Pro-Taxes or Pro-Internet?

October 17, 2007

Pro-Taxes or Pro-Internet?

October 17, 2007

By Rep. Anna G. Eshoo, Robert Atkinson and James Gattuso

The Hill

In 1998, Congress passed the Internet Tax Freedom Act, establishing a moratorium on all new taxes on Internet access. The Internet has changed tremendously since then, with the number of Americans online tripling and broadband use soaring from virtually zero to over 50 percent. Experts disagree about whether this growth is fast enough, or inclusive enough. But on one point there is surprising consensus across the ideological spectrum: The Internet tax moratorium has been a success. And letting it expire - as it will do this November unless Congress acts - would be a step in the wrong direction.

The importance of the Internet is hard to overestimate. It has been a key driver of growth and productivity gains in the national economy, with the U.S. economy almost $2 trillion larger than it would be without the post-1995 IT revolution. And the economic benefits are matched by the social benefits of the digital economy - in education, in health care, and in civic participation in democracy itself.

It is in this context that making permanent the moratorium is so important. Unfortunately, there is considerable confusion about what the proposed legislation does and does not do. To be clear, the Internet Tax Freedom Act does not ban states from imposing sales taxes on products purchased online, although states do face practical difficulties in collecting sales taxes on out-of-state Internet transactions. Nor does it preclude states from continuing to tax (at relatively high levels) telephone and cable TV service, even if those services are bundled with Internet access. What it does do is ban the imposition of taxes on Internet access and "multiple" or "discriminatory" taxes that states and localities might impose because of the Internet's inherent cross-border nature.

The idea of making the tax ban permanent, or even extending it for another several years, has - predictably - been strongly opposed by state tax collectors, who worry about the revenue losses. How substantial these losses are is a matter of debate. The access fees currently imposed under the grandfather clause constitute only 0.1 percent of the combined tax revenue for the nine states involved. Potentially, the long-term revenue loss could be significantly higher if states sought to impose the kinds of taxes on Internet access that are now imposed on most other telecommunications services. Some point to fees on cell phones - which approach some 20 percent of the typical bill - as a benchmark. For consumers, however, tax levels of this magnitude are hardly reassuring, and raising the price of broadband Internet access would make it harder to close the digital divide.

State officials, nevertheless, call this an issue of federalism - arguing that Washington shouldn't second-guess their tax policy decisions. But in this case, there's a legitimate role for federal rules. The Internet, by its nature, is an interstate - in fact, global - network. States have an incentive to tax Internet access because they receive all of the tax revenues as a benefit, but the net social cost of lower rates of Internet access extends beyond the states' borders to affect the entire nation. 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 that come with Internet access. The network effect of having more citizens online creates positive externalities that translate into economic benefits for the entire country. In this case, bad policies in one state are borne not just by that state's citizens, but by citizens of other states as well. This "political externality" can be direct - by taxing firms that are disproportionately based out-of-state - or indirect, by simply slowing the growth of the Internet, and decreasing its benefits for the whole country. In this case, federal intervention is not only justified, it's necessary.

The ban on special taxes on the Internet has proven to be sensible and successful. Rather than let it expire, policymakers should make it permanent.

Eshoo is a member of the House Energy and Commerce Committee and sponsor of H.R. 743, the Permanent Internet Tax Freedom Act, which has 242 bipartisan co-sponsors; Atkinson is president of the Information Technology and Innovation Foundation; Gattuso is the senior research fellow in regulatory policy in the Roe Institute for Economic Policy Studies at The Heritage Foundation.