Revenue Impact on State and Local Governments of Permanent Extension of the Internet Tax Freedom Act

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Short-Term Fiscal Impact of H.R. 49 as Approved by the House Judiciary Committee and Comparison with Impact If the Bill Were Amended to Reflect Congressional Intent

Based on the best available information, H.R. 49—by preempting a variety of activities that go beyond access by customers to the Internet and by expanding the scope of the preemption to income, property and other business taxes—will reduce revenues from current taxes levied by the 50 states, the District of Columbia and local governments a minimum of $4 billion and up to $8.75 billion annually by 2006. Whether the losses rise to the higher level depends on the outcome of anticipated litigation over the provisions of H.R. 49 if enacted.

The estimates above are conservative because they do not include the full impact of services, information and content that can be exempted from tax by being bundled with Internet access or offered as a service over the Internet.

In contrast, if the language of H.R. 49 were amended to conform to Congress' intent of preempting only sales taxes on solely Internet access to customers, including broadband, and extending the preemption to "grandfathered" sales taxes of certain states, the cost to state and local governments would be limited to approximately $500 million in 2006. This estimate is based on amending the language to reflect the original intent of the Internet Tax Freedom Act, with modifications to reflect the objectives of technological neutrality and national uniformity expressed in the deliberations of the House Judiciary and Senate Commerce Committees. However, the current language of H.R. 49 has a much broader scope and impact than what appears to be Congress' intent.

Long-Term Fiscal Impact of H.R. 49 as Approved by the House Judiciary Committee

H.R. 49 will eventually exempt all or nearly all of the telecommunications industry from major state and local taxes: sales, excise, income, property and other taxes. The date when the virtual exemption from state and local taxes occurs depends on the speed at which the industry completes the conversion of its services to the Internet—a technological change now clearly underway. The point of virtually complete exemption from state and local taxes will occur earlier in some states and localities than others. If the current language of H.R. 49 had been in effect in 2002 and if the industry had completed the transfer of its services to the Internet, the revenue loss to state and local governments would have been $22 billion.

A fundamental change is occurring in the telecommunications industry that will enable it to qualify its services as "Internet access" and thus eligible for a state and local tax exemption

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under the current terms of H.R. 49. The traditional telephone system is in the process of being replaced by the Internet operating at increasingly higher speeds. *Business Week* magazine reports that Verizon is basing its future business plan on the "conviction that telecom as we know it is history. In its place will emerge a 'broadband industry' that will use the new, superfast Net links and high capacity networks to deliver video and voice communications with all the extras."[2] *The Wall Street Journal* reports that MCI by year-end will have moved 25% of its voice traffic to the Internet backbone and by 2005, plans to have 100% of the voice traffic there.[3] In this article, MCI Senior Vice President Vint Cerf (one of the original co-authors of the TCP/IP formula) discusses the future of telecommunications in terms of how some day customers will buy all voice services for one flat rate when "voice will be just one more application traveling . . . across the Net."[4]

Under existing law, telecommunication services were excluded from the definition of Internet access and thus not within the scope of the preemption of state and local taxes. Under the current language of H.R. 49, telecommunications would benefit from the tax preemption to the extent that they provide Internet access. As noted above, all telecommunications will eventually qualify as Internet access as they become a service offered over the Internet. When that point is reached—and the transition is unfolding rapidly—telecommunications will be exempt from all major state and local taxes.

Functional Impact on State and Local Governments

The revenues that would be preempted under this proposed legislation can also be thought of in terms of what public services could be affected. For example, the National Center for Education Statistics projects that it will cost state and local governments $8,557 for each pupil enrolled in public elementary and secondary schools in 2005.[5] Every $1 billion that would be preempted by this proposed legislation, and not made up by other revenues, or reductions in other services could have been used to provide education for nearly 117,000 pupils. Similarly, at 2001 compensation rates, each $1 billion in state and local revenues preempted by this legislation translates to nearly 20,000 fewer policemen on "the beat" or nearly 20,000 fewer firefighters, or more than 27,000 hospital workers. Similarly, for each $1 billion preempted, there could be nearly 25,000 fewer instructional staff in public elementary and secondary schools or more than 17,000 fewer instructional personnel in college classrooms and laboratories (Summary Table 1).[6]

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[2] Steve Rosenbush with Tom Lowry, "Verizon's Gutsy Bet," *Business Week Online*, August 4, 2003.
[3] Holman W. Jenkins, Jr., "Internet Pioneer Meets the Telecom Wars," *The Wall Street Journal Online*, August 6, 2003.
[4] Ibid.
[5] U.S. Department of Education, National Center for Education Statistics, ***Projections of Education Statistics to 2011***, May 2001, Table 33., http://nces.ed.gov/pubs2001/proj01/tables/table33.asp
[6] U.S. Bureau of the Census, ***Public Employment in 2001***, ttp://www.cbo.gov/showdoc.cfm?index=4434&sequence=0

Summary Table 1 Full-time Equivalent Personnel Per $1 Billion of State and Local Revenue: 2001	
Function	
Police With Arrest Power	19,895
Firefighters	19,922
Hospital Personnel	27,027
Instructional Staff	
Elementary and secondary Education	24,762
Higher Education	17,358
Source: U. S. Bureau of the Census, Public Employment, 2001, and Multistate Tax Commission calculations.	

Summary of Fiscal Estimate Data

Short Term Fiscal Estimates

The Summary Table below presents the data for the short-term fiscal estimates and the assumptions on which they are based.

Row 1 row presents data for the estimate that the current language of H.R. 49 will cost state and local governments a minimum of $4 billion from current taxes. Row 2 presents data for the estimate that the current language could cost up to $8.75 billion in revenue, again, from current taxes. Row 3 presents the estimate for the slightly more than $500 million cost to state and local governments of a permanent preemption of only sales taxes on solely Internet access—the result if the language of H.R. 49 were amended to reflect Congress' intent. The footnotes in the table detail the types of taxes affected and the types of telecommunications services that would be exempted in the short-term.

Summary Table 2 Short-Term Fiscal Impact in 2006 of Extension of Internet Tax Preemption under Three Assumptions[1] (millions of dollars)			
Assumptions	Total Preempted Taxes	Trans-actions Taxes[2]	Business Taxes[3]
1. H.R. 49: Ambiguities Interpreted Moderately by Courts[4]	$3,977	2,074	1,903
2. H.R. 49: Ambiguities Interpreted More Broadly by Courts[5]	$8,751	5,091	3,660
3. Legislation Amended to Conform to Congressional Intent to Preempt Sales Taxes on Only Internet Access[6]	$529	529	

1. These estimates do not include the full impact of services, information and content that can be bundled with Internet access or offered as another service over the Internet. They also do not include potential transactions taxes that state and local governments could impose if the current moratorium were allowed to expire because such estimates would not reflect any losses from current taxes.
2. Includes gross receipts taxes, consumer sales taxes, 911 fees, and other transactions taxes.
3. Includes sales taxes on business inputs, property taxes, capital stock taxes, and business income taxes,
4. Internet access plus Voice over Internet Protocol (VoIP) and wireless communications over the Internet (WoIP) +Internet backbone services.
5. Internet access, VoIP, WoIP, and other telecommunications services interpreted as an "other service offered over the Internet"
6. Internet access clearly defined as a service that connects retail users to an initial point of presence on the Internet by any means, including DSL and wireless access. Preemption limited, as under current law, to only sales and other transaction taxes, but extended to those states currently allowed to collect preexisting transactional taxes on Internet access.

Long-Term Fiscal Estimate

Because the date when the telecommunications industry converts its services to operate over the Internet is not known at this time, this paper places in perspective the impact of a virtually complete exemption for the industry from state and local taxes by estimating the total amount of taxes paid by the industry in 2002. This amount was projected by adding to total state and local telecommunications taxes, other than corporate income taxes, in 1999 an estimate of such income taxes and then projecting that amount forward to 2002. The estimated amount of total state and local telecommunications taxes in 2002 is $22.3 billion.[7]

[7] Robert Cline, "Telecommunications Taxes: 50-State Estimates of Excess State and Local Tax Burden," Tax Analysts, **State Tax Notes**. June 30, 2002, p. 932; and IRS Statistics of Income, **Corporate Income Tax Returns, 1999.** State corporate taxes for telecommunications companies were assumed to be 20% of the federal tax liability of those companies.