U.S. House of Representatives
Committee on the Judiciary

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Before the Judiciary Committee
Subcommittee on Commercial and Administrative Law
U.S. House of Representatives on
The Internet Tax Freedom Act: Internet Tax Moratorium
May 22, 2007

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 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 initiatives. 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 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.