|---|---|---|---|---|---|
| Birmingham, AL | $2.19 | 6.00% | Milwaukee, WI | $1.83 | 5.00% |
| Montgomery, AL | $2.19 | 6.00% | Santa Fe, NM | $1.83 | 5.00% |
| Bismarck, ND | $1.83 | 5.00% | Sioux Falls, SD | $1.46 | 4.00% |
| Fargo, ND | $1.83 | 5.00% | Seattle, WA | $0.32 | 0.88% |
| Madison, WI | $1.83 | 5.00% | **Average for 9 cities** | **$1.70** | **4.65%** |
| | | | **Average for 59 cities** | **$0.26** | **0.71%** |

## 7. Total Taxes and Fees on Communication Services

In this section, all the taxes and fees imposed on consumers of communication services are summed and compared to general sales taxes imposed on other goods. Consumers who subscribe to all four services have an estimated average monthly bill of $188.17, being $52.36 for cable, $49.33 for wireline telephone, $49.98 for wireless telephone, and $36.50 for Internet access. The burden of taxes and fees is reported as average monthly payment, as a percentage of the average monthly bill, and in terms of the average tax rate imposed on other products.

### Taxes and Fees Vary by State

Figure 8 combines the taxes and fees reported in Figures 4 through 7 and lists the monthly burden faced by average consumers in 59 cities who have cable, wireline telephone, wireless telephone, and Internet services. The average monthly cost imposed on consumers is $20.77, for an imputed rate of 11.04 percent.

The total burden ranges from a low of $10.93 (5.81 percent) in Lansing, Michigan to a high of $34.27 (18.22 percent) in Jacksonville, Florida. Consumers in the cities of Kansas City, Missouri, Dallas, Texas, Omaha, Nebraska, and Tallahassee and Jacksonville, Florida endure the highest burden. Meanwhile, consumers in Lansing, Michigan, Billings, Montana, Carson City, Nevada, Wilmington, Delaware, and Las Vegas, Nevada enjoy the lowest rates.

Since Internet access is rarely taxed, removing it from the bundle of communication services reveals the relatively higher average taxes on cable television, wireline telephone, and wireless telephone, the three remaining services. The average monthly bill for cable TV, wireline phone, and wireless phone totals $151.67 per month. Taxes and fees on these three services total $20.51 a month, or 13.52 percent of the average monthly bill.

> Taxes and fees on cable TV, wireline phone, and wireless phone services total $20.51 a month, or 13.52 percent of the average monthly bill.

### Taxes and Fees Vary by Technology

Figure 9 presents descriptive statistics of the taxes and fees applied in all 59 cities. Other than Internet service (which is taxed only by a few states), cable television services on average experienced the lowest rate, 11.69 percent versus 11.78 percent for wireless phone and 17.23 percent for wireline. Due to differences in monthly bills, wireless customers pay the lowest dollar amount in taxes and fees, at $5.89 a month, $2.61 lower than the wireline average of $8.50 and $0.23 lower than the $6.12 a month paid by cable television subscribers.

Calculating the standard deviation enables us to measure the average amount by which monthly tax payments and tax rates differ from the mean average. Sixty-eight percent of all measurements fall within one standard deviation of the average, and 95 percent of all measurements fall within two standard deviations of the average.

**Figure 8**
**Average Monthly Taxes and Fees Paid by**
**Subscribers to All Four Communication Services**

| City | Tax | Tax Rate | City | Tax | Tax Rate |
|---|---|---|---|---|---|
| Lansing, MI | $10.93 | 5.81% | Jefferson City, MO | $20.96 | 11.14% |
| Billings, MT | $10.94 | 5.81% | Baltimore, MD | $21.22 | 11.28% |
| Carson City, NV | $11.47 | 6.10% | Montgomery, AL | $21.49 | 11.42% |
| Wilmington, DE | $12.06 | 6.41% | Tucson, AZ | $21.94 | 11.66% |
| Las Vegas, NV | $12.36 | 6.57% | Huntington, WV | $22.22 | 11.81% |
| Boston, MA | $13.19 | 7.01% | Fort Smith, AR | $22.57 | 11.99% |
| Columbus, OH | $13.30 | 7.07% | Phoenix, AZ | $22.64 | 12.03% |
| Casper, WI | $13.84 | 7.35% | Bismarck, ND | $22.83 | 12.13% |
| Portland, OR | $13.99 | 7.43% | Annapolis, MD | $22.90 | 12.17% |
| Dover, DE | $14.31 | 7.60% | Fargo, ND | $22.99 | 12.22% |
| Minneapolis, MN | $15.35 | 8.16% | Birmingham, AL | $23.01 | 12.23% |
| Milwaukee, WI | $16.51 | 8.77% | Philadelphia, PA | $23.43 | 12.45% |
| Augusta, ME | $16.80 | 8.93% | Raleigh, NC | $23.63 | 12.56% |
| Des Moines, IA | $17.22 | 9.15% | Little Rock, AR | $23.72 | 12.60% |
| Colorado Springs, CO | $17.24 | 9.16% | Denver, CO | $23.77 | 12.63% |
| Gulfport, MS | $17.72 | 9.42% | Springfield, IL | $23.84 | 12.67% |
| Davenport, IA | $17.81 | 9.46% | Charlotte, NC | $23.96 | 12.73% |
| Madison, WI | $17.85 | 9.49% | Santa Fe, NM | $25.30 | 13.45% |
| Fort Wayne, IN | $17.91 | 9.52% | Wichita, KS | $25.71 | 13.66% |
| Indianapolis, IN | $17.95 | 9.54% | Chicago, IL | $26.69 | 14.18% |
| Charleston, SC | $18.05 | 9.59% | Los Angeles, CA | $27.16 | 14.43% |
| Portland, ME | $18.37 | 9.76% | Sacramento, CA | $27.69 | 14.71% |
| Manchester, NH | $18.61 | 9.89% | Memphis, TN | $27.91 | 14.83% |
| St. Paul, MN | $19.03 | 10.11% | Kansas City, MO | $28.61 | 15.20% |
| Concord, NH | $19.27 | 10.24% | Austin, TX | $28.95 | 15.39% |
| Salt Lake City, UT | $19.33 | 10.27% | Omaha, NE | $29.69 | 15.78% |
| Cheyenne, WY | $19.36 | 10.29% | Dallas, TX | $29.93 | 15.91% |
| Seattle, WA | $20.32 | 10.80% | Tallahassee, FL | $33.92 | 18.03% |
| Atlanta, GA | $20.47 | 10.88% | Jacksonville, FL | $34.27 | 18.22% |
| Sioux Falls, SD | $20.84 | 11.08% | **Average for 59 cities** | $20.77 | 11.04% |

**Figure 9**
**Variability of Average Monthly Taxes and Fees Paid by Subscribers to Cable, Wireline, Wireless, and Internet Services**

| | Cable | | Wireline | | Wireless | | Internet Access | | Total | |
|---|---|---|---|---|---|---|---|---|---|---|
| Statistic | Tax | Tax Rate | Tax | Tax Rate | Tax | Tax Rate | Tax | Tax Rate | Tax | Tax Rate |
| Min | $1.63 | 3.11% | $4.32 | 8.76% | $1.81 | 3.62% | $0.00 | 0.00% | $10.93 | 5.81% |
| Max | $11.07 | 21.14% | $16.39 | 33.24% | $10.67 | 21.35% | $2.19 | 6.00% | $34.27 | 18.22% |
| Mean | $6.12 | 11.69% | $8.50 | 17.23% | $5.89 | 11.78% | $0.26 | 0.71% | $20.77 | 11.04% |
| Standard Deviation | $2.21 | 4.22% | $3.18 | 6.45% | $1.93 | 3.87% | $0.65 | 1.78% | $5.54 | 2.95% |

For total monthly taxes and fees paid on all communication services, the standard deviation is $5.54 (2.95 percent). Cities with monthly taxes and fees greater than $26.31 (13.99 percent) are more than one standard deviation above the mean. Cities with monthly taxes and fees less than $15.23 (8.09 percent) are more than one standard deviation below the mean. Taxes and fees on wireline service vary the most, as shown by the standard deviation of $3.18 (6.45 percent).

The data in Figure 9 make clear that taxes and fees vary greatly according to the type of technology used to deliver otherwise-identical services. Consider:

- A typical phone call placed with a wireline phone is subject to taxes and fees of 17.23 percent, while a call billed at the same rate but placed over a cell phone is subject to taxes and fees of 11.78 percent.
- If placed using a Voice over Internet Protocol (VoIP) service like Vonage, or the "digital phone" services increasingly offered by cable companies, the call in most states won't be subject to *any* taxes or fees.
- A typical pay-per-view movie ordered through a cable TV box is subject to taxes and fees amounting to 11.69 percent, while the same movie downloaded over the Internet using a service such as Vongo or Amazon.com is not subject to *any* taxes or fees.
- The new video services being offered by wireline phone companies will probably be taxed at 5 or 6 percent, depending on the prevailing franchise fee, but possibly more.
- Time spent on the Internet using a broadband connection is not subject to taxes or fees, except in the eight states with grandfathered taxes, but the same amount of time spent on the Internet using a wireline dial-up connection is subject to the same taxes and fees as a wireline phone call, 17.23 percent.

These cost disparities can be seen from a consumer's perspective by applying the imputed average tax-and-fee rates to similarly priced services. Figure 10 shows the varying rates and dollars per month cost of communication taxes and fees on a hypothetical telephone calling package costing $35.99 a month. The wireline customer pays $5.94 more per month than the

VoIP customer for the same service. Over the course of the year, the wireline customer pays $71.28 more – enough to pay for two months of VoIP service – in excess taxes and fees.

**Figure 10**
**Tax and Fee Disparities on a $35.99/month Phone Service Package**

| Technology | Price | Tax Rate | Ratio to lowest tax rate | Tax Amount | Total Monthly Bill |
|---|---|---|---|---|---|
| Wireline | $35.99 | 17.23% | 24.27 | $6.20 | $42.19 |
| Wireless | $35.99 | 11.78% | 16.59 | $4.24 | $40.23 |
| VoIP | $35.99 | 0.71% | 1.00 | $0.26 | $36.25 |

Figure 11 compares taxes and fees paid on a hypothetical premium video service such as HBO, offered by a cable company or phone company for $11.95 per month, compared with a Web-based subscription service offering a menu of the same types of movies for the same price and wireless cell phone-based movie services which, while not available now, are likely to be available within the next 12 months as bandwidth technology improves and videos downloaded via wireless networks become easier to move to larger handheld devices, such as iPods. In this case, the cable customer pays $1.40 a month in taxes and fees, more than double the $0.60 paid by the wireline telephone customer. The wireless subscriber would pay $1.41 a month.

**Figure 11**
**Tax and Fee Disparities on a $11.95/month Premium Movie Subscription**

| Technology | Price | Tax Rate | Ratio to Lowest Tax Rate | Tax Amount | Total Monthly Bill |
|---|---|---|---|---|---|
| Cable TV | $11.95 | 11.69% | 16.46 | $1.40 | $13.35 |
| Wireless* | $11.95 | 11.78% | 16.59 | $1.41 | $13.36 |
| Wireline Telephone** | $11.95 | 5.00% | 7.04 | $0.60 | $12.55 |
| Third-party Internet | $11.95 | 0.71% | 1.00 | $0.08 | $12.03 |

* Service not yet available, assumes current wireless taxes would apply.
** Assuming a 5 percent franchise fee.

Figures 10 and 11 also display the ratio of taxes and fees on the specific service and on the service with the lowest average monthly burden. A person placing a phone call using a wireline phone pays an imputed rate 24 times higher than a person using VoIP. A cable TV subscriber pays an imputed rate twice that of a wireline phone company video customer for the same video content service. All this compared to *no or nearly no tax at all* on a subscription video service offered by a third-party provider over the Internet. There does not seem to be any rationale or logic behind these variations.

The seeming absurdity of the current tax regime is growing worse over time as people increasingly watch videos on their cell phones, place calls using their cable modems, and connect to the Internet with devices ranging from personal computers to cell phones to iPods. With new devices such as Microsoft XBox, Internet downloads are not confined to a desktop PC or iPod screen, but can be displayed on any TV screen in the house. As the Reuters news service recently reported:

> Annual consumer spending on Internet downloads of movies and TV shows will top $4 billion in 2011, up from just $111 million last year. According to Adams Media Research, the growth will be fueled by the introduction of hardware devices such as Apple TV, a $299 box that converts videos downloaded from the Internet into signals that can be played on high-definition television sets. Adams is betting that video downloads will ramp up gradually as Apple TV and similar devices win acceptance among consumers.[16]

### Relative to General Sales Taxes on Other Goods

A comparison of communication taxes and fees to general sales tax rates imposed on other goods reveals a sizeable difference: Subscribers to cable and telephone services in the 59 cities for which we have data pay taxes and fees that are *twice as high* as the national average sales tax on other goods.

> Subscribers to cable and telephone services pay taxes and fees that are twice as high as the national average sales tax on other goods.

The Tax Foundation was asked to calculate the national average general sales tax in the U.S. for this study. Using its own database of state, county, and local sales taxes, it compiled total state sales tax rates, determined the percentage of national personal income affected by each state's taxes, and then calculated a weighted average tax rate. The conclusion: The national average sales tax rate is equal to 6.61 percent. Appendix 2 presents the data used for this estimate.

The average taxes and fees paid by subscribers to cable and telephone services, 13.52 percent of the average bill, is more than two times the national average sales tax rate of 6.61 percent. In other words, telephone calls and cable services are taxed at twice the rate as clothing, sporting goods, and other household products.

The average consumer in the U.S. pays $20.51 per month ($246.12 a year) in taxes and fees on cable television and phone service. If those taxes and fees were no higher than the general sales tax applied to other goods and services, he or she would pay only $10.03 per month ($120.36 a year) in communication taxes and fees, for a savings of $10.48 a month ($125.76 a year).

A closer examination of taxes in 11 cities finds higher average taxes and fees on communication services as well as higher general sales taxes on other goods. (See Figure 12.) Cable and

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[16] "Spending on Video Downloads to Surge," Reuters, February 22, 2007.

telephone taxes in those cities average 14.77 percent[17] and general sales taxes imposed on other goods average 7.58 percent. Once again, communication taxes and fees are about twice as high as taxes on other goods.

**Figure 12**
**Communication Service Taxes and Fees Compared with Taxes on Other Goods and Services***

| City | Medicine | Food | General Sales | Beer | Liquor | Tobacco | Wireline Phone | Wireless Phone | Cable TV |
|---|---|---|---|---|---|---|---|---|---|
| Birmingham, AL | exempt | 9.00% | 9.00% | 27% | 54% | 31% | 14.91% | 9.88% | 16.29% |
| Jacksonville, FL | exempt | exempt | 7.00% | 19% | 23% | 28% | 33.24% | 18.47% | 16.53% |
| Chicago, IL | 1.00% | 1.00% | 9.00% | 20% | 23% | 64% | 27.78% | 18.49% | 7.16% |
| Charlotte, NC | exempt | 2.00% | 7.50% | 21% | 36% | 29% | 16.12% | 10.08% | 20.94% |
| Minneapolis, MN | exempt | exempt | 7.15% | 16% | 22% | 48% | 11.40% | 11.02% | 8.06% |
| Phoenix, AZ | exempt | exempt | 8.10% | 16% | 21% | 45% | 18.41% | 14.23% | 12.31% |
| Des Moines, IA | exempt | exempt | 6.00% | 15% | 42% | 28% | 14.32% | 9.54% | 10.29% |
| Los Angeles, CA | exempt | exempt | 8.25% | 17% | 21% | 39% | 30.40% | 17.83% | 6.22% |
| Raleigh, NC | exempt | exempt | 7.00% | 20% | 36% | 29% | 15.47% | 10.08% | 20.92% |
| Seattle, WA | exempt | exempt | 8.80% | 18% | 50% | 54% | 12.29% | 18.29% | 9.17% |
| Milwaukee, WI | exempt | exempt | 5.60% | 13% | 19% | 35% | 10.95% | 7.98% | 10.10% |
| Average | 0.09% | 1.09% | 7.58% | 18.36% | 31.50% | 39.09% | 18.66% | 13.26% | 12.54% |

* Sources: Drugs, Food, and General Sales tax rates - Federation of Tax Administrators, http://www.taxadmin.org/fta/rate/sales.html);
Beer rates - Federation of Tax Administrators, http://www.taxadmin.org/fta/rate/beer.html;
Liquor rates - Federation of Tax Administrators, http://www.taxadmin.org/fta/rate/liquor.html;
Tobacco rates - Federation of Tax Administrators, http://www.taxadmin.org/fta/rate/cigarett.html;
Additional data, where necessary, were compiled from each state's Department of Revenue Web site, as well as the Retirement Living Information Center's Web site http://www.retirementliving.com/RLstate1.html. Calculations on effective tax rates for beer, liquor, and tobacco were done by Sean Parnell of The Heartland Institute. For a complete description of his methodology, visit The Heartland Institute's Web site at www.heartland.org.

Figure 12 also reports the 11 cities' tax rates on medicine and food – products that often are given preferential treatment under tax codes because they are considered essential goods – and on alcohol, beer, and tobacco – products taxed at high levels presumably to discourage consumption. Food and drugs are generally exempt from state and local sales and excise taxes, while alcohol, beer, and tobacco are subject to higher so-called "sin" taxes.

Since communication services generate no known negative effects on users and nonusers, and indeed are generally recognized to produce positive effects on users and nonusers, one might expect their tax rates to more closely resemble those on medicine and food than those on alcohol,

[17] This was derived by multiplying the average monthly bills for cable TV, wireline phone, and wireless phone by the average tax rates reported in the last row of Figure 12, and then dividing that figure ($22.40) by the total monthly bill ($151.67).

beer, and tobacco. But that is not the case.

Average taxes and fees on cable and telephone services in the 11 cities in Figure 12 are 164 times as high as taxes on medicine and 13 times as high as taxes on food. While average taxes on alcohol, beer, and tobacco were greater than the average imputed rate of taxes and fees on the three communication services, the average imputed rate on wireline phone service was higher than the average tax on beer.

In several cities, so-called "sin taxes" are lower than communication taxes and fees. In Jacksonville, Florida, taxes and fees on wireline phone service (33.24 percent) are higher than taxes on beer (19 percent), liquor (23 percent), and even tobacco products (28 percent). In Chicago and Los Angeles, taxes and fees on wireline phone users also are higher than taxes on beer and liquor, though not tobacco products.

Average taxes on cable and telephone services in the 11 cities in Figure 12 are 164 times as high as taxes on medicine and 13 times as high as taxes on food.

Other researchers have compared taxes and fees imposed on communication companies (rather than consumers) versus other types of businesses and arrived at conclusions similar to ours. A study performed by Ernst & Young in 2005 found "the telecom industry's state and local effective business tax rate (ETR) ... is 2.5 times higher than the average rate for all industries. From the perspective of non-business consumers, the multiple taxes on telecom purchases result in an ETR on sales that is 2.3 times higher than the ETR on sales of other selected goods and services."[18]

The Council on State Taxation (COST) study partially relied on for the present research found the average combined tax rate – national, state, and local – on telecom services is three times higher than the general business rate – 18.7 percent versus 6.12 percent.[19] That analysis included the 3 percent national excise tax on phone calls, property taxes, and other costs excluded from the present analysis.

## 8. Negative Impacts of High Taxes and Fees

Taxes and fees on communication services that are twice as high as taxes on other goods and services impose a heavy burden on consumers and distort consumer choices and investment decisions, resulting in large and unnecessary social costs. In addition, excessive taxes and fees reduce capital spending on the country's communications network, which reduces productivity, output, and employment and erodes the ability of U.S. companies to compete in global markets.

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[18] Ernst & Young, "Total State and Local Taxes Paid by the Telecommunications Industry FY 2004," July 14, 2005.

[19] Council on State Taxation (COST), *2004 State Study and Report on Telecommunications Taxation*, p. 4.

### Burden on Consumers

The total annual cost of taxes and fees paid by communications customers can be estimated by multiplying by 12 the average monthly taxes paid by cable TV, wireline phone, and wireless phone customers, and then multiplying those numbers by the numbers of franchised cable, wireline, and wireless customers in the U.S. in the fourth quarter of 2005, the latest quarter for which comparable data are available. Figure 13 shows the results.

The total annual bill, approximately $37 billion, represents a massive redistribution of wealth from communication consumers to government treasuries. As large as it is, this estimate is *less* than the true burden on consumers, which includes losses due to reduced investment, productivity, and consumption. Estimates of those losses appear later in this section.

**Figure 13**
**Estimated Total Taxes and Fees Paid on Cable TV and Telephone Services in 2005**

| Service | # Customers | Average Annual Taxes and Fees per Customer | National Total Taxes and Fees Paid |
|---|---|---|---|
| Franchised Cable* | 65,400,000 | $73.44 | $4,802,976,000 |
| Wireline Phone** | 175,400,000 | $102.00 | $17,890,800,000 |
| Wireless Phone** | 203,700,000 | $70.68 | $14,397,516,000 |
| Total | n.a. | $246.12 | $37,091,292,000 |

* FCC, *Twelfth Annual Report on the Status of Competition in the Market for the Delivery of Video Programming,* http://hraunfoss.fcc.gov/edocs_public/attachmatch/FCC-06-11A1.pdf

** FCC, *Local Telephone Competition: Status as of December 31, 2005*, July 2006, pp. 2-3. http://hraunfoss.fcc.gov/edocs_public/attachmatch/DOC-266595A1.pdf

### Effect on Low-Income Households

Taxes and fees on communication services are regressive with respect to income: Their rate as a percent of household income declines as household income rises.[20] A family that earned the upper limit of the lowest quintile of households in the country ($24,780) and paid the average amount in communication taxes and fees ($249.24) shouldered a tax and fee burden of about 1.0 percent. A household that earned the median average income ($44,334) and paid the same amount in communications taxes and fees paid only half as much, about 0.56 percent, of its annual income. A household in the top income quintile, earning $173,640 a year, paid an effective communication tax rate of only 0.14 percent, about one-tenth the rate paid by low-income households.

[20] Campbell R. McConnell, *Economics,* 9th Edition (New York: McGraw-Hill Book Company, 1984), pp. 118-121.

Looking back to Figure 8, we see a typical consumer in Chicago with a wireline and wireless phone and cable TV pays $26.69 a month ($320.28 a year) in communication taxes and fees. Residents of Los Angeles pay $27.16 a month ($325.92 a year), and residents of Jacksonville, Florida pay more than any other city in our sample, $34.27 a month – a hefty $411.24 a year. Thirteen of the 59 cities in our sample collect more than $300 a year from a typical household. For households in the lowest income quintile, these are considerable tax burdens.

If taxes and fees on cable television and phone services were no higher than general sales taxes on other goods, the average household would save approximately $125.76 a year. The savings in big cities would be much higher, even though their general sales taxes tend to be higher than the national average. Based on the numbers in Figure 12, the average household in Chicago would save $156.53 a year if cable and phone services were taxed at the 9.0 percent general sales tax rate. In Los Angeles, the annual savings would be $175.85; and in Jacksonville, $283.96.

If taxes and fees on cable television and phone services were no higher than those on other goods, the average household would save approximately $125.76 a year.

High communication taxes and fees make it more difficult for middle- and low-income households to afford services beyond basic phone and cable TV. This is a genuine problem because access to the Internet at home is quickly becoming the way parents monitor their children's performance in schools, take advantage of flex-time to do work-related activities at home, learn new skills, and find out about new employment opportunities.

Public officials who are concerned about the so-called "digital divide" sometimes support grants to nonprofit groups to give away free computers or provide free public access to broadband at public locations. But a more effective strategy would simply be to lower the price of communication services by repealing discriminatory taxes and fees.

If communication services were not subject to discriminatory taxes and fees, the monthly tax bill would be about $10.48 lower, which means more low-income families could afford to sign up for broadband services.[21] As other authors have pointed out,[22] reducing the tax burden on communication services is the most direct and efficient way to get people with modest incomes connected to the Internet.

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[21] According to a survey conducted in 2001 by the General Accounting Office, 27.4 percent of respondents who then had only narrowband Internet access said they would be willing to pay between $5 and $10 a month more for high-speed Internet access. U.S. General Accounting Office, "Characteristics and Choices of Internet Users, Report to the Ranking Minority Member, Subcommittee on Telecommunications, Committee on Energy and Commerce, House of Representatives," February 2001, p. 48, http://www.gao.gov/new.items/d01345.pdf.

[22] Wayne A. Leighton, "Broadband Deployment and the Digital Divide: A Primer," *Cato Policy Analysis* #410, August 7, 2001, p. 27.

### Distortion of Consumer Choices and Investment Decisions

While taxes on communication services are substantial, the out-of-pocket expense is only part of the burden imposed on consumers and producers. As Ellig and Taylor explain:

> When taxes and fees increase prices, consumers buy less of the service, and they are worse off as a result. In economic terminology, the value that consumers forego, minus the price they would have paid, is the "forgone consumer surplus." Similarly, when prices inflated by regulation prompt consumers to use less of a service, producers sell less of it. The operating profits they lose on the sales they don't make are called "forgone producer surplus." ... The total forgone surplus is also called a "deadweight loss."[23]

The average tax on cable television service, which we previously estimated to be 11.69 percent, reduces consumer demand for cable television by between 17.5 percent and 35.0 percent.

To determine the effect of taxes, fees, and government regulations on the amount of communication services purchased, economists use an estimate of price sensitivity called elasticity of demand. Basic telephone service tends not to be very price-sensitive, but other communication services are. Price elasticity estimates for cable television demand generally range from -1.5 to -3.0.[24] In other words, a one percent increase in the price of cable causes demand to fall between 1.5 and 3.0 percent. The price elasticity of demand for wireless phone service is between -.43 and -.71 when estimating the number of people who subscribe, and -1.12 and -1.29 when estimating the number of minutes used.[25]

The average tax on cable television service, which we previously estimated to be 11.69 percent, reduces consumer demand for cable television by between 17.5 percent and 35.0 percent. The average tax on wireless telephone services of 11.78 percent reduces the number of wireless phone customers by 5.1 - 8.4 percent and the number of minutes used by 13.3 - 15.3 percent.

Ellig and coauthors have estimated the annual deadweight loss due to cable taxes and fees[26] and wireless taxes and fees[27] at $2.6 billion and $8.8 billion, respectively. In each case, the

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[23] Jerry Ellig and James Nicholas Taylor, "The Consumer Costs of Wireless Taxes and Surcharges," *Working Paper in Regulatory Studies*, Mercatus Center, March 2006, Table 1, p. 17. This paper is forthcoming in *Loyola Consumer Law Review*, Vol. 19, #1.

[24] See Jerry Brito and Jerry Ellig, "Public Interest Comment on Video Franchising," MB Docket No. 05-311; FCC 05-189, February 13, 2006, p. 16, for sources.

[25] Ellig and Taylor, supra note 23, pp. 15-16.

[26] Jerry Ellig and Jerry Brito, "Video Killed the Franchise Star: The Consumer Cost of Cable Franchising and Proposed Policy Alternatives," *A Working Paper in Regulatory Studies*, February 2006, Table 4, p. 23. This paper is forthcoming in *Journal on Telecommunications and High Technology Law*, Vol. 5, #1.

[27] Ellig and Taylor, supra note 23.

deadweight loss does not include losses due to regulations, but only to taxes and fees.

Discriminatory taxation leads consumers to choose goods and services on the basis of how they are taxed rather than their quality or true costs. For example, when local governments impose franchise fees and sales taxes on cable video services, but satellite services are not taxed, some share of consumers will choose satellite service only because of the tax savings. Discriminatory taxes on communication services can have a major effect because consumers don't need to leave their homes to switch service providers.

This kind of consumer arbitrage was critical to the early success of Voice over Internet Protocol (VoIP) companies such as Vonage and 8 x 8. Consumers learned that when Vonage said service was $29.99 a month, that was the charge that appeared on the bill. Cell phone customers, however, were surprised to get monthly bills with taxes and fees adding up to an average of $5.89 (in the 59 cities for which we have complete data) and as much as $10.67 (in Omaha, Nebraska, the city with the highest tax on wireless telephone service). The taxes have become so high that most wireless carriers have agreed to disclose the estimated monthly bill inclusive of taxes, fees, and surcharges at the time of purchase.

## 9. Paths to Reform

Policymakers at the national, state, and local levels all have opportunities to reduce taxes and fees on communication services and make them more uniform.

**Local Reforms**

The biggest opportunity for reform at the local level is to reform video franchises. The days when local officials could view cable franchises as "urban oil wells" (in the memorable words of New York Mayor John Lindsay) are over. Franchise fees should be brought in line with the opportunity cost incurred by a business's use of the public right-of-way (ROW) and nonprice concessions should be reduced or eliminated.

The days when local officials could view cable franchises as "urban oil wells" (in the memorable words of New York Mayor John Lindsay) are over.

Local governments tend to view cable franchises as an opportunity to collect rent on ROWs, but this is not the correct model. Rent is what is collected by owners who made investments in assets in the expectation that future payments would exceed their operating costs. Public ROWs are different. As Thomas Hazlett explains, they "are not constructed via risky capital invested by private owners, but are created by police powers of the government. It is counter-productive to maximize rent payments; it puts a dollar into one pocket (the municipality's) and takes many more out of others (belonging to the municipality's current and future cable subscribers)."[28]

[28] Thomas W. Hazlett, "Cable TV Franchises as Barriers to Video Competition," March 5, 2006, George Mason Law & Economics Research Paper No. 06-06, p. 14. Available from the Social Science Research Network at http://ssrn.com/abstract=889406. On page 7, Hazlett attributes the Lindsay quote cited at the

According to Hazlett, "The proper regulatory instrument is price, ensuring that entrants pay the opportunity cost of the resources consumed. This rule may be instituted without controlling entry via cable franchises. Imposing liability on operators for damage they inflict and for additional investments required to maintain ROWs forces incumbents and entrants to internalize the costs they impose."[29] Hazlett goes on to cite newspaper publishers as companies that use public streets for deliveries and public sidewalks for vending machines yet "are regulated with generic laws that limit inconvenience or disruption in the community, no franchise needed."[30]

Economists have repeatedly estimated the consumer benefits of ending local cable franchises.[31] Many of these past studies, while suggestive, were compromised by small sample sizes or reliance on FCC data now known to be inaccurate.[32]

> The net annual social benefits of competition in cable markets nationwide would total $2.9 billion (consumer surplus of $8.9 billion minus producer losses of $6 billion).

An econometric model originally published by the General Accounting Office in 2003[33] and then updated by the re-named Government Accountability Office in 2005[34] provides a credible estimate of the effect on consumer prices of competition in cable markets. The GAO authors created a large data sample (705 cable franchises), corrected errors in FCC's database, specified a three-stage least squares model with 22 variables, and concluded that basic service cable fees "were approximately 16 percent lower in areas where a second cable company – known as an overbuilder – provides service."[35]

Assuming an elasticity of demand of 1.5 and if new entrants capture 25 percent of the marketplace, GAO's estimate would mean the net annual social benefits of competition in cable markets nationwide would total $2.9 billion (consumer surplus of $8.9 billion minus producer

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opening of this section to a 1973 *New York Times* article by Albin Krebs.

[29] Ibid.

[30] Ibid.

[31] A dozen empirical studies are surveyed in Jerry Ellig and Jerry Brito, supra note 26, pp. 6-9.

[32] See General Accounting Office, "Issues Related to Competition and Subscriber Rates in the Cable Television Industry," GAO-04-8, October 2003, Highlights: "FCC's cable rate report does not appear to provide a reliable source of information on the cost factors underlying cable rate increases or on the effects of competition."

[33] Ibid. The model appears in Appendix 4.

[34] Government Accountability Office, "Telecommunications: Direct Broadcast Satellite Subscription Has Grown Rapidly, But Varies Across Different Types of Markets," GAO-05-257, April 2005, Appendix 3.

[35] Ibid., p. 33.

losses of $6 billion).[36] Hazlett, who generated this estimate in 2006, says there is "a very large opportunity to improve consumer welfare" by repealing local video franchises, though he cautions that "in reality, eliminating municipal franchise barriers would not produce an instant nationwide build-out by entrants. Nor would a lack of reform necessarily block all competitive entry by wireline video providers."[37]

**State Reforms**

State reform efforts should focus on video franchise reform and comprehensive tax reform. On the first, states can replace, reform, or eliminate video franchise laws, following the example of such states as Texas, which in August 2005 was the first state to pass legislation creating statewide franchising. Since then, nine more states (Arizona, California, Indiana, Kansas, Michigan, New Jersey, North Carolina, South Carolina, and Virginia) have passed similar legislation. Arizona and Virginia streamlined and codified the rules of local franchising, but stopped short of authorizing statewide authority. The legislature in an eleventh state, Louisiana, passed video franchise reform legislation that was vetoed by the governor.[38]

The American Legislative Exchange Council (ALEC) has written model legislation for states interested in pursuing video franchise reform, though that model has been criticized for not going far enough in allowing incumbent cable companies to exit franchises when competitors enter their markets.

> Both the American Legislative Exchange Council (ALEC) and the National Conference of State Legislatures (NCSL) have adopted resolutions calling for more uniform and less complicated taxes on communication services.

On state tax reform, policymakers will also find good models in states that have taken the lead in making their communication taxes and fees lower, simpler, and more uniform. Virginia and Ohio adopted legislation that streamlined and lowered communication taxes and fees, while Florida passed laws that streamlined but did not lower taxes and fees.

In Virginia, local governments can no longer impose their own taxes on communication services. Instead, all communication services are subject to the same 5 percent sales tax rate that is imposed on other goods and services. Fees for 911 service were equalized between landline and wireless services at $0.50/month. Companies using public rights-of-way pay a single charge of 0.5 percent, intended to represent the actual cost of using the right-of-way and not simply a tax disguised as a fee. Companies make just one payment to the state, which then distributes money back to the local jurisdictions.

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[36] Thomas Hazlett, "Cable TV Franchises as Barriers to Video Competition," George Mason University Law and Economics Research Paper Series, March 2006, pp. 63-66. www.heartland.org/pdf/19021.pdf.

[37] Ibid., p. 66.

[38] Steven Titch, "Cable Franchise Reform Spreads," *Budget & Tax News*, March 2007, pp. 1, 4.

Both ALEC and the National Conference of State Legislatures (NCSL) have adopted resolutions calling for more uniform and less complicated taxes on communication services. According to Neal Osten, federal affairs counsel for communication and interstate commerce with NCSL:

> The taxes of all providers of services should be the same; no provider should be tax-free or taxed higher than others. Eventually, all taxes should be no higher than general business taxes. Collection and administration of the taxes should be simple, too, similar to what most states are doing with sales taxes right now.[39]

Local governments often oppose state communication tax and fee reforms because they fear a loss of revenue. However, a coalition of local governments that criticized the 2004 COST study on telecommunication taxes and fees, which included the National League of Cities, U.S. Conference of Mayors, and National Association of Counties, nevertheless agreed that reform of telecommunication taxes and fees is necessary:

> Recognizing the convergence among different types of telecommunications services, local governments generally favor the imposition of taxes on a nondiscriminatory basis, regardless of the technologies used, on competing communications service providers that offer functionally equivalent services. They also favor reforms that will create a level playing field for competition among existing and new service providers. Further, they favor simplifying the administration of state and local taxes on communications services to encourage continued investments and innovations.[40]

One estimate puts the potential increase in local franchise fee receipts nationwide at between $249 million and $413 million per year.

Most opposition to video franchise reform comes from local government officials who fear losing the capital grants and nonprice concessions that cable incumbents now pay and fee-based revenue due to falling prices. But econometric models show that while video franchise reform would cause prices to fall, the number of customers and the quantity of communication services they purchase would rise faster, resulting in higher total receipts for the industry and consequently greater tax revenues for local governments. One estimate puts the potential increase in local franchise fee receipts nationwide at between $249 million and $413 million per year.[41] This suggests there is room for state tax policy reforms that can win the acceptance of local officials.

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[39] Quoted in Mary Lou Jay, "Taking Their Toll: Is Excessive Taxation Penalizing Wireless Consumers for Embracing Technology?" *Wireless News*, CTIA, n.d.

[40] *Local Government Perspective on Telecommunications Taxes: A Response to Industry's 2004 COST Study*, Summer 2006, http://www.gfoa.org/documents/TelecomTaxBriefing_FullReport.pdf.

[41] Robert W. Crandall and Robert Litan, "The Benefits of New Wireline Video Competition for Consumers and Local Government Finances," Criterion Economics, LLC, n.d.

**National Reforms**

National preemption of state and local tax and regulatory authority in this arena is justified for several reasons. First, communication services have clearly become a national and global form of commerce in the past decade, resulting in consumers and businesses outside the borders of particular cities and states being affected negatively by those states' and municipalities' tax and regulatory decisions. This is the basis for the FCC's assertion of jurisdiction over broadband services, VoIP, and cable video franchises. Second, there is precedent for preemption in the history of railroads in the U.S., when Congress passed the Railroad Revitalization and Regulatory Reform Act of 1976 preempting state and local governments from imposing discriminatory taxes on railroads.

The Federal Trade Commission recognizes that the optimal scale for a cable operator often exceeds the borders of a typical municipality, making state or national regulation more economically efficient than local regulation.[42] The FCC announced in March 2007 new rules limiting municipal franchising authority, including the creation of a "shot clock" requiring municipalities to act on applications for franchises within a set amount of time.[43] Legislation would be needed for the FCC to actually forbid or replace local franchising authority. Bills to do so have been introduced in Congress.

National legislation could prohibit discriminatory sales, use, or business taxes on communication services. Such a prohibition could extend to all three levels of government and "discriminatory" taxes would be defined as those that apply only to communication services or are imposed at rates higher than those paid by most other businesses. Exempted from the ban would be 911 fees, relay service fees, and other fees actually used to fund services to communication consumers that are specifically enumerated in the legislation.

State and local government could be given a reasonable period of time, but probably no more than three years, to phase out discriminatory taxes.

State and local government could be given a reasonable period of time, but probably no more than three years, to phase out discriminatory taxes. After that period, U.S. district courts would be authorized to invalidate taxes or fees they determine are discriminatory. With many states enjoying record growth in tax receipts,[44] this could be a good time to require that they update one part of their tax codes.

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[42] FTC, "Sports Programming & Cable Distribution: The Comcast/Time Warner/Adelphia Transaction," Report to the Senate Committee on Judiciary, December 7, 2006, p. 4.

[43] FCC, "In re Implementation of Section 621(a)(1) of the Cable Communications Policy Act of 1984, as amended," FCC no. 06-180, March 5, 2007.

[44] Lois Romano, "Most States Have Budget Surpluses, Some Find Creative Uses for Cash," *Washington Post,* August 19, 2006, p. A04.

**Universal Service Fund Reform**

With proper review, the revenue demands of the Federal Universal Service Fund (USF), as well as state USF funds, could be substantially reduced yet accomplish much more. The FCC should take back authority for universal service and reform both the pay-in mechanisms to reflect the larger base of communication companies now providing service, perhaps by moving to a per-number charge, and the dispersal mechanisms so they encourage the deployment of economical and innovative alternatives.

Vince Vasquez, a policy analyst for the Pacific Research Institute, writes:

> By eliminating USF taxes and subsidies, lawmakers can facilitate new growth and investment in underserved communities without manipulating markets and dissuading industry innovation. Consumers will be exempt from rising phone bill fees, and free from funding dubious service providers fattening from the trough of public funds. Responsible companies will have more capital to finance new technologies, and could work cooperatively, rather than compulsively, with policy regulators to achieve public goals in quality service and affordable calling rates.[45]

> The FCC should take back authority for universal service and reform both the pay-in mechanisms and the dispersal mechanisms.

Vasquez proposes a "seven-point road map" to reform the USF that includes changing the legal definition of universal service to a detailed and reasonable public goal, replacing the current board of directors with professional administrators without financial conflicts of interest, having the FCC inspector general conduct thorough audits and investigations, and replacing corporate subsidies with consumer vouchers. The Mercatus Center also has proposed a series of USF reforms focusing on performance measures for the fund.[46]

## 10. Conclusion

This study has presented original research on taxes and fees on communication services in 59 cities in the U.S. The methodology used was extremely conservative. It included only taxes and fees known to be passed through, dollar for dollar, to consumers and not justifiable as payment for, say, expenses incurred during the use of public rights-of-way. Removed from the tally were the 3 percent national excise tax on phone calls, which was expiring as our research was underway, as well as capital grants and nonprice concessions paid by cable companies, even though other researchers have found them to be considerable. Also excluded was the cost of radio frequency leases incurred by wireless phone service providers.

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[45] Vince Vasquez, "Digital Welfare: The Failure of the Universal Service System," Pacific Research Institute, February 2006, p. 21.

[46] Maurice McTigue and Jerry Ellig, "Performance Measures for FCC Universal Service Programs," Mercatus Center, October 17, 2005, RSP 2005-07.

Taxes and fees imposed on the consumers of cable television and telephone services in the U.S. were found to be twice as high as general sales taxes on other goods – 13.52 percent versus 6.61 percent. Communication taxes and fees vary significantly from city to city: Consumers in the city with the highest taxes (Jacksonville, Florida) pay $23.34 a month more – $280 a year – than consumers in Lansing, Michigan, the city with the lowest taxes.

Communication taxes and fees also vary based on the type of communication service (television, telephone, and Internet access) as well as by the type of technology used to deliver otherwise-identical services. Taxes and fees on a phone call placed with a wireline phone are 24 times higher than the taxes and fees on a call placed using VoIP, while cable subscribers pay twice the taxes and fees on a video product as they are likely to pay for similar products delivered by telephone companies using IPTV technology.

High and discriminatory taxes and fees ought to be cut, simplified, and made uniform across different technology platforms.

Besides the direct burden of $37 billion a year in taxes and fees on communication services, consumers also suffer needless social welfare losses, estimated to be more than $11 billion each year, due to reduced consumption and investment.

Policymakers ought to act quickly to bring public policy up-to-date with the latest changes in the communication arena. High and discriminatory taxes and fees ought to be cut, simplified, and made uniform across different technology platforms. Some states have already taken the lead in enacting needed reforms; other states should follow. Similarly, the national government should step up its efforts to forbid state and local governments from imposing discriminatory taxes and fees on communication services and enforcing regulatory barriers to competition.

# Appendix 1: Methodology

The project goal was to obtain all of the information regarding local, state, and national taxes and fees imposed on consumers of cable, wireline, and wireless services. The original dataset consisted of 100 cities – the largest city, measured by population, and capital city in each of the 50 states. Researchers at the Beacon Hill Institute at Suffolk University in Boston were ultimately able to compile complete data on 59 cities. The finished product, besides this report, is a series of tables available online at www.heartland.org and www.beaconhill.org that displays the taxes and fees imposed on services in dollars per month and percent of the monthly bill for an average customer.

## Cable Video Services

BHI identified franchise fees, public, educational, or governmental (PEG) access fees, and initial capital grants as the three most prominent taxes and fees imposed on cable companies offering video service. It obtained these fees and taxes (the dollar amount paid by the cable franchise) by reviewing franchise agreements and contacting local officials. Documentation for all sources is available at BHI. Video services provided by wireline and wireless companies are too new for reliable data to be available, so no tax data pertaining to these services were collected or reported.

### *1. Franchise Fee*

Cable franchise fees are paid by the cable company to the local government in exchange for the use of public rights-of-way (ROWs). Because of the way these fees are calculated and collected, it is clear they are not based on actual costs incurred by local governments, but rather determined by how much municipalities believe they can charge. The franchise fee is typically 5 percent of the gross revenue from providing cable services.

### *2. PEG Access Fees*

FCC regulation allows local franchising authorities to require cable operators to set aside noncommercial channels for public, educational, or governmental (PEG) access. Cable companies may retrieve the cost of providing PEG channels from their subscribers in the form of monthly access fees.

Since it is up to the municipality to determine whether it wants to retrieve access fees from the cable providers, not all cities in our dataset contain a value for this fee. Generally, when access fees are applicable they are included in the franchise agreements as either a per-subscriber or monthly fee.

### *3. FCC User Fee*

Cable regulatory/user fees are determined by the FCC and are imposed on all cable television

systems. The FCC figure of $0.72 per subscriber for fiscal year 2005 was used for all cities. The $0.72 figure is divided by 12 months to attain the monthly value of $0.06 tax per subscriber.[47]

4. *Cable Television Relay Service (CARS) License*

The FCC charge of $155 for the Cable Television Relay Service (CARS) license is too small to break out by subscriber, and thus the fee is not included in the tables.

5. *Initial Capital Grants and other Nonprice Concessions*

Local franchising authorities may also require a one-time contribution, or initial capital grant, from cable operating systems. Capital grants may be used for a number of purposes, such as purchase of equipment needed to supply PEG access, refurbishing and upgrading video equipment, etc. Cable system providers also are often obligated to provide, free of charge, the initial connection and basic monthly service to municipal buildings, including public schools, libraries, and other public buildings.

As indicated in the text, these requirements can be very expensive, with one estimate from 1989 putting the cost at 26 percent of the cost of building cable networks and 11 percent of operating expenses. However, as indicated on pages 6-7, we decided not to include these costs in our calculation of taxes and fees on cable companies. Why?

It is an economic axiom that cost does not determine price, that businesses set their prices based on what consumers are willing to pay, and that their profit is the difference between that price and the firm's marginal costs. An increase in costs – particularly "sunk costs," defined as spending that does not vary with profitability or the number of customers – may reduce profits but not prices, or lead a business to reduce output and keep profits and prices the same. In either case, the increase in cost will not cause an exactly equal change in prices. Hence, knowing the cost of capital grants and other nonprice concessions made by a cable company does not enable us to say whether or by how much the price of cable TV increased.

Consumers certainly do pay for these costs, partly through lower consumption due to less investment, partly through higher prices due to less competition (estimated by GAO to be about 16 percent), and partly through other trade-offs. When Ellig et al. estimate the deadweight loss due to cable taxes and fees at $2.6 billion a year, they are capturing these effects. But it would be incorrect to simply add up these costs (some of them one-time expenses for long-lived assets, some of them repeating every year) and treat them no differently than the taxes and fees that are paid on a per-subscriber or percent of income basis.

We re-visit this issue in the discussion, below, of the radio frequency licenses paid by wireless services. Consistency, as well as good methodology, compels us to exclude those costs as well.

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[47] Federal Communications Commission, "Regulatory Fees Fact Sheet: What You Owe – Cable Television Systems for FY 2005," Washington, DC, July 2005.

6. *Letters of Credit and Performance Bonds*

In addition to capital grants, local governments may require cable providers to supply them with a letter of credit and/or a performance bond. These securities are established to ensure the faithful performance of the provisions of the franchise agreement. They are typically effective throughout the length of the agreement. Letters of credit and performance bonds are not included in the estimates of taxes and fees per subscriber because the letters and bonds are retrievable when the cable provider has satisfied all of its obligations to the municipality.

## Wireline Telephone Services

Taxes and fees paid by wireline telephone and cable companies to state and local governments came from the 2004 Council on State Taxation (COST) study,[48] and then verified and updated by BHI staff by contacting state and local officials. The COST report identified taxes and fees that are unique to the communication industry.

The COST study was criticized in 2006 by a coalition of local government associations[49] for combining user fees with taxes, not including corporate income taxes, and not taking into account accounting practices by some communication companies allegedly used to avoid paying local property taxes. We have considered these criticisms.

It is appropriate to include franchise fees that are charged as a percent of gross receipts because they clearly are not based on any real costs imposed on cities by the use of public rights-of-way, and they are passed through to consumers just as general sales taxes are. Like COST, we have removed genuine user fees and nonprice concessions. We agree with the critics, however, that it is incorrect to refer to fees as "transaction taxes," and we do not dispute that such fees are legal.

Like the COST study, our analysis does not include corporate income taxes. Available data sources would not have allowed us to attribute specific amounts to consumers in specific cities, and so many variables influence corporate income tax collections on a year-to-year basis that selecting any one year would not have produced generalizable results.

COST's critics point out that companies with costly physical assets generally pay less in corporate income taxes than companies with fewer assets because they are able to deduct depreciation expenses from their taxable earnings. But the rationale for the deduction is sound – buying assets is a legitimate business expense and should thereby be tax deductible – and all that depreciation does is defer the tax break that would otherwise be allowed. The critics either believe depreciation is an unjustified tax break, which isn't true, or perhaps that the corporate income taxes paid by communication companies are less than those paid by companies in other industries that are similarly asset-heavy, which has not been proven.

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[48] Telecommunications Tax Task Force of the Council on State Taxation, "2004 State Study and Report on Telecommunications Taxation," Washington DC, March 2005.

[49] "Local Government Perspective on Telecommunications Taxes: A Response to Industry's 2004 COST Study," Summer 2006, http://www.gfoa.org/documents/TelecomTaxBriefing_FullReport.pdf.

Our analysis does not include property taxes for similar reasons. Anecdotes about how some communication companies avoid paying local property taxes are not relevant to our analysis.

All national, state, and local taxes that are applicable to wireline voice services were applied as well to cable voice services provided over the PSTN via leased telephone lines. However, when cable companies provide telephone service with VoIP, the taxes on VoIP, to the extent they exist in only eight states, apply. This is one of the best examples of how government applies different tax formulas to the same service – even from the same company – when different technology platforms are used.

That many of these taxes and fees apply to cable provision of voice services when VoIP is not used to carry the signal was confirmed through conversations with several state and local officials (Maine, North Dakota, Kansas City) and customer service representatives of cable companies. Some cable representatives and local officials produced conflicting information, and in the absence of definitive answers, we assumed the same taxes and fees apply to cable and wireline voice services. The treatment of national taxes and fees is described below.

1. *National Excise Tax*

The IRS has agreed to stop collecting the national telephone excise tax of 3 percent, enacted in 1898 to fund the Spanish American War, levied on long-distance telephone calls. The repeal was in effect as of July 31, 2006. The IRS will issue refunds of tax collected on long-distance service for the past three years. Congressman Gary Miller introduced HR 1898, which proposes to abolish the national excise tax on all telephone services.[50] We have not included the tax in our estimates.

2. *Federal Universal Service Fund*

The Federal Universal Service Fund was established to provide subsidies for affordable communication services in low-income and rural areas. All providers of communication services, including but not limited to cellular telephone and paging, and private line services, are required to contribute to the Federal Universal Service Fund. A 1.00 percent tax rate, based on the COST report, was applied to all cable and wireline voice services.

3. *911 Tax*

Many states impose a 911 tax on voice providers to help fund the cost of providing this emergency service. Typically, revenue generated from the tax is used to offset maintenance, system upgrades, and the salaries of dispatchers paid by the state, county, and/or city in order to supply a 911 emergency service. State governments may also permit county and/or local governments to levy a 911 tax on cable/wireline voice providers.

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[50] Congressman Gary Miller, "IRS Abolishes Federal Long Distance Tax," http://www.house.gov/garymiller/PhoneTax.html.

In some cases, local officials provided estimates of taxes and fees per subscriber for a state and/or city 911 tax. Otherwise the rates reported in the COST study were used to compute the monthly charge.

## Wireless Telephone Services

The 2004 study of state and local taxes and fees imposed on the wireless communication industry by Scott R. Mackey provided state and local taxes and fees on wireless services.[51] The estimate of the monthly bill ($49.98) is the Average Revenue per Unit (ARPU) in 2005, as calculated by CTIA and reported by the FCC.[52]

The major taxes and fees that apply to wireless telephone services include the Federal Universal Service Fund (2.48 percent) and state and local 911 fees described above. The 3 percent national excise tax on wireless phone customers ended in 2006 so we removed it from our calculations, even though many consumers in 2005 would have paid the tax.

We have chosen not to treat the cost of radio frequency licenses as a "fee" paid by wireless services for the same reasons given earlier in this appendix for excluding capital grants and other nonprice concessions paid by cable companies: Costs, particularly sunk costs, do not determine price. Evan Kwerel, an economist with the Federal Communications Commission, concurs:

> Standard economic theory predicts that *sunk* costs are irrelevant to the pricing and output decisions of firms. A sunk cost is one that is not escapable. It does not vary with output or even if the firm goes out of business, and thus should have no effect on any business decision. The amount paid for a spectrum license in an auction is such a sunk cost. Once it is paid, the payment cannot be recovered from the government and it does not vary with output. Therefore, the historical cost of winning bids at auctions should have no effect on the price or availability of spectrum-based communications services for customers.[53]

Auctioning radio frequency licenses restricts supply and consequently raises consumer prices,[54] but this does not mean the cost of licenses is passed along to consumers in a dollar-for-dollar fashion as are the taxes and fees reported in this study. Regulations, by limiting competition and

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[51] Scott Mackey, "The Excessive State and Local Tax Burden On Wireless Telecommunications Service," *State Tax Notes* (July 2004): 181-194.

[52] FCC, "Annual Report and Analysis of Competitive Market Conditions With Respect to Commercial Mobile Services," 11th Report, September 29, 2006, p. 69 and Table 10 on p. 106.

[53] Evan Kwerel, *Spectrum Auctions Do Not Raise the Price of Wireless Services: Theory and Evidence*, FCC, 2000. http://wireless.fcc.gov/auctions/data/papersAndStudies/SpectrumAuctionsDoNotRaisePrices.pdf.

[54] Auctioning off 200 MHz of currently unused or little-used radio spectrum would cause the per-minute price of wireless service to fall by 50 percent. See Thomas W. Hazlett et al., *Sending the Right Signals: Promoting Competition Through Telecommunications Reform*, U.S. Chamber of Commerce, September 22, 2004, pp. 68-69.

depressing consumption, impose large costs on cable and wireline phone customers as well as wireless customers. While other researchers have documented these effects, we have focused on what most people, including policymakers, would recognize as taxes and fees.

### Broadband Internet Access Services

The Internet Tax Freedom Act of 1998 – renewed in 2004 – prohibits state and local governments from imposing new taxes on the Internet through 2007.[55] Taxes prohibited by the bill include all taxes on Internet access services provided to end users, including sales and excise taxes. However, the bill allows state Internet taxes that were "imposed and actually enforced prior to October 1, 1998," granted that the provider of Internet services "had a reasonable opportunity to know ... that such agency has interpreted and applied such tax to Internet access services." Of the eight states allowed to grandfather their Internet taxes, cities in six – Alabama, New Mexico, North Dakota, South Carolina, Washington, and Wisconsin – were included in our study.

Our conversations with state and local officials in other states confirmed they do not currently tax Internet access or that a tax is imposed only if the access is provided through fixed telephone lines and the Internet access service cannot be distinguished from telephone services.

### Number of Subscribers

Most public authorities were not able to provide the number of subscribers to each communication service for their city, and referred BHI to service providers who were also not forthcoming. However, the Federal Communications Commission (FCC) publishes data estimating the number of high-speed Internet access and wireless subscribers in each state. The FCC breaks out the Internet access data by medium of access including cable, wireless, satellite, and telephone. The FCC also produces telephone subscriber penetration rates for each state. The National Cable Television Association provides estimates of the total number of basic cable and residential cable telephone subscribers in the United States. These estimates were used to impute values for the number of subscribers for each city.

The U.S. Census Bureau estimates for population of the United States, the states, and each city in 2005 were used to distribute the FCC and NCTA national and state subscriber figures to each city. First, we calculated the ratio of the population of each state to the total U.S. population and the ratio of the population to each city to total state population. Next, we applied these ratios for each city to the FCC estimates of the number of subscribers in each state.

For example, the population ratio of Sacramento to California is 1.26 percent (454,330 / 35,842,038 = 1.26 percent). The FCC estimates that California had 3,263,324 high-speed Internet data lines in 2005, and therefore we estimate Sacramento to have 41,118 DSL subscribers (3,263,324 x 1.26 percent = 41,118). A similar process was applied to all cities using the FCC estimates for DSL, cable broadband, and wireless voice and broadband subscribers.

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[55] The Internet Tax Freedom Act, Public Law 108-435 (2003).

The FCC estimates the percentage of households with a wireline telephone for each state. We applied this percentage rate for the respective state to the population estimates for each city. The FCC estimates that 95.4 percent of households in California have a wireline telephone, and we thus estimate Sacramento, for example, has 147,929 wireline telephone subscribers.

A similar approach was used to impute the NCTA estimate of total cable video subscribers in the United States to the cities. First the ratio of the population for each state was used to distribute the estimate of national cable subscribers to each state. Then the ratio of the city population to the state population was used to distribute our estimate of the number of cable subscribers in each state to the respective cities.

Using Sacramento as an example, the ratio of California's population to the U.S. population is 12.2 percent (36,132,147 / 296,410,404 = 12.2 percent) and applying this ratio to the total number of cable subscribers in the United States reported by NCTA provides an estimate of 7,984,388 cable subscribers in California (65,500,000 x 12.2 percent = 7,984,388). We applied the ratio of Sacramento population to California population, 1.26 percent, to estimate the total number of cable subscribers in Sacramento, 100,397 (7,984,388 x 1.257 percent = 100,397). We computed the number of subscribers that get their telephone service through cable using the same method.

## Average Monthly Bill

Data on prices and monthly bills came from FCC's 2006 *Annual Report and Analysis of Competitive Market Conditions With Respect to Commercial Mobile Services*, 2005 *Report on Cable Industry Prices*, and 2003 *Long Distance Telecommunications Industry Report*. Full citations with links appear in footnote 4 on page 4. The latest estimates for the average bills for wireline phone service available from the FCC were for the year 2002. We used the average compound growth rate for bills reported for the years 1995 through 2002 to raise the 2002 figures to an estimated 2005 level.

The total average monthly bill was estimated to be $188.17, with $52.36 for video service through cable, $49.33 for telephone service through wireline, $49.98 for telephone service through wireless, and $36.50 for Internet. The bill for Internet service was calculated by taking the weighted average price of the two types of Internet service: cable, which has an average bill of $41.00, and fixed line, which has an average bill of $32.00.

The average bill was applied to all cities. For example, if the local cable franchise fee was reported as 5 percent of gross receipts and we were not able to obtain an annual revenue figure, we multiplied the 5 percent by the national average cable bill of $52.36 to obtain the tax per subscriber. Consequently, similar tax rates result in similar tax bills across several cities, even though consumers in some cities (generally where higher-income families reside) clearly have higher average monthly bills than others.

## Method of Calculation

The computations of the effective tax rate, tax per subscriber, and annual tax revenue for each

service (video, voice, and Internet access) and tax depended on the data source and level of detail. The calculation method described below was employed for all three means of service delivery: cable, wireline, and wireless.

*1. Annual Tax Revenue*

If the amount of annual tax revenue is available, BHI divided this figure by the number of subscribers and divided this result by 12 to obtain the estimate of the monthly tax paid per subscriber. For example, the franchise fee for Montgomery, AL was computed: ($1.3 million reported annual tax revenue / 44,413 subscribers)/12 months = $2.43 monthly tax per subscriber. We calculate the effective tax rate by dividing the average bill by the tax per subscriber (Montgomery, AL: $2.43 tax per subscriber / $52.36 average cable bill = 4.6 percent).

*2. Tax Rate*

If the percentage tax rate is available, BHI multiplied the average bill by the percentage rate to obtain the monthly tax per subscriber. For example, the franchise fee for Sacramento, CA was computed: $52.36 x 5 percent = $2.62 tax per subscriber. The annual tax revenue was calculated by multiplying the tax per subscriber figure by the number of subscribers and 12 months (Sacramento, CA: $2.62 x 100,397 x 12 = $3.16 million).

The percentage rate for some taxes (franchise fees in particular) applies to the firm's gross revenues, while others apply to the customer's bill. In the absence of any figure for gross revenues, we computed the annual revenue by using the average monthly bill as a proxy, multiplying the monthly bill by the tax rate and multiplying the result by the number of subscribers.

*3. Tax per Subscriber*

If the monthly dollar amount paid per subscriber is available then BHI used it directly in the tax per subscriber column. The calculations for the effective tax rate and the annual tax revenue remain the same as in the previous two paragraphs.

*4. Data Discrepancies*

In some instances, BHI collected data from different sources that provided conflicting results. In these cases, we used the revenue calculation that, in our opinion, provided the most reasonable result.

The COST and Mackey studies report the tax rate or flat dollar amount as either a single rate (e.g., $0.50), a range (e.g., 5 percent to 10 percent), or broken out by city (5 percent for City A, 10 percent for City B). In the case of a flat rate or amount, BHI applied the reported figure to both the capital and largest city. In the case of a range, we apply the midpoint of the range (7.5 percent) to both cities to calculate the other values. If COST or Mackey report values that were

broken out for each city, then these are applied to the respective cities.

In some cases there exist discrepancies between the values reported by COST and Mackey for the same tax and city. We use the values reported by COST for taxes and fees that apply to wireline telephone services and those reported by Mackey for taxes and fees that apply to wireless services.

## Appendix 2: National Average General Sales Tax

The Tax Foundation was asked to calculate the national average general sales tax in the U.S., to provide a figure against which the tax on communication services could be compared. Using its own database of state, county, and local sales taxes, it compiled total state sales tax rates, determined the percentage of national personal income affected by each state's taxes, and calculated a weighted average tax rate. The conclusion: The national average combined sales tax rate is 6.61 percent. Figure 14 presents the data used for this estimate.

**Figure 14**
**Determination of a National Average Sales Tax Rate**
**Weighted by Personal Income**

| State | Sales Tax Rate (%) | Personal Income ($) | % of Personal Income | Weighted Rate (%) |
|---|---|---|---|---|
| Alabama | 6.6689 | 144,063,125 | 0.0133 | 0.0886 |
| Alaska | 3.1366 | 25,030,875 | 0.0023 | 0.0072 |
| Arizona | 7.7518 | 194,080,375 | 0.0179 | 0.1388 |
| Arkansas | 7.5130 | 78,875,750 | 0.0073 | 0.0547 |
| California | 7.7517 | 1,416,227,500 | 0.1307 | 1.0129 |
| Colorado | 4.5072 | 184,417,250 | 0.0170 | 0.0767 |
| Connecticut | 6.0000 | 175,115,375 | 0.0162 | 0.0969 |
| Delaware | 0.0000 | 33,205,625 | 0.0031 | 0.0000 |
| Florida | 6.4462 | 651,143,250 | 0.0601 | 0.3873 |
| Georgia | 5.1027 | 299,965,875 | 0.0277 | 0.1412 |
| Hawaii | 4.0000 | 46,547,375 | 0.0043 | 0.0172 |
| Idaho | 6.0000 | 43,940,125 | 0.0041 | 0.0243 |
| Illinois | 7.5460 | 492,548,875 | 0.0454 | 0.3429 |
| Indiana | 6.0000 | 205,783,750 | 0.0190 | 0.1139 |
| Iowa | 6.0689 | 100,246,125 | 0.0092 | 0.0561 |
| Kansas | 6.8164 | 96,268,000 | 0.0089 | 0.0605 |
| Kentucky | 6.0000 | 124,049,875 | 0.0114 | 0.0687 |
| Louisiana | 8.3198 | 133,489,875 | 0.0123 | 0.1025 |

| State | Sales Tax Rate (%) | Personal Income ($) | % of Personal Income | Weighted Rate (%) |
|---|---|---|---|---|
| Maine | 5.0000 | 42,998,750 | 0.0040 | 0.0198 |
| Maryland | 5.0000 | 248,619,750 | 0.0229 | 0.1147 |
| Massachusetts | 5.0000 | 295,732,750 | 0.0273 | 0.1364 |
| Michigan | 6.0000 | 343,050,500 | 0.0317 | 0.1899 |
| Minnesota | 6.7320 | 200,716,750 | 0.0185 | 0.1247 |
| Mississippi | 7.0000 | 77,398,125 | 0.0071 | 0.0500 |
| Missouri | 6.0208 | 192,141,375 | 0.0177 | 0.1067 |
| Montana | 0.0000 | 28,711,000 | 0.0026 | 0.0000 |
| Nebraska | 6.3549 | 61,236,875 | 0.0057 | 0.0359 |
| Nevada | 9.4254 | 93,012,750 | 0.0086 | 0.0809 |
| New Hampshire | 0.0000 | 51,999,625 | 0.0048 | 0.0000 |
| New Jersey | 6.0000 | 406,538,750 | 0.0375 | 0.2251 |
| New Mexico | 6.3934 | 57,982,750 | 0.0054 | 0.0342 |
| New York | 8.2372 | 817,206,750 | 0.0754 | 0.6211 |
| North Carolina | 7.0628 | 284,344,625 | 0.0262 | 0.1853 |
| North Dakota | 5.6531 | 20,817,500 | 0.0019 | 0.0109 |
| Ohio | 6.7479 | 382,978,250 | 0.0353 | 0.2384 |
| Oklahoma | 6.8842 | 115,105,125 | 0.0106 | 0.0731 |
| Oregon | 0.0000 | 124,045,125 | 0.0114 | 0.0000 |
| Pennsylvania | 6.1194 | 455,575,250 | 0.0420 | 0.2572 |
| Rhode Island | 7.0000 | 39,945,500 | 0.0037 | 0.0258 |
| South Carolina | 5.4849 | 127,639,000 | 0.0118 | 0.0646 |
| South Dakota | 4.8003 | 26,725,250 | 0.0025 | 0.0118 |
| Tennessee | 9.3500 | 195,626,500 | 0.0181 | 0.1688 |
| Texas | 7.0989 | 805,403,500 | 0.0743 | 0.5275 |
| Utah | 6.3051 | 73,719,500 | 0.0068 | 0.0429 |
| Vermont | 6.0000 | 21,245,750 | 0.0020 | 0.0118 |
| Virginia | 5.0000 | 300,256,000 | 0.0277 | 0.1385 |
| Washington | 8.4899 | 238,152,000 | 0.0220 | 0.1866 |
| West Virginia | 6.0000 | 50,003,750 | 0.0046 | 0.0277 |
| Wisconsin | 5.3755 | 193,449,750 | 0.0178 | 0.0959 |
| Wyoming | 5.2957 | 20,879,250 | 0.0019 | 0.0102 |
| **Sum (weighted average):** | | | | **6.6070** |

Source: Tax Foundation, original research provided to the authors on February 15, 2007.

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**David G. Tuerck** serves as professor and chairman of the Department of Economics at Suffolk University in Boston, Massachusetts. Dr. Tuerck holds a doctorate in economics from the University of Virginia. His dissertation director was James M. Buchanan, Nobel Laureate in Economics.

Dr. Tuerck founded and serves as executive director of the Beacon Hill Institute (BHI), a nonprofit research and education organization affiliated with Suffolk University. He is the principal coauthor of scores of reports in recent years on the economic impact of state tax changes, prescription drug importation, and tort reform, and studies of the economics of municipal broadband initiatives.

Prior to joining Suffolk University in 1982, he was a director in the Economic Analysis Group at Coopers & Lybrand, Washington, DC. Prior to that, he served as director of the Center for Research and Advertising at the American Enterprise Institute.

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**Steven Titch** is recognized internationally as one of today's top communication journalists and analysts. Titch became a Heartland Institute senior fellow in April 2004. He is also managing editor of *IT&T News*, Heartland's monthly publication for state legislators and policymakers on communication and information technology issues.

Titch previously was editorial director of *Telephony* magazine and its international spin-off, *Global Telephony*. Titch planned and executed *Telephony's* mid-90's turnaround and its 1996 redesign and relaunch. He also was founding editor of *Global Telephony*. While at *Telephony*, Titch authored several major investigative articles about the industry, including "Blind Faith" (September 1997) on the troubled commercial introduction of CDMA wireless technology worldwide. The article was a runner-up in its publication revenue group for a Jesse H. Neal Award for best business-to-business magazine article of the year.

Titch's experience as a communication industry journalist goes back to 1980, when he started his career as associate editor-telecommunications at *Electronic News*. He was founding editor of

*Cellular Business* (now *Wireless Review*), which in 1984 was the first business-to-business publication serving the nascent wireless industry, and Midwest Bureau Chief for *Communications Week* (now *Internet Week*).

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*Senior Fellow, The Heartland Institute*

**John Rutledge**, a senior fellow with The Heartland Institute, is chairman of Rutledge Capital and president of Mundell International University of Entrepreneurship in Beijing. He is also a board member of the Progress and Freedom Foundation and a senior fellow at the Pacific Research Institute.

Dr. Rutledge appears weekly on "Forbes on Fox" and on CNBC's "Kudlow and Company." He wrote the Business Strategy column for *Forbes* for more than a decade and now writes for Forbes.com, TheStreet.com, and *China Daily*. He also authors the Rutledge Blog on economic and technology issues at www.rutledgeblog.com.

Dr. Rutledge is one of the principal authors of the U.S. Chamber of Commerce study on telecommunications reform and has written two books and hundreds of articles for *The Wall Street Journal*, the *American Spectator, Barron's, Forbes, Fortune, National Review, Financial Times, U.S. News and World Report, Business Week*, and other publications. He has testified before congressional committees on tax, telecom, and technology issues and has advised government officials in the U.S., U.K., Ireland, and Kuwait.

Dr. Rutledge served on the faculties of Tulane University and Claremont McKenna College, where he taught monetary economics, international finance, and econometrics. In 1978, Dr. Rutledge founded the Claremont Economics Institute, an economic advisory business in Claremont, California. He holds a B.A. from Lake Forest College and a Ph.D. from the University of Virginia.

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The authors alone are responsible for any errors that might remain in the report.

## About The Heartland Institute

The Heartland Institute is an independent national nonprofit organization based in Chicago. Founded in 1984, it originally focused on Illinois issues. Over the years, Heartland evolved into a regional and now a national organization providing information to the nation's 8,300 state and national elected officials and more than 8,400 local officials. It has a staff of 30 and a 2007 budget of $4.5 million.

Heartland operates *PolicyBot*, a Web-based clearinghouse for the work of some 350 think tanks and advocacy groups. Approximately 18,000 documents are available from the service for free. Heartland publishes five monthly newspapers as well as occasional books, policy studies, and shorter essays. Some 450 elected officials serve on Heartland's Legislative Advisory Board, and 100 academics and economists serve on a Policy Advisory Board.

Heartland welcomes your support as a member or donor. Memberships start at just $29 a year, and additional contributions are tax deductible. For more information, visit its Web site at www.heartland.org, call 312/377-4000, or write to The Heartland Institute, 19 South LaSalle Street #903, Chicago, Illinois 60603.

## About the Beacon Hill Institute

Founded in 1991, the Beacon Hill Institute (BHI) is the research arm of the Department of Economics at Suffolk University in Boston. The institute draws on faculty and student resources to produce readable, timely analyses of policy issues. It distributes its research to interested citizens and to key opinion leaders and policymakers through various print and electronic media, including its quarterly newsletter, *BHI NewsLink*; policy studies; *BHI FaxSheets*; policy forums; opinion editorials; radio and TV interviews; and its Web site (www.beaconhill.org).

Since its founding, BHI has employed its capabilities to acquire a reputation, not only in Massachusetts but also in other states and abroad, for its concise and incisive policy analyses. BHI's most notable accomplishments include:

- Constructing more than 25 STAMP models for states and cities across the nation. STAMP is a computer program designed to provide the user with the ability to perform tax policy "simulations" – analyses of how hypothetical tax changes will affect the state economy.

- Training undergraduate and graduate students in the application of market-based economics to public policy issues.
- Providing testimony before the U.S. Congress and the legislatures of Massachusetts, New Hampshire, Florida, Rhode Island, and Arizona.

BHI publications and events have been the subject of more than 1,000 reports, stories and opinion pieces in major newspapers and magazines across the United States, including the *Boston Globe, Boston Herald, Christian Science Monitor, Chronicle of Philanthropy, Financial Times, Los Angeles Times Magazine, New Republic, Newsweek, The New York Times, U.S. News and World Report, Wall Street Journal,* and *Washington Times.* Coverage in the electronic media includes ABC World News Tonight, C-SPAN, CBS Evening News, CNBC, Fox News, MSNBC, National Public Radio, and all major Boston radio and TV stations as well as AP, UPI, Reuters, and Bloomberg wire services.

Ms. SÁNCHEZ. Thank you, Mr. Rutledge.

Mr. Murphy, will you please begin your testimony?

**TESTIMONY OF MARK MURPHY, AMERICAN FEDERATION OF STATE, COUNTY AND MUNICIPAL EMPLOYEES (AFSCME), WASHINGTON, DC**

Mr. MURPHY. Good afternoon, Madam Chair and Ranking Member Cannon and Members of the Subcommittee. My name is Mark Murphy. I am a fiscal policy analyst with the American Federation of State, County and Municipal Employees, and we are pleased to offer our testimony on this subject of the Internet access tax ban.

We have worked on this issue for nearly a decade, a decade or more, perhaps, and our views are representative of many unions with public employee interests, including the AFL-CIO, the National Education Association, the American Federation of Teachers and Firefighters.

We have three key concerns that I will talk about here today.

First, a permanent ban would have a negative impact on State and local government. The costs of congressional action on this issue is going to be borne entirely by State and local governments and are not paid for by the Federal Government.

These jurisdictions, as was mentioned earlier, they balance their budgets every year, and they face revenue shortfalls and budget deficits with every recession, and so the loss of revenue capacity is certain to negatively impact their ability to provide services and will negatively impact tax burdens. They will be forced to raise other taxes.

Just to give you a sense of the scale of the problem, for every $1 billion in lost local and State revenues, that could pay the salaries of 24,000 schoolteachers or 19,000 police officers or 19,000 firefighters or 27,000 hospital workers.

The second problem we see is that there is a distinct lack of evidence that a permanent ban would be an effective and cost-effective way to pursue the worthy goals that we all share of seeing the Internet grow and develop and affect productivity for the entire economy. We just don't see the evidence that a moratorium or a ban, particularly a permanent ban, would have that effect.

In fact, we have seen evidence to the contrary. The Government Accountability Office has studied the issue and found no discernible effect. Also, economists at the University of Tennessee studied the issue and compared States that had the tax on Internet access to those that don't and found no discernible effect of a tax on the ability of people to have Internet access.

When the moratorium was imposed in 1998, it was intended to be a temporary pause to allow a system, a fair system, of taxation to develop, and unfortunately that fair system has not been developed. Instead, we have seen an effort to transform what was supposed to be a temporary moratorium into a permanent ban.

At the time, Congress also wanted to foster growth in a new technology, and I think the growth of the Internet and its status today cannot be debated. It is well-established, its widespread, and whether you attribute that to a ban on taxation or a moratorium on taxation or not, I think that it is beyond debate that it is now

widespread. And so a permanent ban cannot be justified as a needed stimulus.

The third and final concern we have with a permanent ban is that it would have a negative influence on tax policy. When Congress preempts State and local taxation and taxing authority it narrows the tax base and raises rates, as was mentioned in previous testimony.

That is the opposite of what jurisdictions need to do to minimize the economic distortions that taxes have on private activity, and so preemption should be something Congress should consider very carefully before they step into State and local taxing authority. Also mentioned earlier, in previous testimony, was that granting one industry a complete and total exemption would be a very dangerous precedent, that other industries that can also make very valid claims toward having contributing benefits to society will step forward as well and ask for their exemption.

I believe that this impulse to wall off all new technologies and services is a harmful one, even if it is motivated by good intentions, because as society progresses, more and more economic activity is going to be innovative and advanced. It is by definition. It cannot all be made tax exempt, and we did not take this approach earlier in our history by exempting manufactured goods, the automobile and gasoline and airline service and calling them tax-free zones.

If we had, we would have left agriculture as the only industry to bear the entire Nation's tax burden. If we exempt future technological breakthroughs, we are going to further limit that tax base and concentrate it more narrowly on today's industries. We think that will have a very deleterious impact on consumers of vital public services.

Thank you.

[The prepared statement of Mr. Murphy follows:]

PREPARED STATEMENT OF MARK MURPHY

Good afternoon, Madam Chairwoman and members of the Subcommittee. My name is Mark Murphy. I am a Fiscal Policy Analyst for the American Federation of State, County and Municipal Employees (AFSCME). I am pleased to offer testimony on behalf of AFSCME on the subject of the Internet Access Tax Ban. We have worked on this issue for nearly a decade now and our views are representative of many unions with public employee interests.

I would like to address four key points today regarding a permanent ban on state and local Internet access taxes. Those are:

- What would a permanent ban cost?
- What benefits would be gained?
- What are the potential unintended consequences? And
- What are the tax policy implications?

WHAT WOULD A PERMANENT BAN ON INTERNET ACCESS COST?

A permanent ban on Internet access taxes would immediately cost state and local governments an estimated $120 million per year if the grandfathered taxes are eliminated.[1] This immediate impact would quickly multiply into the billions if, as we expect, additional goods delivered over the Internet are considered tax-exempt, or the scope of prohibited taxes expands, consequences I will elaborate on later in my testimony. While the range of estimates is necessarily broad, I cite it because

[1] Government Accountability Office, "Internet Access Tax Moratorium: Revenue Impacts Will Vary By State," GAO 06-273. GAO cites Congressional Budget Office estimates of the revenue impact.

we should be mindful of both the long-term complications that a permanent ban will produce, as well as the short-term impact.

The Government Accountability Office (GAO) notes that it is difficult to predict how many states and local governments would have levied taxes on Internet access without enactment of the first moratorium in 1998. At the time of the first moratorium, only 20 percent of Americans had an Internet connection in the home, compared to 50 percent just six years later. The increased penetration of the Internet in the population and its growth as a component of economic activity suggests that the immediate cost on grandfathered states and local governments represents only a fraction of the medium- and long-term fiscal impact on all states.

No matter what the actual revenue loss of a permanent Internet access tax ban would be or may become, it is important to keep in mind that the costs of Congressional action would be borne entirely by states and local governments. Congress recently reformed its budget rules to require a pay-as-you-go approach to federal tax cuts. If the Internet access tax ban affected federal revenues, then other spending cuts or revenue increases would be necessary to compensate for the lost revenue. Instead, the ban imposes revenue losses and a loss of revenue capacity on states and local governments, and is not paid for. As such it is an unfunded mandate.[2] These jurisdictions must balance their budgets every year, and face revenue shortfalls and budget deficits on a cyclical basis. Therefore, the loss of revenue capacity is certain to negatively impact local constituent services and tax burdens. To get a sense of the harm this would do, consider that each $1 billion in lost state and local revenue would pay the salaries of more than 24,000 school teachers, or 19,000 police, or 19,000 firefighters, or 27,000 hospital workers, according to estimates by the Multistate Tax Commission.[3]

WHAT WOULD A PERMANENT BAN ACCOMPLISH?

The policy rationale for barring state and local taxation of Internet access has shifted over time, from establishing a fair system of taxation on the new medium, to fostering growth of an innovative technology, to closing the digital divide, to preserving an incentive for even more widespread Internet adoption.[4] Are these realistic arguments, or should we be skeptical of the effectiveness and cost-effectiveness of the ban in achieving these goals?

The argument that taxation reduces Internet adoption rests on the assumption that Internet access consumers are sensitive to relatively small cost increases. However, there is no reliable evidence that this is the case. In fact, economists at the University of Tennessee conducted a regression analysis to determine the impact of the existing state and local Internet access taxes on Internet access. These researchers found that "Internet access taxation has no statistically discernable effect."[5]

The growth in popularity of broadband also points to the negligible effect that a state and local tax ban has on Internet access. Broadband Internet adoption has grown at a rapid pace over the last five years, even as the total number of Internet users has leveled off. A Pew Internet Center survey conducted last year found that 57 percent of broadband Internet users chose it for greater speed, while only 4 percent cited any price factor, such as a discounted introductory rate, in their decision.[6] With broadband access prices averaging $36 per month, compared to $18 for dial-up service, the growth of broadband offers compelling evidence to counter the assumption of high price sensitivity among Internet access consumers.

Banning states from levying Internet access taxes similarly is unlikely to have a measurable impact on the digital divide. The cost of a computer alone may be the single greatest financial barrier to Internet access for those of low and moderate incomes, followed by subscription requirements that often require a credit card.[7] Internet access charges themselves are small compared to these impediments; tax levies on those charges are smaller still.

So far, the debate over permanent extension of the Internet access tax ban is proceeding very differently from the typical examination of other government initia-

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[2] Michael Mazerov, "Making the Internet Tax Freedom Act Permanent in the Form Currently Proposed Would Lead to a Substantial Revenue Loss for States and Localities," Center on Budget and Policy Priorities, October 20, 2003; Congressional Budget Office, "Cost Estimate: S. 150, Internet Tax Nondiscrimination Act," September 9, 2003.

[3] Elliott Dubin, Multistate Tax Commission, email correspondence, May 16, 2007.

[4] Mazerov, op. cit. p. 24.

[5] Donald Bruce, John Deskins, and William F. Fox, "Has Internet Access Taxation Affected Internet Use?," State Tax Notes, May 17, 2004, p. 519.

[6] John B. Horrigan, "Home Broadband Adoption 2006," Pew Internet & American Life Project, May 28, 2006 <http://www.pewinternet.org/pdfs/PIP—Broadband—trends2006.pdf> accessed May 16, 2007.

[7] Mazerov, op. cit., p. 27.

tives. Consider some major domestic programs, such as Head Start, State Children's Health Insurance, and the Workforce Investment Act, just to name a few. During reauthorizations and appropriations, these programs are subject to regular oversight, monitoring and even rigorous, scientific program evaluations designed to isolate the effects of the program from other factors, to truly determine the effectiveness and value of the government's investment in the program. The Government Performance and Review, as well as the Administration's Program Assessment Rating Tool, are employed in an effort to identify ineffective or wasteful programs to shrink or eliminate. In sharp contrast, proponents of permanent extension of the Internet access tax ban have provided shifting rationales for the ban, yet have not adequately demonstrated its effectiveness and value. We are left to conclude that the drumbeat for the ban may be motivated more by the desire to enhance corporate profits than the pursuit of more laudable societal goals.

UNINTENDED CONSEQUENCES OF A PERMANENT BAN

Permanent extension of the Internet access tax ban presents a number of potentially harmful unintended consequences. These concerns are based on our experience with the ban over nearly a full decade, and include properly defining Internet access and eliminating the grandfathered state and local taxes.

The definition of "Internet access" has been and remains problematic. Past issues included the taxable status of voice-over-IP telephone and components of DSL services, as well as which parts of the Internet "backbone" are taxable.[8] Today's debate centers around audio and video content bundled with Internet service. These are complex issues that usually take a number of years to resolve. What new products and services will be developed in the future and how will providers arrange and package them? We cannot know that today, but if a permanent ban is put into place that includes an existing or future loophole, content providers will certainly migrate to that channel. Such an arrangement would give much favored status to one particular industry over many others. For these reasons, any moratorium on Internet access taxes must be temporary, to allow for clarifications, updates and adjustments to the definition and scope of the ban.

Eliminating the grandfathered state and local taxes would have direct revenue impacts on those jurisdictions ($120 million, as noted above), but may also put at risk other state and local taxes that are not intended to be covered by the ban but are not protected by the exception for corporate income, capital stock, net worth and property taxes. Such additional taxes could include payroll taxes, workers' compensation taxes, sales taxes on inputs, excise taxes on inputs, and potentially others. An elimination of the grandfather clause would put at risk a number of these levies solely because they would apply to entities that happen to provide Internet access. Newly enacted state and local taxes that apply to Internet access providers also may be at risk, even if they do not single out these entities or charge them higher tax rates.[9]

WHAT ARE THE TAX POLICY IMPLICATIONS OF A PERMANENT BAN?

The tax policy implications of making the Internet a "tax-free zone" are huge and far-reaching. Any time a legislature closes off economic activity from taxation, it narrows the scope of remaining economic activity and societal wealth that may be tapped for public purposes. In the case of Internet access, banning state and local taxation effectively limits a tax base that already faces significant challenges, for example, from remote sales and tax planning by multi-state corporations. Consequently, states and local governments will be forced to consider undesirable choices, such as raising other taxes or reducing the level of service to their citizens.

Exempting the entire category of Internet access services—whether or not that includes bundled content or other goods—also violates the horizontal equity principle of tax policy. Horizontal equity is the principle that tax laws should attempt to avoid imposing a higher burden on one taxpayer than on another similarly situated taxpayer. Providing one industry with such generous tax treatment—a complete ban on state and local taxation—makes it more difficult for firms in other industries to accept their tax burden. This will undoubtedly lead to calls for special treatment from other industries that can make compelling claims that they contribute benefits to society at large.

The impulse to wall off newly developed technologies and services from taxation is a harmful one, even if it is motivated by good intentions. As our economy and society evolves, by definition more and more economic activity will be innovative

[8] GAO, op. cit., p. 43; Mazerov, op. cit., pp. 8, 13, 18.
[9] Mazerov, op. cit., pp. 15, 19.

and advanced. It cannot all be made tax-exempt. One can imagine that if this approach to tax policy had been taken earlier in our history, then manufactured goods, or the automobile and gasoline, or airline service would be "tax free," while only agriculture would be left to bear the tax burden. But a greater concern is what happens in the future with the next technological breakthrough? Will we make all fuel-efficient vehicles permanently tax-exempt? Will we ban taxes on advanced textiles, innovative consumer services and new entertainments?

What will be left in the taxable sector if we do this? What will be the impact on the consumers of vital public services? How will we invest in the public institutions and initiatives that helped to develop so many of our technological and social advances, including the Internet itself?

In conclusion, I want to reiterate our overall concern with a permanent ban on Internet access taxation. It is costly to state and local governments and of questionable value to the greater public, it risks unintended consequences for a broad range of state and local revenue sources, and it poses troubling tax policy problems for all levels of government.

Madam Chairwoman and members of the Subcommittee, I thank you for the opportunity to offer testimony today and I am happy to answer any questions you may have.

Ms. SÁNCHEZ. Thank you, Mr. Murphy.

We are now going to begin the question-and-answer part of the hearing, and I will recognize myself for 5 minutes of questioning.

Mr. Quam, my first question is for you. If a permanent moratorium were to be imposed, what single recommendation would you make to protect State and local governments?

Mr. QUAM. The priority, really, is the definition of Internet access. A bad definition, a 1998 definition, just does not meet the demands of today's Internet. While governors are not calling for a permanent, they call for a temporary as a very important safety device, frankly, to make sure that we review any changes, the definition is the most problematic.

We believe that the ability to bundle any service with Internet access and make it tax-free subjects State and local governments to a lot of uncertainty going forward as the Internet develops, so addressing the definition should be a top priority.

Ms. SÁNCHEZ. Thank you.

Mr. Rutledge, why should Congress simply not impose a temporary moratorium? I am interested.

Mr. RUTLEDGE. The benefits of permanent tax rates are that you can make investment plans with them. People talk about the stock market as if it is a short-term game, but if you value the S&P 500 using projected free cash flows, which is what investors get, there is a number called the duration you would calculate, which says how long would you have to wait to get back half of the value of the money you spent on the stock, and the number is 28 years.

And so when you put capital in the ground, you have to be able to see 20, 30 or even 40 years in the future in terms of the environment you are going to be facing. So whether the tax is high or low, a permanent tax and a permanent structure is better than a temporary one for people who have to make capital decisions.

Ms. SÁNCHEZ. Thank you.

Mr. Murphy, what effect does the moratorium have on the members of AFSCME?

Mr. MURPHY. Thank you, Madam Chair.

AFSCME members work in a wide variety of public services, primarily at the State and local level, and also in healthcare. The numbers I gave earlier are about the number of salaries you could

pay for with $1 billion of revenue loss, kind of give you the idea of just how important these revenues are and the capacity to raise revenues, particularly in recessions and budget downturns, we believe that we would see, as we have already seen in previous economic downturns and budget shortfalls, State and local jurisdictions trying to get by with unfilled vacancies, seeing corrections officers who are working with less staff to patrol the same number of inmates in a prison, for example, because they just don't have the money to fill those vacancies.

Ms. SÁNCHEZ. Thank you.

Mr. Johnson, if there is a moratorium, should the grandfather protection continue and, if so, why?

Mr. JOHNSON. I think to the States the grandfather protection is very important. It is our view that as part of the original moratorium there was a desire to keep States harmless and not reduce the existing taxes on the States that at that time levied the tax on Internet access. So we do think it is important for that reason to keep that commitment.

We also think it is important to make sure that the scope of the moratorium isn't expanded to other tax types, and we think that the grandfather clause is helpful in being clear that it does not do that.

Ms. SÁNCHEZ. Okay.

And, Mr. Mackey, in light of the February 2006 GAO report concluding that the taxation of Internet access has no statistically significant effect on the deployment of broadband Internet access, how can we believe that taxing Internet access creates a barrier to individuals accessing the Internet?

Mr. MACKEY. I think the report did show that there was a statistical correlation. But the issue of whether or not taxes matter, if you will, on broadband penetration, there are a lot of factors. Taxes are just one. There is a lot of factors that go into how broadband has penetrated down to lower-income families, the wealth, how much competition is available.

I think clearly taxes and prices do matter, because when we have seen the explosion in the growth of broadband penetration, it has been when competition has driven down prices to certain price points, below which some of our low-and moderate-income consumers are able to afford broadband access.

And we have seen that time and time again, when a second competitor comes into a marketplace, the competition drives down prices and you have much more broadband penetration. So, as an economist, I have to believe that taxes do matter. Whether a statistical correlation can be found, you really need to look at a number of different factors, but clearly taxes and prices do matter to consumers for any product sold in the economy.

Ms. SÁNCHEZ. Thank you.

I would now recognize our distinguished Ranking Member for 5 minutes of questioning.

Mr. CANNON. Thank you, Madam Chair.

And thank you all for being here today. This is an extraordinarily difficult issue. It is one of the very first issues I dealt with when I came to Congress 10 years ago, more than that now, and

it is an environment that is dynamic, so we appreciate your impact on these issues.

Let me start, Mr. Quam, how long do you think the temporary moratorium should be extended? What should the next bill cover, what period of time?

Mr. QUAM. That is a tough recommendation. The other extensions have been, first one was for 2 years, the last one was I believe for 4. Two or 4 years, probably 4 years an extension gives the Internet time to, again, evolve.

Four years ago, the issue, as I said, was VOIP. And at the time it was being debated, VOIP was not really commercially available. During that debate, that changed.

Mr. CANNON. Isn't that amazing?

Mr. QUAM. It is absolutely amazing.

Mr. CANNON. We have much, much, much cheaper service at vastly better quality and more variety.

Mr. Murphy, how long do you think it should be extended?

Mr. MURPHY. Thank you, Mr. Cannon.

We support the temporary extension of the same reasons as Mr. Quam stated——

Mr. CANNON. But how long?

Mr. MURPHY. For 2 to 4 years.

Mr. CANNON. Two to 4 years. Again, thank you.

Mr. Rutledge, somewhere you suggested that families in the lowest quintile of earnings pay 10 times as much as families in the highest quintile as a percentage of their income for telecommunications taxes. Is that correct?

Mr. RUTLEDGE. Yes, that is one of the calculations in this Heartland study.

Mr. CANNON. That is actually, in some ways, a little misleading, because people who are very wealthy pay rent or pay a mortgage or own a house. They have some kind of cost of capital in that. People who are very poor pay for rent or mortgage or whatever they do for their house. Everybody buys groceries.

So if you take the income of a person who is relatively poor and take out the things that those families have to pay for, their marginal income is much, much smaller, is it not? And therefore that 10 times might be 100 times.

Mr. RUTLEDGE. Of discretionary income, absolutely, after essentials, yes. And it is also true in terms of the impact of broadband services on education, education costs, which is also a very regressive impact.

Mr. CANNON. So the people who need it most, the people who are on the margin, people whose kids have the ability to use access to the Internet and move up in life, are the people who you are hitting hardest with taxes.

Mr. RUTLEDGE. Yes, and those are the kids that should have the highest return to education, as well.

Mr. CANNON. And then, of course, education is evolving, even as we speak. I am not going to give my lecture here, although I would love to. There are dramatic things. We finally got to the tipping point in education, and communications is a big, big part of that. So never has there been a society where people have had the ability to move from one level of society to another with more ease,

based upon personal merit and education than we have today, and yet we have these taxes that are sort of in the way of the process.

Could you describe, Mr. Rutledge, or maybe Mr. Mackey, the role of telecommunication companies in collecting taxes for States?

Mr. MACKEY. Because they were formerly monopolies, telecommunications companies are subject to many, many State and local taxes, and States vary, but clearly if you look overall at where telecommunications companies rank in terms of what share of the services is taxable and these taxes are of course pushed onto consumers, it is somewhere in the study that John Rutledge did, it was about 31.5 percent of the average communications service tax, and that includes cable TV, wireless and wireline, was paid in taxes.

So, for instance, Mr. Cannon, if you were to impose that 13.5 percent on Internet access, which the average price in the study, it was found to be $36.50 a month, that would mean essentially an additional $5 a month in taxes on families that are already paying approximately $250 a year in taxes on their communications bill.

So it is not an insignificant amount of money when you consider that a $5 reduction when competing providers are out there trying to sell service and they tout that they are selling it for $5 less than their competition can provide significant new market opportunities for them. It is not an insignificant amount of money, particularly to low-income families.

Mr. CANNON. Thank you. Will we have a second round?

Ms. SÁNCHEZ. [Off-mike.]

Mr. CANNON. Why don't we have a second round? I think we have time.

Thank you. I would very much like to get a little more in depth here, and so I will yield back on the hopes that we will have a separate round of questioning. Thank you.

Ms. SÁNCHEZ. Mr. Johnson, the gentleman from Georgia, is recognized for 5 minutes.

Mr. JOHNSON OF GEORGIA. Thank you.

I don't think I will have 5 minutes' worth of questions, but I do want to know, if we could liken the Internet to a mall, a place where you can go in and purchase goods and services, and also liken it to a library, a place where you can go and pull a book, pull a resource and obtain some information, why would we tax a person upon entering the mall? Or why would we tax a person upon entering the library?

Is there anyone who would care to answer that from a public policy standpoint? Why would we do that?

Mr. QUAM. Sir, to take that question just a little differently, your example with regard to the mall, if the moratorium is allowed to expand and cover more and more services that are coming over the Internet, you are actually creating a disparity between the goods being sold in the mall and those being sold online, so that you are actually not creating equal treatment of your retailers who are in your community selling the book and somebody who is selling it online.

Moratoriums actually distort the tax base and create fewer opportunities for States to do what many telecommunications companies would love to see States do, which is reform telecommuni-

cations taxes, something that, frankly, States will have to do because of the changing nature of that technology.

The Internet is a means to get there. It is a service that traditionally may be subject to sales tax.

Mr. JOHNSON OF GEORGIA. Well, certainly, goods and services purchased over the Internet would be subject to taxation, but just the entry onto the premises, if you will.

Mr. QUAM. Well, and that is one of the reasons NGA is supporting an extension of the moratorium. Governors are saying, we don't need to tax that access. You are absolutely correct. That can remain tax-free, but we have to get the definitions right, less the distortion occur within the mall and between the mall and somebody selling online.

And so the moratorium, we are calling for an extension of the moratorium to prevent happening exactly what you are saying.

Mr. JOHNSON OF GEORGIA. I understand that, but I am just wondering, why would we at the end of the moratorium consider charging someone to just enter the mall or enter the library?

Mr. MACKEY. Mr. Johnson, I think your example is a very good one, and I think in terms of the issue that was raised about whether the definition of Internet access needs to be narrowed so that, for instance, abuses don't occur and anything that is sold with Internet access can be swept in. The report that the GAO did said that based on their reading of the statute that that was unlikely and they didn't read it that way.

Secondly, there was a bundling provision added, which made clear that if services are sold with taxable Internet access, the whole bundle would be taxed unless specifically the Internet access portion could be separated out in books and records.

Also, we haven't seen any real-world examples that I am aware of of companies trying to use this "loophole" to try to sneak things in and say they are Internet access as part of a package. So, for those reasons, I think, while we are certainly happy to look at the language, we think the 2004 amendments already added some protections.

As Mr. Quam said, the VOIP specifically carved out the bundling language, and I know this is technical, but I do think there are provisions to protect from, as you said in your example, sir, the things in the mall being swept in with taxing the entrance to the mall.

And I think you raised a very good point as to why access is so important. You are providing access to be able to shop and do business over the Internet, without necessarily taxing or not taxing the other items that are already covered differently under State sales tax law.

Mr. MURPHY. I wonder if I might add something to that question. I think it is a good question, but I think what would be a better analogy is if the owners of the mall charged access to the mall——

Mr. JOHNSON OF GEORGIA. That would be different than government charging access, though, right?

Mr. MURPHY. Well, in this case, the companies that provide Internet access are charging consumers for Internet access and the State and local governments may or may not charge a tax on that charge to access the Internet.

If there were a case such as the mall I go to, Pentagon City Mall, they charge for parking, I think it would be perfectly appropriate for a State or a local government to charge a tax, a regular sales tax, on a parking charge. That would be the analogy that I would think would be most appropriate.

Ms. SÁNCHEZ. The time of the gentleman has expired.

Mr. Jordan is recognized for 5 minutes.

Mr. JORDAN. We were meeting with our Ranking Member on immigration issues, and I didn't catch everyone's testimony, and I apologize.

But I did hear Mr. Quam's testimony. He mentioned that the moratorium on the taxes on the Internet had really no impact on the phenomenal growth we have seen in this industry.

I would like the rest of your reaction to that. Because taxes always impact everything else in our economy, every other industry, and I would assume they have had a major impact in this area, as well.

So maybe some thoughts in that area from our panel. And we will go with the guy I referenced first.

Mr. QUAM. The reference I was making was something Mr. Mackey had been talking about, both a GAO report and there is also a University of Tennessee report, which basically found no statistical correlation between tax on Internet access and broadband penetration.

Those two were not linked, and they were able to study that because you have certain grandfather States who have taxes remaining on Internet access that go back to 1998. Broadband penetration was no different in those States than the others. Those two studies started to indicate that a tax on Internet access was really not relevant to broadband.

The growth of the Internet, although the tax ban has been in place, there are times when it has lapsed, and during those lapses the Internet certainly did not fail, did not fall and did not falter. It is a very dynamic industry that is growing. The price points and competition continue to increase the number of goods and services that can be offered, continue to grow.

Mr. JORDAN. Mr. Mackey?

Mr. MACKEY. Thank you.

No, I agree. I think that taxes do matter. I mean, as an economist, we just have to believe that taxes do matter.

Now, in a specific situation, in a given timeframe, when you are comparing a grandfathered State versus a non-grandfathered State, there are going to be other factors besides just the moratorium or no moratorium, what is the wealth of the State? Is broadband widely available? How broad is it available to the public? Is it a rural State, is it an urban State?

So I think there are many factors, and I don't think anyone would claim that taxes are the sole factor driving broadband penetration. I certainly wouldn't make that claim. But it is one of a number of factors that people look at.

In terms of the lapsing of the moratorium, Mr. Quam is right, it did lapse, but I do think there was an expectation that the moratorium was going to be extended. And, as Mr. Rutledge said, when we are talking about investors and investments where you have to

have a long time horizon, those brief lapses in time weren't going to make any difference in terms of impact——

Mr. JORDAN. I mean, would a tax on the Internet, would that be largely regressive?

Mr. MACKEY. Absolutely, as Mr. Rutledge said before, yes, the burden would be 10 times higher on the lower quintile of the population than the upper. And if you are looking at just discretionary income, the impact would be even greater.

Mr. JORDAN. That is what I figured.

Mr. JOHNSON. I would just like to say, I don't disagree with Scott's comment that taxes matter. I think they matter both on the end of people who pay them, but they also matter on they are there to provide services to people. And so I think we would all like to pay no taxes or to pay very little taxes, but we all recognize the need for revenues to carry on essential government services.

I would also say that I think the studies do show that the impact of the incremental level of taxation hasn't been a significant factor on whether or not broadband service is available to people.

So I do think the studies do support the idea that the level of taxation that we are talking about has not hindered the ability of people to have access to those services.

Mr. RUTLEDGE. In a boardroom when you are making an investment decision, taxes matter a lot, and you wouldn't make them if you didn't know the tax rates applied. The reason these studies don't show much impact is they happened during a time when the rules were changing and the business regarding the ownership of telecom assets, including property rights, the ability to price your assets, regulations and so forth. So they are washed away by these giant tidal waves.

But believe it that taxes are passed onto consumers. If you pass them on to consumers, it will raise the price 1 percent, consumers will buy about 1.5 percent less of the stuff you are selling, so it is very important for consumers.

Mr. MURPHY. I would like to say that both studies did show no statistical relationship between the tax burdens that are imposed in those States that have them and the penetration of either broadband or Internet access.

And I think the question is whether the Congress is going to set a precedent of exempting an entire industry based on something where there hasn't been any evidence. I think that that would be outside of experience when it comes to Congress acting on either appropriated programs or tax issues.

Ms. SÁNCHEZ. The time of the gentleman has expired, and we are getting called to our next vote.

I do, however, think that we can conclude the hearing today by recognizing Mr. Delahunt for 5 minutes of questioning, and at the close of that, we will wrap up the hearing.

Mr. DELAHUNT. I thank the gentlelady.

Putting definitions aside, I am sure that there is the possibility of constant tweaking there. I think to suggest that taxation as it has been, particularly in those grandfathered States, has had a significant, as opposed to a minimal, impact really doesn't hold water when you take a look at the evidence, voiceover for example.

I mean, can you give to me the statistics in terms of the growth of e-commerce in the course of the past 5 years?

Mr. Quam?

Mr. QUAM. E-commerce has grown considerably. In 2007, I believe the number is expected to hit $252 billion.

Mr. DELAHUNT. And what was it 3 or 4 years ago, if you are aware, or if anybody has that?

Mr. QUAM. I do. It was $176 billion just in 2005, $220 billion in 2006.

Mr. DELAHUNT. I think you have answered my question. The evidence is this is a dynamic, growing, prosperous market.

Now, I understand all that, but let me again speak to the issue of the States and tax revenue. How much, collectively, in the aggregate, did the grandfathered States receive from the existing taxes back in the 1998 taxes?

Mr. QUAM. CBO estimates if the grandfather clause went away, those States lose between $80 million and $120 million.

Mr. DELAHUNT. Okay, between $80 million and $120 million.

How much do they lose in terms of sales tax revenue?

You should know that answer, Mr. Quam.

Mr. QUAM. In terms of sales tax revenue from——

Mr. DELAHUNT. In a single year. I mean, why do we have this streamlined sales tax initiative?

Mr. QUAM. Under streamline, the estimates are that States are not collecting anywhere from $15 million to $22 million per year.

Mr. DELAHUNT. So we are talking $15 million to $22 million as opposed to $80 million to $120 million. I mean, what we are talking here is chump change when we talk about the revenue sources for the States.

I think this is a very—I welcome this hearing, I think it is very informative, but I will be filing legislation come July that hopefully will deal with the issue of the SST, because we are really putting at risk revenue sources for our States to fund all of the service that the public demands.

And my own position is we ought to have a temporary moratorium until we finally resolve the issue of how the States are going to support public services with an eroding tax base, predicated on the growth of e-commerce. I think that is really kind of simple.

Why should we have a permanent ban until we can be assured that the States and political subdivisions are going to be so limited in terms of their tax revenues that they will go to extremely regressive forms of taxation?

Mr. CANNON. Will the gentleman yield?

Mr. DELAHUNT. I yield to my friend.

Mr. CANNON. Just for the record, Mr. Quam, would you mind supplying us with the numbers that you just gave about the sales tax that has been missed based upon what the sales are? Just doing a rough calculation in my mind, I suspect that was a little high, so I would love to see those numbers if you have a study to that effect.

Mr. QUAM. We do.

Mr. CANNON. Thank you.

Ms. SÁNCHEZ. Does the gentleman yield back?

Mr. DELAHUNT. Well, I think somebody has a need to answer.

Mr. MACKEY. Just very briefly.

Ms. SÁNCHEZ. You have 40 seconds.

Mr. DELAHUNT. It will be a 40-second response.

Mr. MACKEY. Just very briefly, it is very easy to quantify the revenue loss by measuring how much the grandfathered States are collecting on Internet access.

What is very difficult to quantify are the benefits to the States of the productivity enhancements that Dr. Rutledge was talking about, of the low interest rates that are raising property values for local governments, and all the other benefits that this high-tech and information technology-boosting productivity provides to the States.

And I think one of the reasons States are so flush with revenue right now is because of the strong economy that is due in part to the growth in e-commerce.

Ms. SÁNCHEZ. The time of the gentleman has expired.

I want to thank again the witnesses for your testimony today and for being so patient with us.

Without objection, Members will have 5 legislative days to submit any other additional written questions, which we will forward to the witnesses and ask that you answer as promptly as you can, to be made part of the record.

Without objection, the record will remain open for 5 legislative days for the submission of any other additional materials.

Again, thank you for your time and your patience.

And this hearing of the Subcommittee on Commercial and Administrative Law is adjourned.

[Whereupon, at 4 p.m., the Subcommittee was adjourned.]

# APPENDIX

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## Material Submitted for the Hearing Record

POST-HEARING QUESTIONS SUBMITTED BY THE SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW

## QUESTIONS FOR SCOTT MACKEY

1. In your prepared testimony for the hearing, you provide "three important reasons why Congress should make the Internet tax moratorium permanent." Please explain why Congress should not impose a temporary moratorium and revisit this issue in a few years.

2. The February 2006 GAO report concluded that the taxation of Internet access has no statistically significant affect on the deployment of broadband Internet access. What actual barriers, if any, does taxing Internet access create for individuals accessing the Internet?

3. One of the purposes of the Internet tax moratorium was to protect the industry in its infancy. Now that electronic commerce has increased, and the deployment of broadband has made access easier and quicker for consumers, why does the industry still need protection from Internet access taxes and discriminatory taxes on electronic commerce?

4. What can we do to improve the tax structure to create more equity between services that offer Internet access? How can we reform taxation to make it technology neutral, so that the local mom-and-pop business will not be at a competitive disadvantage with companies selling goods over the Internet?

5. With the endless advances in technology, such as VoIP and music purchases in the last few years, what products and services does the industry anticipate selling over the internet in the future which could be bundled with Internet access?

6. What are the benefits and detriments for industry if Congress extended the moratorium for 4 years? For 6 years? For 8 years?

7. What is the primary reason the industry favors a permanent moratorium on Internet access taxes, considering that industry passes on the taxes to the consumer and the February 2006 GAO report concluded that Internet access taxes do not significantly affect broadband deployment?

8. By eliminating grandfather protection for the states and local governments currently protected under the Internet Tax Freedom Act, the states and local governments would lose approximately $120 million in revenues from taxing Internet access. Would not this amount trigger the Unfunded Mandate Point of Order? What responsibilities would the Federal Government then have to the state and local governments? Would this not cause Federal taxpayers money?

## QUESTIONS FOR JOHN RUTLEDGE[1]

1. How do you respond to the concerns of states that the Internet tax moratorium continues to hurt disproportionately those states that rely on sales and use taxes for revenue?

2. How do you respond to the concerns of states rights' advocates that the Internet tax moratorium restricts states' revenue collection, and thus limits the money they have for programs, salaries, and other expenditures?

3. How would eliminating the moratorium affect the growth of electronic commerce? Of the deployment of the internet? Or the advancement of technology?

4. What evidence exists to show that the Internet tax moratorium has met its expectations of fostering growth of an innovative technology, of closing the digital divide, and of increasing Internet adoption?

5. What are the benefits to consumers of imposing a permanent ban on Internet access taxes and multiple and discriminatory taxes?

6. How do you respond to the concerns of states rights' advocates that the Internet tax moratorium is just another encroachment on states' rights under the 10th Amendment?

7. How would you change the definition of "Internet access" so that state and localities will still have a source of revenue while not stifling electronic commerce and the growth of the industry? Have the states and industry worked together to develop an acceptable and workable definition of "Internet access"?

8. What are the benefits and detriments for the economy, consumers, and industry if Congress extended the moratorium for 4 years? For 6 years? For 8 years?

9. By eliminating grandfather protection for the states and local governments currently protected under the Internet Tax Freedom Act, the states and local governments would lose approximately $120 million in revenues from taxing Internet access. Would not this amount trigger the Unfunded Mandate Point of Order? What responsibilities would the Federal Government then have to the state and local governments? Would this not cause Federal taxpayers money?

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[1]At the time of the publication of this hearing, the Subcommittee had not received a reply from Mr. Rutledge.

## Questions for the Record from the Minority Office

### Mr. Rutledge[1]

- A recent report by the Heartland Institute entitled "Taxes and Fees on Communication Services" states that taxes and fees on communication services nationally add up to $37 billion a year and that "Families in the lowest quintile of earnings pay 10 times as much as families in the highest quintile, as a percentage of their income." The intent of Internet tax moratorium was to promote equal access to the Internet and protect electronic commerce from discriminatory state and local taxes. Can you speak about the increase of communications taxes since the moratorium was first signed into law in 1998?

- With the proliferation of technology access to the internet is no longer relegated to sitting at your home computer. Internet access includes blackberry use and cell phones. When we address the internet tax moratorium should we be addressing other discriminatory taxes?

[1] At the time of the publication of this hearing, the Subcommittee had not received a reply from Mr. Rutledge.

**Mr. Mackey**

- You mention in your testimony that discriminatory tax policy has the effect of reducing investment in telecommunications deployment. In some states, there have been taxes imposed on DBS or satellite broadcasts. Representing a rural area satellite is an integral way to deploy TV and companies like Wild Blue are deploying internet access over satellite connection. These rural areas have no hopes of receiving broadband and internet access anytime soon and internet access via satellite is the only option they will have besides dial up. Isn't the growing hunger to tax services like those provided by DBS companies represent a discriminatory tax and in essence a backhanded internet access tax that runs the potential of destroying internet deployment in its infancy?

- Regressive taxes are taxes on the consumer and they hit lower income families on a fixed budget more disproportionately. In the City of Baltimore, there is a $3.50 tax per line on wireless and wireline so the single mother of two who has the cheapest wireless plan of $25.00 is paying $11.50 in taxes per month if she wants to add two cellphones to her plan to keep in contact with her children. Because wireless phones

are no longer used just to place a call and can be used for digital downloads and internet access. Do we need to look at these discriminatory taxes in the context of the internet tax moratorium?

- I would like to have a better understanding about how these discriminatory taxes are imposed. If you know how these local taxes get agreed to, can you explain if they are imposed through regulation, executive decision and/or by legislative bodies? Are these taxes agreed to as part of private agreements between interested parties and the applicable government body or are they agreed to as part of a public deliberation process? And do you know whether the public has the opportunity to some sort of notice and comment procedure before the taxes are imposed?

- Many of these taxes are buried in bills and are not explicitly stated for the consumer. Without transparency the consumer loses the power to know what taxes they may be paying and they lose the power to petition the government on what they may contend to be an unfair or unnecessary tax. Should the Committee be looking at greater disclosures so the consumer can see what taxes they may be paying?

## Response to Post-Hearing Questions from David C. Quam, National Governors Association, Washington, DC

**Responses to House Subcommittee on Commercial and Administrative Law from David C. Quam**

1. In your written testimony for the, you state that a "core concern for states is the potential breadth of the ITFA's definition of "Internet access." How would you change the definition of "Internet access" so that state and localities will still have a source of revenue while not stifling electronic commerce and the growth of the industry? Have the states and industry worked together to develop an acceptable and workable definition of "Internet access"?

Answer: NGA recommends first altering the definition so as not to allow Internet access providers the ability to bundle other services with Internet access and make the entire offering tax free. The existing definition of Internet access allows for bundling of services, but it was also designed for a "dial-up" Internet where traditionally taxable goods and services were not delivered by Internet. The development and deployment of broadband technologies make the Internet an attractive delivery system for services such as voice-over-internet-protocol phone service or Internet-protocol television. Altering the definition to limit the moratorium to the service that connects a person to the Internet would return the law to its original intent without increasing the risk of substantial revenue losses on state and local government and without imposing any new tax on Internet access. NGA has expressed its concerns to industry and would welcome the opportunity to craft a mutually agreeable definition that meets our goals.

2. What affect does the moratorium have on state and local revenues?

Answer: The moratorium prohibits state and local governments from imposing taxes on Internet access services. Since it has been in place since 1998, most state and local governments do not tax Internet access. Those that do were grandfathered under the 1998 law and collect approximately $120 million annually according to the Congressional Budget Office.

3. Because there have been so many advances in technology in the past few years, what are the benefits of having a temporary moratorium instead of a permanent moratorium? Or is it better to have a permanent ban?

Answer: The constant changes in technology and the Internet economy necessitate a temporary moratorium to ensure that Congress revisits the law and can make changes to address any unforeseen consequences. Temporary extensions have served both industry and state and local government stakeholders in the past. Major changes were made to the definition of Internet access in 2004 at the request of industry to address the emergence of broadband access. NGA likewise supported changes to exempt voice-over-internet-protocol services from the law because the law threatened the states' $12 billion telecommunications tax base. Congress should once again extend the moratorium on a temporary basis to ensure that any shortcomings in the law are addressed in a prudent and timely manner.

4. What are the benefits and detriments for states and localities if Congress extended the moratorium for 4 years? For 6 years? For 8 years?

Answer: The longest extension of the moratorium to date was the four year extension that was passed in 2004, but made retroactive to 2003. Considering the speed at which the Internet marketplace and technologies change, four years is a sufficient amount of time to unveil any unintended consequences of the law. Longer moratoriums would only exacerbate any problems that arise because of changes in technology or consumer use of the Internet.

5. What is the worst case scenario for states and localities if Congress imposes a permanent ban on Internet access taxes and multiple and discriminatory taxes?

Answer: Because the moratorium is a prohibition on state and local taxation, all of the risk of any unintended consequences from the law lands disproportionately on state and local governments. If the definition of Internet access creates an unforeseen opportunity for traditionally taxed services and products to avoid taxation, then a permanent bill could put at risk billions of dollars in existing state and local revenues forcing law makers to raise taxes or cut services to balance their budgets.

6. Please explain the controversy with bundling, as it relates to "Internet **access."**

Answer: A core concern for states is the potential breadth of the ITFA's definition of "Internet access." The current definition of Internet access states:

> "Internet access means a service that enables users to access content, information, electronic mail, or other services offered over the Internet, ***and may also include access to proprietary content, information, and other services as part of a package of services offered to users***. Such term does not include telecommunications services, except to the extent such services are purchased, used, or sold by a provider of Internet access to provide Internet access." *(Emphasis added)*

The first sentence of the definition has not changed since 1998 and allows a provider of Internet access to bundle "proprietary content, information, and other services" together with access to make the entire offering tax free. NGA believes that the unlimited ability of providers to bundle together content and "other services" into a single, tax-free offering represents a loophole that could have the unintended effect of exempting content, information or services from otherwise applicable taxes merely because they are delivered over the Internet.

7. If there is a moratorium, should grandfather protection for the states continue? Why?

Answer: Any extension of the moratorium should preserve existing state and local revenues by continuing the so-called grandfather clause for taxes imposed prior to 1998. The grandfather clause serves two purposes; first, as a protection for existing state and local tax revenue; and second, as a means to preserve other state and local taxes not specifically mentioned by the ITFA.

Today only nine states have direct taxes on Internet access that qualify for the protection of the 1998 grandfather clause. Those states include Hawaii, New Hampshire, New Mexico, North Dakota, Ohio, South Dakota, Texas, Washington and Wisconsin. According to Congressional Budget Office estimates from the 2004 ITFA extension, eliminating the grandfather clause will cost those states between $80 million and $120 million annually. While these amounts may seem insignificant in

terms of federal dollars, balanced budget requirements at the state level require that any unanticipated loss of revenues must be made up by either cutting services or raising revenues. These losses also are high enough to make the elimination of the grandfather clause an unfunded federal mandate under the Unfunded Mandate Reform Act. Any extension of the moratorium should therefore preserve the grandfather clause so as not to reduce existing state and local tax revenues.

The grandfather clause also serves as an important protection for all state and local taxes that indirectly affect providers of Internet access. Under the ITFA, a "tax on Internet access" means:

> [A] tax on Internet access, regardless of whether such tax is imposed on a provider of Internet access or a buyer of Internet access and regardless of the terminology used to describe the tax."

Because a tax on Internet access includes both taxes on users and Internet access service providers, some experts interpret the moratorium as applying to both direct taxes on Internet access and indirect taxes such as business taxes on a provider of Internet access. In fact, the pre-1998 versions of the moratorium expressly excluded certain indirect taxes such as income and property taxes from the moratorium. That language was later dropped because the grandfather clause applies to all taxes on Internet access in force before October 1, 1998.[1] Although the 2004 extension does preserve the ability of states to impose a tax "levied upon or measured by net income, capitol stock, net worth, or property value," this list is not exhaustive. Preservation of the grandfather clause is important because it allows Congress to avoid having to define those direct taxes subject to the moratorium and any other taxes that lie outside the scope of the moratorium.

8. What role does the Streamline Sales and Use Tax Agreement play in the discussion about the Internet tax moratorium and how would it affect states and localities if Congress allowed the collection of these taxes?

Answer: The National Governors Association has long supported state's efforts to pursue federal legislation, provisions that would require remote, out-of-state vendors to collect sales and use taxes from their customers. Such action is necessary to restore fairness between local retail store purchases and remote sellers and to provide a means for the states to collect taxes that are owed under existing law. The rapid growth of the Internet and electronic commerce underscores the importance of maintaining equitable treatment among all sellers.

In the *Quill* decision, the U.S. Supreme Court stated that, to secure a level playing field in the collection of sales and use taxes, states needed to eliminate undue administrative burdens on interstate commerce by simplifying the collection process for these taxes. The Court also clarified that Congress has the power to grant equitable collection authority to the states for sales and use taxes on remote sales. Governors support the development of a 21st century sales tax system that simplifies compliance requirements and streamlines sales taxes to ensure that states are prepared for the global electronic marketplace.

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[1] Mazerov, Michael, "Making the Internet Tax Freedom Act permanent in the form currently proposed would lead to a substantial revenue loss for states and localities," Center on Budget and Policy Priorities, October, 20, 2003.

Several states are working to eliminate undue administrative burdens on interstate commerce associated with sales and use taxes by participating in the Streamlined Sales and Use Tax Agreement (SSUTA). The SSUTA is designed as an agreement between states to simplify their sales and use tax systems to provide greater uniformity and certainty for businesses and consumers. Simplification would be accomplished through several key features, including uniform definitions within tax laws, rate simplification, state level tax administration of all state and local sales and use taxes, uniform sourcing rules, simplified exemption administration, uniform audit procedures, and state funding of the system.

SSUTA was triggered on October 1, 2005, when 13 states representing more than 20 percent of the population were certified as having met the requirements of the agreement. Currently, 15 states are full members; 6 states are associate members; and 19 states and the District of Columbia serve as advisor states to the agreement. Since the agreement was triggered, more than 1,000 businesses have taken advantage of the simplifications offered by the agreement by volunteering to comply and collect sales taxes from their remote sales.

Previous congresses have linked Streamlined and Internet access because an ill defined or overly broad moratorium on state and local taxation of Internet access could undermine state efforts under SSUTA. The two issues deal with different taxes, but because both involve transactions over the Internet, efforts should be made to ensure that they compliment rather than interfere with one another.

RESPONSE TO POST-HEARING QUESTIONS FROM SCOTT MACKEY, KIMBELL SHERMAN ELLIS, MONTPELIER, VT

Written Responses to Questions

Hearing on
"Internet Tax Freedom Act: Internet Tax Moratorium"
May 22, 2007

Submitted by Scott Mackey
Partner / Economist
Kimbell Sherman Ellis LLP
Montpelier, VT
802/229-4900 X109

August 22, 2007

**Answers to Majority Office Questions:**

1) One of the most important benefits of the moratorium is to expand the availability and affordability of broadband Internet access, so that all American households will have access to the myriad educational and economic benefits of the Internet. In addition to keeping the cost of Internet access down for American households, the permanent moratorium is also critical to providing a stable investment climate for businesses that not only provide access to the Internet but also create the applications, products, and services that are accessible through the Internet.

A permanent moratorium will send a very favorable, pro-investment signal to the firms that are driving innovation in our economy that states are not going to impose excessive and discriminatory taxes on Internet access. In terms of "doing no harm," a permanent moratorium will prevent states and localities from imposing taxes that slow growth of the Internet.

A permanent moratorium would not prevent future Congresses from revisiting this issue should it decide that changes need to be made to definitions or other provisions of the moratorium. Therefore, a permanent moratorium does preserve Congress' flexibility to address changing market conditions, and Congressional oversight authority provides for periodic review and study of these issues.

2) There are a myriad of factors that influence the rate of broadband penetration in the states, including household income, geography, and the presence of absence of competing providers. For this reason, it is very difficult to find statistically significant studies that can isolate the impact of the moratorium on broadband penetration.

Having said that, however, there is evidence that the presence or absence of competition among broadband providers influences broadband penetration rates. This is because competition results in lower prices to consumers, which in turn increases broadband penetration as more households decide that they can afford to purchase broadband Internet Access.

This highlights that the key beneficiaries of the extension of the moratorium are consumers, and in particular low and moderate income consumers. Not only will the moratorium prevent these consumers from facing burdensome new taxes that increase the price of Internet access, but the moratorium will also encourage investment by competing providers that will lower costs to consumers by promoting healthy competition between providers.

Given the evidence that price is a significant factor in broadband purchasing decisions, I have to believe that the moratorium plays a significant role in expanding broadband penetration. Without the moratorium, it is likely that some states would conclude that broadband Internet access falls under the definition of "telecommunications service" as this term is defined broadly in many states.

Recent studies from the Heartland Institute and the Council on State Taxation have documented that telecommunications services are, on average, taxed at rates nearly twice as high as general sales and use taxes. The Heartland study of 51 large cities found that the average rate is 13.5%, while the COST study tagged the rate at 14.2%. At current broadband prices, such taxes could add as much as $8.00 to the monthly cost of broadband Internet Access. These taxes would have a measurable impact on broadband penetration and would hit low and moderate income households the hardest.

3) I agree that one of the original purposes of the moratorium was to protect a new and emerging industry from taxation, and it is certainly true that the Internet industry is no longer an infant industry. However, the US still has a long way to go to provide low income citizens and those citizens that live in rural or underserved areas with access to a broadband Internet connection.

Again, a key point is that the extension of the moratorium helps low and moderate income consumers the most because it will protect them from excessive new taxes on Internet access. In addition, encouraging investment in broadband networks by competing providers, it also lowers costs to consumers by promoting healthy competition between providers.

A permanent moratorium will help these consumers in two important respects. First, a stable tax climate will encourage investment in rural and underserved areas so that all Americans can benefit from broadband Internet access. Second, the moratorium will prevent states and localities from imposing new taxes that drive up the price of Internet access and make it less affordable to low and moderate income Americans that need such access to participate in the 21st Century digital economy.

4) The amendments adopted by Congress in 2004 brought equity between types of Internet access providers by clarifying that states and localities could not impose hidden taxes that had the effect of taxing Internet access provided by telecommunications companies but not by other types of providers. Some states have tried to avoid the intent of Congress by asserting that these wholesale taxes still apply. Congress needs to clarify once and for all that wholesale taxes on the Internet backbone – which ultimately are borne by the consumer – are not permitted.

The issue of whether states can require Internet and other remote sellers to collect sales taxes on goods and services sold over the Internet is a separate issue. States are working to address this issue through the Streamlined Sales Tax Project and I understand that a separate bill has been introduced to address this issue.

5) There may be many products and services that are "bundled" with Internet access in the future. However, the current definition of Internet access and the "bundling rule" adopted by Congress in 2004 will prevent companies from claiming that such products and services are exempt from taxation.

The accounting rule in Section 1106 provides that if the charges for Internet access are "bundled" with charges that are subject to taxation, then the charges for Internet access may be subject to taxation unless the Internet access provider can reasonably identify the charges for Internet access from its books and records. Therefore, an Internet access provider has a strong incentive to "unbundle" for tax purposes those taxable services in order to ensure that the entire package of services that include the Internet access are not subject to taxation.

I cannot think of any examples where companies have tried to use the moratorium to exempt products and services bundled with Internet access to avoid taxation.

6) For companies that are investing billions of dollars in broadband networks, the best solution is a permanent extension because it allows planning for investment decisions based on a stable, long-term tax climate. If Congress chooses not to make the moratorium permanent, the longest possible extension would send the strongest possible signal to investors.

7) The "Don't Tax Our Web" coalition supports a permanent moratorium for two primary reasons: first, as discussed above, it provides for more stable and predictable investment planning; second, we know from experience that price does matter when it comes to consumer purchases of broadband service.

Concerning the second point, there are certain price points for broadband service that cause lower and moderate income consumers to purchase service. The emergence of

competition between cable providers, telecommunications companies selling DSL, and wireless companies has led to price reductions that have increased the number of broadband subscribers. So we do not agree with the GAO conclusion that taxes don't matter. Taxes do matter because they increase the price to the consumer.

Consumers are particularly at risk that states and localities will not only impose sales taxes on Internet access but also telecommunications taxes as well. These discriminatory telecommunications taxes are typically two times higher than sales taxes.

There are a myriad of factors that influence the rate of broadband penetration in the states, including household income, a state's geography, and the presence of absence of competing providers. For this reason, it is very difficult to find statistically significant studies that can isolate the impact of the moratorium on broadband penetration.

8) The states that continue to tax Internet access under the 1998 grandfather clause have had almost 10 years to prepare for the elimination of the grandfather clause. States have enjoyed large budget surpluses due to strong economic growth over the last five years – much of that economic growth generated by strong productivity gains driven by the communications and information technology sectors. A recent study by *Ovum and Indepen* found that almost 80% of the productivity growth in 2004 was attributable to the communications and information technology industries.

The National Conference of State Legislatures reported in February the following data about surplus revenues held in FY2007 by the eight states still covered by the 1998 grandfather clause:

| STATE | SURPLUS AS % OF GEN. FUND $ |
|---|---|
| Hawaii | 13.9% |
| New Hampshire | 3.8% |
| New Mexico | 8.9% |
| Ohio | 11.1% |
| South Dakota | 13.5% |
| Texas | 17.8% |
| Washington | 3.4% |
| Wisconsin | 0.1% |

The GAO reported that the total revenues in question for the grandfathered states are under $120 million, representing a small fraction of each state's total tax collections. Given the surpluses available in these states, elimination of the grandfather clause would not harm the budgets of the grandfathered states.

**Answers to Minority Office Questions:**

1) The moratorium would apply to consumer purchases of Internet access provided by DBS providers, so consumers of satellite Internet access would enjoy the same benefits of the moratorium as purchasers of wireless, DSL, cable modem, or other Internet access. With respect to DBS Internet access, there would be no discrimination. The issue of whether Congress should prohibit states from imposing taxes on DBS video service as part of reforms that "equalize" the tax burden between various types of video service providers would seem to be outside the scope of the moratorium legislation. Given urgent need to extend the moratorium before the November 1 expiration date, the "Don't Tax Our Web" coalition supports keeping this issue separate from the Internet access moratorium.

2) I agree completely with the assessment of the burden that regressive telecommunications taxes impose on American consumers. Congress definitely needs to address the discriminatory state and local tax burden imposed on consumers and providers of telecommunications services. In fact, I testified at a hearing held by this subcommittee in June, 2006 and provided testimony about the detrimental impact these taxes can have on low income consumers and on companies that are investing billions in communications networks that are vital to US economic growth and competitiveness.

However, given the urgent need to extend the moratorium before the November 1 expiration date, the "Don't Tax Our Web" coalition supports keeping this issue separate from the Internet access moratorium.

3) There are a hose to ways that taxes on Internet access and the underlying telecommunications purchased, used, or sold to provide Internet access can be imposed. In some states, Department's of Revenue have interpreted existing state statutory definitions to claim that internet access is a taxable "telecommunications service." In other states, state legislatures have explicitly decided to tax Internet access. In still other states, state courts have issued rulings on whether a statute should or should not be applied to Internet access. Finally, there are a very few states that have very broad taxes on all services that are not explicitly exempt by statute, so Internet access is deemed to be taxable unless the state legislature and the governor exempt it through legislation.

In addition, without the protection of the Internet moratorium, it is possible that some local jurisdictions will try to impose their local telecommunications or "utility" taxes by ordinance, claiming that they have the authority to do so under their home rule or other powers provided by statute or constitution. What's worse, they may attempt to retroactively claim that the tax has been due for prior periods. Missouri cities are currently attempting to do this to the wireless industry, claiming that wireless service should have been taxable under their utility tax ordinances.

4) Congress closed the loophole in 2004 that had allowed states to impose hidden taxes on the Internet backbone by taxing telecommunications purchased, used, or sold by a provider of Internet access to provide that access. Unfortunately, despite clear Congressional intent, some states are still asserting that they can impose these hidden taxes. Passing a permanent moratorium will protect consumers from these hidden taxes.

RESPONSE TO POST-HEARING QUESTIONS FROM JERRY JOHNSON, OKLAHOMA TAX COMMISSION, OKLAHOMA CITY, OK

**Responses to**
**Questions for Jerry Johnson**

**House Committee on the Judiciary**
**Commercial and Administrative Law Subcommittee Hearing**
**July 17, 2007**

1. In your prepared testimony, you request that "any extension of the Act should be temporary in nature." What are the benefits and detriments for states and localities if Congress extended the moratorium for 4 years? For 6 years? For 8 years?

The reason we feel that any extension of the Internet Tax Freedom Act (ITFA) should be temporary in nature is because Internet technologies and services, the manner in which businesses and individuals use the Internet and the manner in which Internet access is provided continues to evolve at a rapid pace. This means that the manner in the ITFA interacts with state tax laws will also change over time, and the results produced today by the ITFA may not be the same next year or the year thereafter. Since there is no institution other than Congress that has oversight of the ITFA and its impact on either state and local tax systems or the Internet industry itself, it is important that Congress establish procedures that require it to periodically revisit the Act to determine that it is operating in the manner intended and not producing unintended consequences for states and localities or the Internet industry.

With that as background, FTA believes that a 4-year extension of the Act would be appropriate, presuming it is to be extended at all. Four years is consistent with earlier iterations of the Act and is, in reality, a long period of time in "Internet terms." To extend the Act for six or eight years would, we believe, reduce the effectiveness of the Congressional oversight and expose states and localities to the risk that changes in the industry that would adversely affect government revenue bases would not be addressed in a timely manner. We also believe that a shorter term is in everybody's interest given other changes that may be included in the bill such as the definition of Internet access and the treatment of telecommunications.

2. What affect, if any, does the moratorium have on state and local revenues?

The effect of the moratorium is to prevent states and localities from imposing "new" taxes on charges for Internet access. Therefore, it is difficult to calculate the fiscal impact of the moratorium since it is not possible to know how many states might have imposed their sales and use tax on Internet access if there was no moratorium. This much we do know. The nine states that currently have taxes that are grandfathered under the Act estimate that repealing the grandfather would reduce revenues by at least $120 million per year. Moreover, we also know that the amendments adopted in 2004 that prevent states from imposing tax on telecommunications services "purchased, used or sold" to provide Internet access were estimated at the time to reduce state and local revenues (and to reduce the cost of providing Internet access) by $300-$400 million per year. In other words, the overall fiscal impact of the Act on states and localities is not inconsequential.

3. In your prepared testimony, you request that "an extension of the Act should be temporary in nature." If Congress imposed a permanent moratorium, what single recommendation would you make to protect state and local governments?

If the Internet Tax Freedom Act is made permanent, the definition of Internet access must be revised to insure that it includes only the service that allows a user to connect to the Internet and cannot be interpreted to allow an Internet access provider with an ability to bundle other content, information and services with the access and claim an exemption for the entire bundle.

4. What is the controversy with discriminatory taxes? What happens if you interpret the definition of discriminatory tax broadly? What happens if you interpret the definition of discriminatory tax narrowly?

We have not raised issues with the current definition of "discriminatory tax." We are making no recommendations for changing it.

5. What role does the Streamline Sales and Use Tax Agreement play in the discussion about the Internet tax moratorium?

The Streamlined Sales and Use Tax Agreement is not technically related to the extension of the Internet Tax Freedom Act. FTA believes, however, that it is appropriate for Congress to consider the Streamlined Agreement and the remote sales issue as it considers extending the ITFA. That is, if Congress is going to take steps to address one aspect of the relationship of state taxation to the Internet (and restrict state tax authority in so doing), we believe it is appropriate that Congress also consider other ways in which the Internet is affecting state taxation and take steps to address those issues as well. Primary among these is the issue of remote sales and the inability under current law for states to require collection of state and local sales taxes by certain Internet sellers that do not have "nexus" with the taxing state.

The central point to consider in this issue is the tremendous strides that states, working with the retail community, have made in simplifying the administration of sales and use taxes for multistate sellers. Earlier Congresses were reluctant to address the remote sales issue because of the complexity of sales taxes in the various states. The Streamlined Agreement represents the response of states to the demands for simplification, and Congress should reciprocate by authorizing those states that are members of the Agreement to require remote sellers to collect tax on goods and services sold into the state.

FTA believes the provisions contained in the Streamlined Sales and Use Tax Agreement represent sufficient simplifications such that Member States should be authorized to require certain remote sellers to collect tax on goods and services sold into a state. The Agreement uses several strategies to reduce the burden of collecting tax: (a) simplifying many provisions of law (e.g., adopting a uniform tax return); (b) significantly greater uniformity in provisions across states (e.g., uniform definitions of certain items like food or telecommunications); (c) having the

RESPONSE TO POST-HEARING QUESTIONS FROM MARK MURPHY, AMERICAN FEDERATION OF STATE, COUNTY AND MUNICIPAL EMPLOYEES (AFSCME), WASHINGTON, DC

**Answers to Follow Up Questions of the Subcommittee**
**Mark Murphy, Fiscal Policy Analyst**
**Department of Research and Collective Bargaining Services**
**American Federation of State, County and Municipal Employees (AFSCME)**
**Before the Judiciary Committee**
**Subcommittee on Commercial and Administrative Law**
**U.S. House of Representatives on**
**The Internet Tax Freedom Act: Internet Tax Moratorium**
**August 20, 2007**

Dear Chairman Sanchez:

Thank you for the opportunity to testify before the Subcommittee on May 22, 2007 on the Internet Tax Freedom Act: Internet Tax Moratorium, and for your interest in this important issue.

I have provided answers below to the Subcommittee's follow-up questions. If the Subcommittee has any further questions or would like additional information, please do not hesitate to contact me.

1) **How would a 4 year moratorium on Internet access taxes negatively and positively affect state employees? A 6 year moratorium? An 8 year moratorium?**

AFSCME supports an extension of the temporary Internet access tax moratorium in order to fulfill the original intent of the first moratorium, which is to establish a fair, rational system of taxation that avoids unnecessary complexity for consumers while protecting the states' sovereign taxing authority. A moratorium of up to 4 years would meet that need.

AFSCME's support for a temporary extension notwithstanding, it remains clear that an extension of any length would negatively affect state and local government employees by pre-empting those jurisdictions' taxing authority. Because states and cities cannot carry over deficits from year to year, in times of shortfall, public employee jobs are cut, services are reduced, and revenues are raised. If Congress prohibits states and local governments from taxing the charges companies impose for Internet access, those jurisdictions' sources of potential revenues are restricted, and jurisdictions will be more likely to cut jobs and reduce services. As noted in my testimony, a $1 billion reduction in state and local revenue would pay the salaries of more than 24,000 school teachers, or 19,000 police, or 19,000 firefighters, or 27,000 hospital workers. Even for public employees who do not lose their jobs, the impact of job cuts are serious. Corrections officers would face greater risks with lower prison staffing, teachers would have larger classes, and child welfare workers would grapple with escalating caseloads. These are real consequences that have occurred in past fiscal downturns.

**2) What is the worst case scenario if Congress preempts state taxing authority and imposes a permanent ban on Internet access taxes and multiple and discriminatory taxes?**

A permanent ban on Internet access taxes would have both immediate and long-term negative fiscal consequences for states and local governments. Eliminating the grandfather provisions would trigger immediate revenue losses of between $80 million and $120 million in nine states. All other states would have their taxing authority permanently restricted and their tax bases permanently limited.

Over time, a number of other existing taxes that currently apply to Internet access companies may also be challenged, as explained in further detail in the answer to question #4. In addition, Internet access providers could seek tax-free status for additional, "bundled" online services that were never intended to be included in the original moratorium. As we have seen over the past several years, voice-over-Internet-protocol (VOIP) as well as online music and video entertainment have become commonly available since the original moratorium was put in place. A permanent ban on Internet access charge taxes would guarantee that services we cannot even conceive of today will become available online and offered together with basic Internet access for a monthly subscription, which service providers would then seek to shield from state and local taxation.

Most, if not all, states would be impacted by these long-term consequences, which would reach billions of dollars.

**3) In your prepared testimony, you address four points regarding a permanent ban on state and local Internet access taxes. If a permanent moratorium were to be imposed, what single recommendation would you make to protect state and local governments?**

A permanent ban on state and local taxes on Internet access charges would have such negative consequences for those jurisdictions that there is no single recommendation that would adequately protect them. The best single protection, while still inadequate, would be to craft a very specific and narrow definition of the taxes that would be banned. An appropriate definition would cover *direct* sales taxes on charges for *basic* Internet access that includes email and instant messaging. Such language should make it clear that states have the authority to levy taxes that apply to Internet access providers, just as they apply to other entities. And all content bundled with Internet access should be excluded from the definition.

**4) Would there be any effect on the revenues for states and localities if grandfather protection under the Internet Tax Freedom Act is eliminated? If yes, how would this affect public employees? How would this affect the public?**

Eliminating the grandfather provisions for existing state taxes on Internet access charges would have a direct and an indirect negative effect on states and local governments.

First, eliminating the provisions would trigger immediate revenue losses totaling between $80 million and $120 million in nine states – Hawaii, New Hampshire, New Mexico, North Dakota, Ohio, South Dakota, Texas, Washington and Wisconsin – and in some local governments in those states.

Secondly, eliminating the grandfather provisions would open up potential challenges to all states' regular taxes that apply to Internet access providers. Because of carve-out language in the existing moratorium, corporate taxes on net income, capital stock, net worth and property value are protected; however, other taxes, such as gross receipts taxes, sales taxes on business inputs, and unemployment insurance taxes, would be left unprotected. It would be difficult to attempt to enumerate all state and local taxes currently levied on entities that may include Internet access providers, either today or in the future. States and local governments would likely spend significant amounts of time and money responding to court challenges to these completely legitimate taxes, and would face revenue uncertainty as a result.

ARTICLE SUBMITTED BY THE HONORABLE CHRIS CANNON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF UTAH, AND RANKING MEMBER, SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW



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## An Odd-Bedfellow Coalition

Republicans and (many) Democrats see eye-to-eye on Internet-access taxes.

By Kristina Rasmussen

Key congressional players from both parties have realized the potential gains of making permanent a soon-to-expire federal moratorium on Internet-access taxes. This would mean no discriminatory taxes on Internet services — a policy more and more Democrats are rightly coming around to support.

Arch-liberal senators John Kerry and Patrick Leahy — both of whom would do away with many of the flush tax cuts — are teaming up with fellow progressive Ron Wyden to back the bar. Meanwhile, stalwart fiscal conservatives John Sununu and Tom Coburn are joining presidential candidate John McCain and moderate GOPer Olympia Snowe to carry the Republican banner on the issue. Finally, over in the House, California Rep. Anna Eshoo, who received an "F" last year on the National Taxpayers Union's comprehensive fiscal scorecard, has joined with Virginia Rep. Bob Goodlatte, who earned a "B," to champion the effort.

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Surprising? Perhaps — but not after you consider the background.

If you're reading this article on a computer, chances are you have not had to pay any state or municipal taxes on the service you use to connect to the Internet. That's not because governments don't want to levy these taxes — they do. Just think of the fees and taxes on your cell phone bill. But thanks to a federal law passed in 1998, and renewed in 2001 and 2004, a moratorium has been put on new taxes targeting Internet-access services. For instance, DSL, cable modem, and wireless Internet services are now safe from new taxes — although for how much longer remains in question.

The moratorium's sponsors originally had to agree to a sunset in order to get the bill passed; lawmakers wanted to periodically re-evaluate the situation. And now the current moratorium is scheduled to expire on November 1, 2007, with many government officials salivating over the prospect of imposing new taxes and fees on the growing number of Internet users. (Never mind that the revenue raised from such taxes would have little or nothing to do with improving Internet services.)

Of course, Republicans have long been dedicated to stopping new taxes in any form. But why would Democrats support a bill that would deny a new revenue stream to traditionally friendly state and local governments — entities whose leaders applaud Democratic calls for more

federal aid?

Three reasons come to mind:

One, a low-tax Internet is affordable for Americans of all income levels. Telecom taxes can add 20 percent or more to a wireless phone bill. Because this burden tends to fall hardest on lower-income households, many Democrats don't want to be responsible for putting Internet access out of reach for the very Americans they profess to care the most about.

Two, the ban has helped create a dynamic Internet environment that is opening up new employment and commerce opportunities. This is especially good news for the blue states where manufacturing jobs are departing for warmer climates.

Three, Democrats can tune their rhetoric on the moratorium so that it's in sync with the familiar (but shrill) song about "protecting" the Internet with (economically destructive) "net neutrality" rules. It's hard to imagine the net-neutrality scheme having any upside, but that's a fight for another day. In the here and now, Democrats gain an undeniable political benefit by relating these two issues.

The bottom line is that the Internet's relative newness, widespread usage, and incredible potential allow members of both political parties to connect in ways that would be impossible if the discussion were, say, lowering capital-gains taxes. The Internet provides a setting where odd-bedfellow coalitions can be surprisingly successful, and taxpayers should support all those who would make the moratorium permanent — regardless of party.

The next step is to make sure this growing coalition is strong enough to beat the "wait-it-out" team, which wants to see the ban expire quietly. Many legislators are experts at running down the clock, but few want to feel the wrath of constituents who would soon see $5 "Local Internet Access Fees" added to their monthly Internet bills.

Americans are only going to rely more and more on the Internet, and making this tax moratorium permanent could rank among the most far-sighted examples of good tax policy ever produced in Washington. But with the clock ticking down to November (not the elections in 2008, but this year's tax-ban expiration), Democrats have limited time to put this victory in the bag.

Taxpayer advocates stand ready to help.

*— Kristina Rasmussen is director of government affairs for the National Taxpayers Union.*

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