



The Case for Tax-Free Internet Access: A Primer on the Internet Tax Freedom Act

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If while watching the debate this year on renewing the Internet Tax Freedom Act, you experience déjà vu, you are not alone. We are hearing the same arguments and the same debate that we hear every time the Act comes up for renewal. Neither the facts nor the arguments have changed. The only question that remains is how much the views of Congress have changed.

In 1998 Congress recognized that unnecessary and excessive taxation could slow the growth of the Internet and reduce the benefits of a digital economy. Congress passed the Internet Tax Freedom Act to prohibit states from imposing new taxes on Internet access and to encourage economic growth. In 2001 and 2004 Congress reaffirmed its commitment to a pro-technology, pro-innovation policy by renewing the moratorium. However, the current moratorium will expire in November 2007 unless Congress renews the Act or makes it permanent. To ensure that all Americans continue to enjoy the benefits of tax-free Internet access, Congress must recommit to a policy that promotes investment in the foundation on which the digital economy is built. To accomplish this goal, we recommend that Congress should:

- **Make the current moratorium on taxes for Internet access permanent;**
- **Make the current moratorium on multiple and discriminatory taxes on electronic commerce permanent;**
- **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 Internet service providers (ISPs) and does not include non-incident services such as subscription video services.**

The Internet Tax Freedom Act

The Internet Tax Freedom Act established a moratorium prohibiting state and local governments from imposing three types of taxes: Internet access taxes, multiple taxes on online transactions, and discriminatory taxes on online transactions. First, the Act prohibits taxes on all methods of Internet

access, including dial-up, cable, digital subscriber line (DSL), satellite, and wireless. The Act also ensures that taxes cannot be imposed on incidental services such as e-mail or instant messaging. However, the Act is unclear on whether the underlying transport services acquired by ISPs, such as high-speed capacity over fiber or copper-wire, can be taxed. As a result, some states tax ISPs on the telecommunication services acquired to provide Internet access and these ISPs then pass these taxes directly on to their customers in these states. Second, the Act prohibits multiple taxes on online transactions from multiple jurisdictions. For instance, the law prohibits two states from charging sales tax on a single purchase unless credit is given for taxes paid in the other jurisdiction. Third, the Act prohibits discriminatory taxes on online transactions that treat electronic commerce differently than other types of commerce. For example, the Act bars taxes that would only apply when a product is online. It also prohibits states from imposing a different tax rate when a product is sold online.

The Act has a grandfather clause to allow those states and local jurisdictions that had implemented taxes on Internet access before 1998 to continue to tax Internet access. Nine states currently impose taxes under the grandfather clause: Hawaii, New Hampshire, New Mexico, North Dakota, Ohio, South Dakota, Texas, Washington and Wisconsin.¹ The Congressional Budget Office (CBO) estimates that these states collectively receive \$80 to \$120 million annually in taxes on Internet access.² To put this in perspective, consider that this amount represents approximately 0.1% of these states' tax revenues,³ and Texas, for example, recently approved a two-year state budget of \$153 billion.

Perhaps because of the ambiguous name, some people confuse the Internet Tax Freedom Act with a number of other issues. First, the Internet Tax Freedom Act does not address Internet sales tax issues. While the Internet Tax Freedom Act does prevent states from imposing multiple and

discriminatory taxes on electronic commerce, the Act does not address the much debated topic of state taxation of out-of-state Internet sales. Second, the Act does not prohibit states from taxing Internet telephony services. The law only bars taxes on Internet access and services incidental to Internet access, such as e-mail and instant messaging. In 2004, Congress clarified the law specifically to exclude voice over IP (VoIP) services from this ban. Third, the Act neither supports nor opposes net neutrality. The net neutrality debate is about whether telecommunication providers can provide various tiers of service to different content providers, and the effect this would have on consumers.⁴ The Internet Tax Freedom Act does not address any of these non-related issues.

Why the Internet Tax Freedom Act should be made permanent

The Internet Tax Freedom Act has contributed to nine years of economic growth. By reducing the cost of Internet access, Congress has made it more affordable for Americans to go online and share in the benefits that come from Internet access. As we move towards a future in which Internet access is a prerequisite to participating in the global digital economy, we need to ensure that no American is left behind. 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. Broadband adoption creates many positive benefits for society. While basic Internet access allows people unprecedented access to information resources and communication tools, broadband expands the potential of the Internet by enabling many new applications. For example, broadband allows more people to benefit from bandwidth intensive applications such as telework, telemedicine and online learning. Many of these new applications not only offer conveniences for consumers, but

they also provide significant benefits to companies and society. For example, telework reduces transportation time and costs for commuters, creates a more productive workforce for companies, and results in lower amounts of traffic, pollution and oil consumption for society.⁵

Unfortunately, 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 2007.⁶

commerce, education, government services, and civic participation. For example, the federal government has undertaken a significant initiative to expand its e-government services,⁷ 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.⁸

Broadband in particular creates many opportunities for businesses to operate more efficiently. For

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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

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.⁹ 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.¹⁰ As a result, almost every state offers some form of a sales tax exemption on the purchase of new equipment.¹¹ In addition, 40 percent of states provide a general, state-wide tax credit for companies to invest in machinery and buildings.¹² Since states already support tax exemptions and even 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.

Legislative History

A review of the legislative history helps put today's debate in context. In 1998, Congress enacted the Internet Tax Freedom Act¹³ which established a three year moratorium on certain taxes. Specifically, the Act prohibited state and local tax authorities from imposing taxes on Internet access and multiple or discriminatory taxes on electronic commerce. The Act provided an exception for states that had already imposed taxes on Internet access prior to October 1, 1998. In addition, the Act established the Advisory Commission on Electronic Commerce, a group of 19 members from federal, state and local government, and the electronic commerce industry, to conduct a thorough study of the effects of state and local taxation on Internet access and Internet transactions.

The Commission delivered its report to Congress on April 12, 2000.¹⁴ Regarding the moratorium established by the Internet Tax Freedom Act, the report included the following recommendations:

- “Extend the current moratorium on multiple and discriminatory taxation of electronic commerce for an additional five years through 2006.”¹⁵
- “Make permanent the current moratorium on Internet access taxes, including those access taxes grandfathered under the Internet Tax Freedom Act. This proposal is another crucial initiative, targeted to reduce the price of Internet access, and to close the digital divide. By expanding the moratorium to eliminate the current grandfather provision, consumers across the country would participate in electronic commerce without onerous tax burdens.”¹⁶

In 2001, Congress passed the Internet Tax Nondiscrimination Act¹⁷ that renewed the moratorium through November 2003. However, states did not back down from their attempts to tax Internet access and they turned their efforts to exploiting loopholes in the moratorium. For example, by 2003 at least 15 states had enacted legislation to tax Internet access when it was bundled with traditional voice services. In addition, Alabama, Florida and Kentucky decided to classify DSL Internet service as a telecommunication service so that it would be subject to taxation under state laws.¹⁸

In 2004, Congress passed a new version of the Internet Tax Nondiscrimination Act¹⁹ that extended the moratorium through November 2007.²⁰ In addition, the Act included a number of other reforms. First, Congress attempted to close the loophole that allowed states to classify DSL as a telecommunication service so that they could impose state taxes. While the original law stated that the term “Internet access” excluded telecommunication services, Congress redefined the term to exclude telecommunication services “except to the extent such services are purchased, used, or sold by a provider of Internet access to

provide Internet access.”²¹ Under the new definition, states could no longer classify DSL as a telecommunication service and then claim the Internet tax moratorium did not apply. Second, the Act created a temporary exemption for taxes that were enacted during the moratorium. The exemption for these taxes expired on either November 1, 2005 or November 1, 2006, depending on how and when the states had created the new taxes. For example, states were given until November 1, 2006 to stop collecting taxes on telecommunications service “applied to Internet access through administrative code or regulation issued on or after December 1, 2002.”²² Third, the Act contained a grandfather clause for all other taxes that had been enacted prior to 1998. This provision allowed states to continue to collect taxes enacted before 1998. Fourth, to address concerns that ISPs could bundle Internet access with other telecommunication services to avoid taxation, the Act explicitly stated that Internet access, when bundled with other services, was subject to taxation unless the charges for Internet access could be reasonably identified.²³ Fifth, the Act clarified that this law does not apply to Internet telephony, such as VoIP, but that services incidental to Internet access, such as voice-capable e-mail or instant messaging, are covered by the law. Sixth, the Act stated that the ban on taxes does not prohibit universal service fees or 911 service charges. Finally, the Act required the Government Accountability Office (GAO) to conduct a study of the impact of the Internet tax moratorium on the revenue of State and local governments, on the adoption of broadband throughout the United States, and on the deployment of broadband in rural underserved areas of the country.²⁴

In response to this Act, GAO published two reports: “Internet Access Tax Moratorium: Revenue Impacts Will Vary by State” (GAO-06-273), and “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 “Internet Access Tax Moratorium: Revenue Impacts Will Vary by State” (GAO-06-273), GAO looked at the impact on revenue for states as a result of the moratorium. The report concluded that “because it is hard to know what states would have done to tax access services if no moratorium had existed, the total revenue implications of the moratorium are unclear.” This conclusion is supported by the fact that some states that could tax Internet access under the grandfather clause, such as Hawaii, later opted to forgo this taxation and implement their own statewide version of the Internet Tax Freedom Act.²⁵ GAO also responded to the claim made by opponents of the law that an ISP could bundle multiple non-incidental services together to avoid taxation under the moratorium. GAO flatly denied this claim. Instead, they reported that “a tax-exempt bundle does not include video, traditional wireline telephone service referred to as ‘plain old telephone service’ (POTS), or VoIP. These services are subject to tax.”²⁶

This report also addressed a dispute between some states and ISPs over the scope of the moratorium, specifically on the definition of Internet access. At issue was whether or not the underlying transport services acquired by ISPs, such as “high-speed communication capacity over wire, cable, or fiber to carry traffic from customers to the Internet backbone,”²⁷ were exempt from taxes under the moratorium. GAO stated that the way the law is currently written the “Internet tax moratorium only bars taxes on Internet access services provided to end users” and does not prevent states from taxing acquired services.²⁸ While this interpretation is still under dispute, there is no dispute that taxes on transport raise the cost of Internet access for consumers. Furthermore, attempts to tax transport violate the intent of the moratorium and represent a fundamental misunderstanding of the relationship

between the physical connection and the Internet service when using broadband.

When Congress first enacted the Internet Tax Freedom Act in 1998 the distinction between the service and the connection was clear. Dial-up was the predominant form of Internet access and broadband only accounted for one percent of online households.²⁹ With dial-up Internet access, users connect to their ISP using a traditional telephone service. Telephone service can be taxed under the moratorium because it is not used

In the second report, GAO addressed another criticism still being raised today by opponents of the Internet Tax Freedom Act that taxes on Internet access do not affect broadband adoption. GAO reported that “the imposition of the tax was not a statistically significant factor influencing the adoption of broadband service at the 5 percent level.”³¹ However, GAO did find that the tax was statistically significant at the 10 percent level.³² These confidence intervals are used by statisticians to indicate the precision of a measurement or estimate. For example, this means that in 90 out of 100 cases, we can expect the tax on Internet access

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exclusively for Internet access. For example, it can be used for voice and data transmissions. Broadband services use a high-speed channel that is dedicated exclusively for Internet access. For example, DSL works by separating transmissions on the copper-wire telephone line into two channels: a low frequency channel for traditional telephone signals and a high frequency channel for high-speed data signals. Customers can only use the high-speed channel for DSL Internet access, and it has no value on its own without the corresponding DSL service. With broadband, the connection cannot be separated from the service and both should be tax-free under the moratorium. Attempts to tax the physical connection between the ISP and the consumer violate the intent of the Act that Internet access be tax-free. At least four states, including Illinois, New Hampshire, Pennsylvania and Washington, currently impose taxes on ISPs when they purchase the DSL circuits that connect the ISPs to their customers. ISPs pass these taxes directly on to their customers through either a monthly tax recovery fee or higher rates.³⁰ As a result, we recommend that Congress clarify that the ban on taxes for Internet access includes the underlying transport.

to affect broadband adoption. This is important because the average tax rate on telecommunication services is 13.5 percent, more than twice the average tax rate on all other goods and services.³³ GAO reported that the “price of broadband service remains a barrier to adoption of broadband service for some consumers” and noted that “households with high incomes were 39 percentage points more likely to adopt broadband than lower-income households.”³⁴ They also reported that one of the most important factors for companies considering deploying broadband to an area was the expected demand for broadband service.³⁵ Since adoption rates drive demand, not only do Internet access taxes affect the ability of citizens to afford Internet access, but they could also discourage some companies from deploying broadband. This conclusion is supported by recent research by Austan Goolsbee, a leading economist at the University of Chicago. Goolsbee found that “in several medium sized markets, applying a tax on broadband would have reduced the potential producer surplus enough that suppliers would not be able to cover their fixed costs and would choose to delay the diffusion of broadband in those markets.”³⁶

Current Legislation

Congress has twice renewed the moratorium - in 2001 and again in 2004. The moratorium will expire in November 2007 unless the Act is either renewed or made permanent. There are currently two competing proposals for extending the moratorium. First, the Permanent Internet Tax Freedom Act of 2007 (S. 156, H.R. 153) would not change the current language of the law and would simply make the current moratorium permanent. In addition, the Act would allow the grandfather clause to expire for states currently taxing Internet access. Second, the Internet Tax Freedom Extension Act of 2007 (S. 1453) would create a four year extension to the current moratorium. In addition, the Act would continue to exempt the states that currently tax Internet access. Finally, the Act seeks to narrow the definition of "Internet access" to specifically exclude video over IP and any other non-incidental services.

Opposition

Critics of the Internet Tax Freedom Act have raised a number of arguments but have failed to show why states should be taxing Internet access. First, detractors say that the Internet is no longer a nascent technology in need of government protection.³⁷ The premise of this argument is true, but the conclusion is false. As we have shown, the reason to encourage Internet adoption is not to protect a nascent industry, but rather to promote investment in a key enabler of our digital economy. The Internet has taken on an important role in the digital economy and a federal policy is needed to spur investment in broadband. Our current decline in broadband adoption rankings compared to other OECD countries shows that a federal policy is needed to ensure more robust broadband adoption.

Second, opponents of the Internet Tax Freedom Act state that the moratorium is "disruptive" and

poses "long-term dangers for state and local fiscal systems."³⁸ Some states fear that Internet service providers will take advantage of the law by bundling various products together as part of an Internet access package to try to avoid taxes. This argument ignores the fact that the law already allows states to tax bundled services if the ISP does not clearly identify the charge for Internet access. However, to put this argument to rest and to assure states that the law will not be abused, we recommend Congress clarify that "incidental services" do not include subscription video services.

Third, various state and local representatives claim that eliminating the grandfather clause will be costly to the state and local governments that currently tax Internet access. As previously stated, extending the Internet Tax Freedom Act to all states would only cost nine states approximately 0.1% of their combined tax revenue. Furthermore, by reducing taxes on Internet access, more consumers will be able to afford to go online and take advantage of the benefits and cost-savings of Internet access. The network effect of having more citizens online creates positive externalities that translate into economic benefits for the entire country.³⁹ Since the benefits of fostering investment in online services extend to all states, the Act should not contain exceptions for certain states.

Fourth, some people claim that Internet access is simply a consumer good that does not deserve any special protection. However, Internet access is not a consumer good such as an iPod or a DVD player, but rather it is a key enabler of many applications and services.⁴⁰ For example, Internet access allows citizens to access government services, participate in online learning, and benefit from telemedicine.

Furthermore, it is the fundamental building block of our national digital economy, and Congress should eliminate barriers that prevent Americans from joining their fellow citizens online.

Finally, with no arguments left in their reserve, critics fall back on the claim that it would be prudent to act cautiously and only extend the moratorium for a few more years to ensure Congress continues to review its effectiveness. While oversight is an important function of Congress, that does not mean the Internet Tax Freedom Act needs to be reviewed every few years. The fundamental question we are asking every time the Act comes up for renewal is “Is the Internet a public good that the federal government should be supporting?” In 1998 perhaps there was still some healthy skepticism that the Internet would not be the transformative technology that it is today. However, that was nine years ago, and looking forward we can predict with relative certainty that the Internet will be a critical part of our country’s future. More importantly, we can say that access to the Internet will be a fundamental necessity for all citizens, and Congress should act now to ensure all Americans have unfettered access to this basic public good.

Policy Recommendations

There are a number of steps Congress should take to expand and reform the Internet Tax Freedom Act.

First, Congress should make the current moratorium on taxes for Internet access permanent. Internet access provides a number of benefits including access to government services, online learning, and e-commerce. Given that Internet access is a prerequisite for participating in our digital society, Congress should prohibit states from placing barriers that prevent Americans from getting online.

Second, Congress should permanently prohibit multiple and discriminatory taxes on electronic commerce. E-commerce benefits consumers by providing them with lower prices and more choices.⁴¹ Discriminatory taxes unfairly disadvantage e-commerce by subjecting it to

technology-specific levies, thereby reducing competition and innovation. Congress should permanently eliminate these taxes to ensure that states do not restrict the growth of e-commerce.

Third, Congress should eliminate the grandfather clause, which allows certain states and local jurisdictions to impose taxes on Internet access and online services. The prohibition on taxes on Internet access should be consistent across all states and not reward states that early on imposed taxes on Internet access.

Fourth, Congress should clarify that the ban on taxes for Internet access includes the underlying transport services acquired by ISPs and does not include non-incident services such as subscription video services. States have exploited the Act’s current wording to enact new taxes. First, taxes on telecommunication services acquired by ISPs to provide Internet access violate the intent of the Act by directly raising the price of Internet access. Congress should clarify that the Act exempts these acquired services from taxes. Second, opponents of extending the current moratorium repeatedly cite fears that new services, such as video distribution over the Internet, will be exempt from state taxation under the current law. To separate these issues, we encourage Congress to clearly exempt non-incident services from the Act.

Conclusion

In 1998 Congress passed the Internet Tax Freedom Act in the hope that the Internet and e-commerce would contribute to American prosperity. Nine years later we now know that Internet access directly contributes to the significant gains in growth and productivity that we have seen in our economy. Congress should recognize that Internet access will only become an increasingly basic necessity over time, and it should make the moratorium permanent.

Endnotes

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