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A Scare for the Web: Will Congress Let the Internet Tax Ban Expire?

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Unless Congress intervenes, this Halloween will be an especially scary one for U.S. Internet users. At midnight on October 31, the federal ban on Internet taxes expires, loosing state and local governments to tax Internet services received by Americans. The House of Representatives last week voted to extend the tax ban another four years, but it refused to make the ban permanent. The issue is now before the Senate. Since it was adopted nine years ago, the Internet tax ban has proven to be sensible and successful. Rather than let it expire, Congress should make the ban permanent.

Background. The ban on Internet taxes was first imposed in 1998, when Congress adopted a three-year moratorium on state and local taxation of "Internet access." "Multiple" and "discriminatory" taxes were also banned. The moratorium, with some modifications, has been extended twice, in 2001 and 2004.[1]

The extent of the moratorium is often misunderstood. It does not exempt Internet providers from most taxes of general applicability, such as corporate income taxes or property taxes, and does not exempt Internet sales from general state sales taxes, although the collection of such taxes from out-of-state vendors is problematic.[2] It does prohibit all taxes on Internet access services—such as AOL accounts. Surcharges on Internet bills like those often present on cell phone bills, for example, are prohibited, as are "bit" taxes based on Internet usage. In addition, any taxes that single out Internet services or transactions for special or higher fees are also banned.[3]

On October 16, the House of Representatives approved legislation, H.R. 3678, to once again extend the tax moratorium—this time until 2011. The Senate is considering similar legislation, and a group of Senators, including John Sununu (R–NH), Ron Wyden (D–OR) and John McCain (R–AZ) have proposed legislation (S. 156) to make the tax ban permanent.

Internet Growth. Since the moratorium first went into effect, the Internet has expanded its reach beyond the imaginings of 1998, growing from a promising new technology to an integral part of the U.S. economy and American society. Nine years ago, fewer than 40 percent of Americans were online, and "dial-up" service was virtually everyone's sole means of accessing the Internet. Today, some three-quarters Americans use the Internet, and close to half do so through broadband connections—usually DSL lines or cable modems.[4] The Internet has been a key driver of growth and productivity gains in the national economy. And the economic benefits are matched by the social benefits of the digital economy—in education, health care, and civic participation.

Political Externalities. This success, however, would be threatened if state and local tax collectors

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are allowed to target the Internet for taxation. Many opponents of the Internet tax ban argue that it violates principles of federalism; Washington, they say, should not second guess state tax policy decisions.[5] But in this case, there is a legitimate role for federal rules. The Internet, by its nature, is an interstate—in fact, global—network. Bad policies in one state are borne not just by that state's citizens, but by citizens of all states, as well. This "political externality" can be direct—such as taxes imposed on firms based predominantly out-of-state—or indirect—such as slowing the growth of the Internet and decreasing its benefits for the whole country. In such cases, federal intervention is justified.

It is difficult, of course, to predict what kind or what levels of taxes would be imposed if the federal ban expires. The revenues currently collected by several states' "grandfathered" Internet taxes are relatively small, comprising about 0.1 of the combined tax revenue for the states involved.[6] But how high would the taxes be if there were no federal limits? Based on taxes on other communication services, it could be quite high. Wireless phone subscribers, for example, pay almost 12 percent of their monthly bill in taxes, and wire-line phone customers pay close to 17 percent.[7]

It is also difficult to predict what effect taxation of this sort would have; much depends on the details of the tax plans adopted. One particular concern, however, is the effect taxation could have on subscribership to broadband services. While the number of Americans subscribing to such services has been growing rapidly, taxes on access could slow that growth—especially among low-income consumers. With governments at all levels spending millions to subsidize broadband access, and more subsidies being proposed regularly, such a result would be perverse.

This does not mean that the Internet should receive preferential tax treatment. Good tax policy should not favor any particular industry or economic activity, no matter how important it may be. But equally, policymakers should not target any sector with disproportionately heavy taxes. In other words, the Internet need not be taxed less than other parts of the economy, but it should not be taxed more, either.[8]

The Need for Permanence. Congress should make the moratorium permanent, rather than simply extending it once again. Requiring yet another renewal debate in 2011, as provided in the House bill, would only lead to uncertainty for Internet firms, consumers, and investors, limiting the ability for access providers and customers to make long-term plans and investments. There is little to be gained by requiring Congress to review the ban again. In effect for nearly ten years, the ban is hardly untested. Of course, Congress would, as always, retain the power to change the terms of the moratorium, if necessary.

1. See James L. Gattuso, "The Internet: Why the Taxman Should Not Cometh," Heritage Foundation *Webmemo* No. 362, November 7, 2003, at *www.heritage.org/Research/InternetandTechnology/wm362.cfm*.
2. An interstate compact intended to address this problem has been drafted but has not been agreed to by a sufficient number of states to allow it to take effect. Any such compact would also have to be approved by Congress. See Adam D. Thierer and Veronique de Rugy, "The Internet Tax Solution: Tax Competition, Not Tax Collusion," Cato Institute *Policy Analysis* No. 494, October 23, 2003, at *www.cato.org/pubs/pas/pa494.pdf*.
3. Certain state and local taxes which were being collected before the bans went into effect have been permitted to continue under "grandfather" provisions in the law.
4. Mary Madden, "Internet Penetration and Impact," Pew Internet and American Life Project *Data Memo*, April 2006, at *www.pewinternet.org/pdfs/PIP_Internet_Impact.pdf*, and John B. Horrigan, "Home Broadband Adoption 2007," Pew Internet and American Life Project *Data Memo,* June 2007, at *www.pewinternet.org/PPF/r/182/report_display.asp*.
5. See Senators George Allen and Lamar Alexander, "Federalism and the Internet Tax: A Conflict of Two Conservative Principles?" Heritage Foundation Event, February 12, 2004, at *www.heritage.org/Press/Events/ev021204a.cfm*.
6. Government Accountability Office, "Internet Access Tax Moratorium: Revenue Impacts Will Vary by State," GAO-06-293, January 2006, p.3.
7. These figures include taxes from all levels of government. David Tuerck, Paul Bachman, Steven Titch, and John Rutledge, "Taxes and Fees on Communication Services," Heartland Institute *Policy Study* No. 113, June 2007, at *www.heartland.org/Article.cfm?artId=21104*.

The federal restriction on taxes on the Internet has proven sensible and successful. Rather than let it expire, policymakers should make it permanent.

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8. As noted above, current law does not exempt the Internet from most taxes of general applicability. However, all taxes on Internet access service are banned, even if the tax in question applies generally to all businesses. Thus, for instance, Internet access services are exempt from general "gross receipts" taxes that may apply to firms providing other types of services. The House legislation would narrow this protection and allow such taxes if certain conditions are met. The bill includes a requirement that any such tax be imposed on a "broad range" of business activity and that the tax not be "discriminatory to providers of communications services." This seems reasonable. At the same time, there are strong policy reasons why state tax officials should avoid gross receipts taxes for any economic sector. See Patrick Fleenor and Andrew Chamberlain, "Tax Pyramiding: The Economic Consequences of Gross Receipts Taxes," Tax Foundation *Special Report* No. 147, December 4, 2006, at *www.taxfoundation.org/news/show/2061.html*.