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Written Testimony of
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Internet Tax Freedom Act: Internet Tax Moratorium
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Chairwoman Sanchez, 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 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 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.