

The Case for Tax-Free Internet Access

The Internet Tax Freedom Act (ITFA) has reduced the cost of Internet access, spurred investment in the digital economy, and contributed to nine years of economic growth. However, the ITFA will expire in November 2007 unless Congress takes action. We recommend Congress:

- ***Make permanent the current moratorium on Internet access taxes and multiple and discriminatory taxes;***
- ***Eliminate the grandfather clause which allows certain states and local jurisdictions to impose taxes on Internet access; and***
- ***Clarify that the ban on taxes for Internet access includes the underlying transport services acquired by ISPs and does not include non-incidental services such as subscription video services.***

Congress should continue to prohibit taxes on Internet access for the following reasons. ***First, Congress should make the moratorium permanent as part of a national strategy to encourage broadband adoption.*** While the benefits of broadband are well known, the United States has fallen behind in its broadband adoption compared to other countries. Among 30 OECD countries, the United States has dropped in rank for broadband adoption from 4th place in 2001 to 15th place in 2007. Making the moratorium permanent would eliminate another barrier to broadband adoption and help ensure the United States remains competitive in the global digital economy.

Second, Congress should make the moratorium permanent because tax free Internet access is a national issue that should be resolved at the federal level. While states also benefit from higher levels of Internet adoption, there is an asymmetrical distribution between the costs and benefits of taxes on Internet access. When states tax Internet access, they receive all of the financial benefit of the tax, but the net social cost of lower rates of Internet access extends beyond the states' borders to affect the entire nation. States that continue to tax Internet access under the grandfather clause are essentially free riders that happened to get "lucky" by imposing a tax on Internet access before 1998.

Some critics have tried to make this debate into a states' rights issue; however, the cost, speed, and availability of Internet access should be a national priority. Internet access is not a luxury service for most Americans, but rather is a key enabler of commerce, education, government services and civic participation. For example, the federal government has undertaken a

significant initiative to expand its e-government services, and barring taxes on Internet access would help ensure that all Americans can afford to access these services. In addition, high speed Internet access is a fundamental building block for increasing productivity and growth in the national digital economy.

Broadband in particular creates many opportunities for businesses to operate more efficiently. For example, broadband enables companies to allow their employees to telecommute, which creates a more efficient workforce. Companies save money on office space and equipment, and employees save on commuting costs and time. These efficiencies translate into lower prices for consumers. The fact that some companies and federal agencies pay for all, or a portion, of many employees' broadband connections is evidence of the importance of broadband for business. Broadband also creates opportunities for consumers to take on the role of the producer by substituting their own work for services they previously paid for. For instance, consumers have replaced travel agents, tax preparers, and bank clerks with online ticketing, online tax preparation, and online banking. This reduces costs for companies by allowing them to deliver goods and services more efficiently to consumers and at lower prices.

As Internet-enabled consumers conduct more business activity over the Internet, Internet access itself has become a key input to production, much like machinery. ***State tax policy should reflect the fact that Internet access is not merely a consumer good, but rather a tool used by producers to increase economic efficiency and lower the cost of production.*** Investment in machinery has also been strongly associated with economic growth and increased productivity. As a result, almost every state offers some form of a sales tax exemption on the purchase of new equipment. Since states already support these tax incentives, they have little reason to deny these tax benefits to investments in Internet access. Ultimately states will benefit as higher levels of productivity generate lower prices for their citizens. In addition, the economic benefits of a healthy national economy will provide state tax administrators opportunities to increase their state tax revenue.

For more information, download the full report at:

<http://www.itif.org/files/InternetTax.pdf>

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