TAX FOUNDATION

Since 1937

Taxing Talk: The Telephone Excise Tax and Universal Service Fees

BY STEPHEN J. ENTIN
EXECUTIVE DIRECTOR
AND CHIEF ECONOMIST
INSTITUTE FOR RESEARCH ON THE
ECONOMICS OF TAXATION

MARCH 2000

BACKGROUND PAPER NO. 34

Table of Contents

Executive Summary

Enacted in 1898, the federal telephone excise tax was part of a package of new and increased excise taxes levied to finance the Spanish American War. At that time, Congress had to rely on tariffs and excise taxes for war revenue because it did not yet have the income tax at its disposal.

Over the decades, the telephone excise tax has been phased down several times, and even scheduled for outright elimination, only to be boosted to help pay for various emergencies. Every war we fought during the 20th century was used to raise or extend the tax. It got as high as 10 percent in 1966 when President Johnson persuaded Congress that it was a good way to help pay for the Vietnam War. During the 1980s, the tax was scheduled to expire several times, but the concern over budget deficits came to its rescue, and the Revenue Reconciliation Act of 1990 made the tax permanent at three percent.

The telephone excise is one of a host of explicit excise taxes the federal government imposes on various goods and services. An excise tax raises the absolute cost of obtaining a product, which of course makes it more expensive compared to other goods and services. Because of this price distortion, consumers under-utilize the taxed product and over-consume others. The result is a net loss in economic efficiency and satisfaction compared to what would occur if the government raised the same revenue from a more broadly based, less distorting tax.

Perhaps just as economically destructive as the explicit excise tax is the pattern of government interference with market activity through implicit, largely hidden price controls. These regulations tax some users to subsidize others, which is especially unfair when the cross-subsidies are mandated without regard to the incomes of the payee or payor.

The telecommunications industry is saddled with all of these forms of market intervention. There is an explicit federal excise tax of three percent on telephone service. In addition, the "universal service program" imposes hidden charges and subsidies that boost the price of telephone service for some subscribers to hold down the price for others.

The telephone excise and all its attendant taxes, charges, and subsidies violate basic economic principles and should be abolished.

Rationalized at its inception as a luxury tax, the telephone excise has more recently been called a user fee, but it is by no definition a proper user fee. The telephone excise and all its attendant taxes, charges, and subsidies violate basic economic principles and should be abolished.

Congress and the President should stick to sound budget and tax principles, collecting revenue through broad, non-distorting taxes, not through selective excise taxes. Where subsidies are deemed necessary, they should be provided through explicit outlays

The universal service program should be replaced by a more rational system of assistance that focuses on boosting the income of needy individuals rather than attempting to regulate the price of telephone services by geography, provider, and type of consumer.

in the federal budget, readily visible for all to see, funded through general revenues, and based on individuals' needs. There should be no mandates imposed on private industry, no cross-subsidies of one consumer by another, no hidden taxes, and no nonsense.

Several bills have been introduced in the Congress to repeal or scale back the telephone excise tax or the universal service line fees, and to make any fees that remain more visible to telephone customers.

One would eliminate the three percent telephone excise tax, and another would repeal the school and library portion of the internet access program, which should eliminate the associated fees unless the FCC devises some other rationale and use for them.

One would alter the funding mechanisms for the federal portion of the universal service programs, and yet another would eliminate the FCC's authority to require federal line charges for the schools, libraries, and health provider hook-up program and create a telecommunications trust fund.

Governor James Gilmore (R-VA), chairman of the Advisory Commission on Electronic Commerce, has proposed eliminating the federal telephone excise tax as part of his broader proposal to eliminate and prohibit all internet taxes. This plan would use federal funds to reward states that shift to a single telephone excise tax rate and single collection point during a three-year period.

None of these proposals goes far enough. Keeping the telephone excise tax for any length of time for any purpose invites its permanent retention. Allowing the schools and libraries hook-up program to proceed risks establishing a new entitlement and interest group. It would be better to cancel the excise tax, the hook-up fees and the hook-up program immediately.

More fundamentally, the universal service program itself needs to be eliminated and replaced by a more rational system of assistance that focuses on boosting the income of needy individuals rather than attempting to regulate the price of telephone services by geography, provider, and type of consumer. As long as the universal service program remains in place, it will be a tempting platform on which to erect other tax/transfer programs.

Excise Taxes and Economic Distortions

The federal government imposes explicit excise taxes on a handful of goods and services. The government further interferes with market activity in certain products through implicit, largely hidden price controls that tax some users to subsidize others. These taxes and regulations serve chiefly to distort production and consumer demand, thereby reducing the total value of goods and services that could otherwise be extracted from available resources if the resources were directed to their most efficient uses.

An excise tax raises the cost of obtaining a product above its actual cost of production, and relative to the cost of other goods and services. Because of the price distortion, consumers under-utilize that product and over-consume other products. The result is a net loss in economic efficiency and satisfaction compared to what would occur if the government raised the same revenue from a more broadly based, less distorting tax. Furthermore, fairness suffers when some users of a particular product are taxed to provide a cross-subsidy to other users, without regard to the incomes of the payee or payor.

Fairness suffers when some users of a particular product are taxed to provide a cross-subsidy to other users, without regard to the incomes of the payee or payor.

All such market-distorting taxes and regulations should be repealed. Federal efforts to discourage or encourage production and consumption of specific goods and services are generally unwarranted, and should be eliminated. If the objective is to help the poor obtain needed goods and services, there are more direct and less costly ways of doing so. If the objective is to raise general revenues for the government, they should be obtained through less distorting methods.

Federal efforts to discourage or encourage production and consumption of specific goods and services are generally unwarranted, and should be eliminated.

The telecommunications industry is saddled with all of these forms of market intervention. There is an explicit federal excise tax of three percent on telephone service. In addition, the "universal service program" imposes hidden charges and subsidies that boost the price of telephone service for some subscribers to hold down the price for others. These taxes, charges, and subsidies violate basic economic principles and should be abolished.

The Federal Telephone Excise Tax

The federal telephone tax is now more than a century old. It is high time to lay this discriminatory levy to rest.

In 1876, Alexander Graham Bell invented the telephone. In 1877, physicians in Hartford, Connecticut, built the first private telephone exchange. In 1878, the first commercial telephone exchange was established in New Haven, Connecticut. Twenty years later, there were enough telephones in existence to make it worthwhile to tax them.

In 1898, the Congress created the federal telephone excise tax as part of a package of new and increased excise taxes levied to finance the Spanish American War. At that time, Congress did not yet have the income tax at its disposal to get war revenue. Tariffs and excise taxes were all it had to work with.

In 1898, the Congress created the federal telephone excise tax as part of a package of new and increased excise taxes levied to finance the Spanish American War.... In 1965, Ways and Means Chairman Wilbur Mills argued, "The emergency conditions which gave birth to these taxes have long since disappeared. The taxes have remained to become a source of discrimination among taxpayers."

Over the decades, the telephone excise tax has been phased down several times, and even scheduled for outright elimination, only to be boosted to help pay for various emergencies. The tax was eliminated after the Spanish-American War. It was reinstated on long distance calls in 1914, and helped to finance World War I. It was restored to cover revenue losses during the Great Depression. It was extended to local telephone service in 1941 and helped pay for World War II. It was boosted to help pay for the Korean conflict.

The Excise Tax Reduction Act of 1965 provided for the telephone tax to be phased down and eliminated by 1969, among other excise tax cuts. At that time, Ways and Means Chairman Wilbur Mills argued, "The emergency conditions which gave birth to these taxes have long since disappeared. The taxes have remained to become a source of discrimination among taxpayers."[1]

In 1966, however, President Johnson persuaded the Congress to reverse itself, and to increase the tax from three percent to ten percent to help pay for the Vietnam War. The tax was later scaled back, and was scheduled to expire several times in the 1980s, but was extended year to year until 1990 to help reduce the budget deficit. The Revenue Reconciliation Act of 1990 then made the tax permanent at three percent.

Not a User Fee

Some excise taxes are described as user fees, and are dedicated to facilitating the activity being taxed. The gasoline tax is used to construct and maintain roads. The airline ticket tax funds airports and the air traffic control system. These taxes are dedicated to providing specific services. In fact, the government often fails to spend all the revenues collected for the stated purposes of these taxes, but at least it pays lip service to the concept.

It is a different story with the telephone excise tax. The telephone excise tax is not a user fee. It does nothing to promote phone service. All of it goes into general revenue. It is a pure money raiser.

Not a "Luxury" Tax

In 1898, the telephone excise tax was considered a luxury tax, making it part of a "pro-

[1] 111 *Congressional Record,* June 2, 1965 p. 11870.

gressive" tax system. Only businesses and a few upper-income individuals had telephones, so it appeared that only the rich would pay. (That was the rationale many Congressmen used for supporting the income tax 15 years later, too.) Telephones may indeed have been a luxury for several decades thereafter, but falling costs and rising incomes eventually made them common appliances in most homes. In fact, the tax delayed the general availability of phone service to lower income households by raising the cost of the service, and by slowing the growth of demand, it delayed the achievement of economies of scale and efficiencies related to the density of customers along the lines.

Today, we do not consider a telephone to be a luxury. Rather, having access to a telephone is considered a necessity, so much so that federal and state governments have mandated a complicated system of cross-subsidies among consumers and service providers to encourage universal access, even in high-cost-of-service areas.

In fact, the federal telephone excise tax is generally acknowledged to be regressive. The tax takes a higher percentage of income from low-income households than from upper-income households. For many phone users, it is a tax on a tax; it falls on the total phone bill, including the "universal service" and other access fees charged to businesses and low-cost-area subscribers to subsidize subscribers in high-cost areas.

The telephone excise tax is not a user fee. It does nothing to promote phone service. All of it goes into general revenue. It is a pure money raiser.... The sooner the telephone excise tax is repealed, the better.

Not a "Sin" Tax

Other federal excise taxes, such as those on alcohol and tobacco, are rationalized as "sin" taxes. They are supposedly justified as a means of reducing externalities—the damage done to innocent third parties by the misuse of the dangerous products on which they are imposed. These arguments are shaky, at best.

The Excise Tax Reduction Act of 1965 provided for the telephone tax to be phased down and eliminated by 1969.... In 1966, however, President Johnson persuaded the Congress ... to increase the tax from three percent to ten percent to help pay for the Vietnam War.... The Revenue Reconciliation Act of 1990 ... made the tax permanent at three percent to help reduce the budget deficit.

Those who abuse alcohol and injure others should pay damages to the injured parties, but those who use it responsibly should not suffer a special tax burden. Tobacco injures the user, not the public at large, and the costs are internalized within the user's family, which negates the externality argument. In any event, there is a theory, however wrongheaded, underlying the sin taxes.

The telephone, however, does not generally impose external costs on non-users (unless one counts the unwelcome beep of a cell phone going off at a concert). There is no externality argument to be made. Again, the phone tax is a pure money grabber.

No Excuse, Sir!

As with any excise tax, the telephone tax raises the cost of the goods on which it is imposed relative to other goods and services; it artificially depresses consumption of the affected item, distorts consumption patterns, and reduces the general welfare. The telephone excise tax has no social or economic justification; it should be repealed, the sooner the better.

In 1898, the telephone excise tax was considered a luxury tax. ... Today, a telephone is considered a necessity. ... In fact, the federal telephone excise tax is generally acknowledged to be regressive.

Prospects for Repeal

There are three obstacles to repeal. The tax is often unnoticed by phone subscribers, unless they read their phone bills carefully. The tax owed by each subscriber is small enough not to cause too much grumbling even if it is noticed. In the aggregate, however, the tax brings in roughly $5 billion a year to the Treasury, and is expected to raise more than $6 billion annually by 2002.[2] These amounts make the tax a non-trivial revenue source for the federal government. Under the current budget rules, if the tax were to be repealed, alternative revenues would have to be raised or some federal spending foregone. The simplest and most and logical approach, given the projected federal budget surpluses, would be to modify the budget rules to allow the repeal without any offsetting tax increase. Some specific proposals for repeal or reduction in the excise tax are discussed later in the paper.

[2] U.S. Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2001, Historical Statistics* (Washington, DC: Government Printing Office, 2000), p. 39.

The Universal Service Program: Hidden Taxes and Transfers

The universal service program is a federally mandated effort to ensure that people in all parts of the country have access to "reasonably priced" phone service. (The universal service program is not the only federal program that supports telecommunications access. Some 40 smaller programs, such as the Rural Utility Service, deal with the issue.)[3]

Since the 1934 Telecommunications Act, the federal government has required phone providers to make service "affordable" to users even in high-cost (largely rural) areas. AT&T and other pre-break-up phone service providers were allowed to charge above-cost rates to businesses, long distance callers, and low-cost urban residential subscribers to pay for the provision of service at less than full cost to residential and business users in high-cost areas. As long as there was one major monopoly company, these overcharges could go largely unchallenged by competition.

With the break-up of AT&T, however, the long distance providers were separated from the local phone service companies, and local AT&T service was divided among the regional "Baby Bells." Under the direction of the FCC and the states, a revised universal service program has evolved. It consists of a complex web of inter-company and intra-company transfer payments to assist providers in high-cost areas.

Some of the cross-subsidies are subsumed within the basic rate charges. Companies redistribute costs within their own service areas by charging subscribers the same rates regardless of the cost of servicing their particular locations.

The net inter-company payments flow from long distance providers (within or between states) to local exchange carriers, and among regional providers of local services from companies with largely low-cost service areas to companies with larger numbers of high-cost, rural customers. States are involved as well in an effort to even out cost of service within their borders; they have imposed tolls between regions within states and various access fees on incoming and outgoing intrastate hook-ups to fund subsidies to high-cost areas within states, and to hold down residential service charges.

The 1996 Telecommunications Act continued to formalize and refine these arrangements. All telephone subscribers are required to pay various charges and fees to their local and long distance carriers to fund the universal service program. The fees are allocated to the local exchange companies to enable them to offer service below cost to their subscribers in hard-to-serve regions. Some customers end up being net payers, other net recipients. Customers in low-cost service areas (densely settled regions in the Northeast and most urban areas) pay more into the universal pro-

All telephone subscribers are required to pay various charges and fees to their local and long distance carriers to fund the universal service program. Customers in low-cost service areas (densely settled regions in the Northeast and most urban areas) pay more into the universal program than they receive back in diminished basic phone charges, while customers in high-cost service areas have their net phone bills held down by transfers.

[3] Kent Lassman, "Universal Service Reform: Benchmark For Success," *Capitol Comment,* No. 192, Citizens for a Sound Economy, June 16, 1998.

gram than they receive back in diminished basic phone charges, while customers in high-cost service areas have their net phone bills held down by transfers. Businesses are assessed higher line charges than residential subscribers to hold down residential costs.

The universal service charges are larger than the three percent federal excise tax for many phone subscribers. The excise tax is at least visible ("explicit") on the phone bill. By contrast, the universal service taxes and subsidies mandated by the states may be buried in the basic monthly phone charges. Some charges appear on phone bills as vaguely worded "federal line charges" or "access fees" which are incomprehensible to the subscriber/taxpayer. Most subscribers do not know about the program, let alone whether they are net payers or net recipients.

Approximately $24 billion in universal service charges are collected and redistributed annually. ... Some charges may appear on the phone bills as vaguely worded "federal line charges" or "access fees" which are incomprehensible to the subscriber/taxpayer. Most subscribers do not know about the program, let alone whether they are net payers or net recipients.

Approximately $24 billion in universal service charges are collected and redistributed annually in the federal and state support systems (total inter- and intra-company transfers). About $17 billion are collected under state regulations, and about $7 billion under federally-mandated line charges. These numbers are expected to increase rapidly for a few years to implement the Schools, Public Libraries and Rural Health Care Providers Program, and more slowly thereafter with real growth of telecommunications services.

The President's *Budget of the United States Government, Fiscal Year 2001* lists actual federal outlays under the FCC's universal service fund at $3.3 billion in FY 1999, and estimates outlays of $5.8 billion in 2000, $4.9 billion in 2001, $5.6 billion in 2002, $6.1 billion in 2003, $6.8 billion in 2002, and $7.5 billion in 2005.[4]

The potential for further growth of line access charges and subsidies is unlimited, however. Section 254(c)(1) of the 1996 Telecommunications Act requires the program to provide access to an "evolving level of communications services taking into account advances in telecommunication and information technology and services." In other words, we may be facing an open-ended entitlement to "affordable" services of ever-increasing technological sophistication, such as higher-bandwidth lines supporting faster data transmission, video services, etc.

Although a portion of the program appears in the federal budget, the program is a system of inter-customer and inter-company transfers administered by the National Exchange Carriers Association via its Universal Service Advisory Commission. The universal service program is a zero-sum game for consumers and the industry (broadly defined, including Internet providers under the Internet hook-up program, discussed below); there is no federal revenue injected beyond the line/access charges collected by the industry from its customers. Nonetheless, the universal service program is a federally mandated system of charges and transfers with exactly the same characteristics as an explicit federal tax on some phone users and an explicit federal subsidy to others. One cannot change the nature of a tax or a subsidy merely by farming out its administration to the private sector.

Hiding outlays and taxes is a big breach of sound public policy in a democracy. Government subsidies should be explicit on-budget outlays, debated and appropriated annually, and funded by explicit taxes, so that

[4] U.S. Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2001, Analytical Perspectives* (Washington, DC: Government Printing Office, 2000), p. 645.

taxpayers can see the outlays and decide if the program is worth the cost. Any agreed-upon subsidies should be funded out of general revenues, derived from broad-based, non-distorting taxes. The universal service program fails both of these standards. The revenue that funds it comes from a hidden, narrowly-targeted, highly-distorting tax; and the amount spent on it is not subject to the normal budget review process. The program is especially pernicious when it subsidizes the rich at the expense of the poor.

A Poor Anti-Poverty Program

The bulk of the universal service charges and subsidies are based on geography-related cost differentials, not on the income of the payers or recipients. Within the program there are some needs-based transfers under the lifeline and link-up programs, which subsidize monthly charges and connection fees for eligible low-income people. Nonetheless, the geographically-based universal service program is an extremely clumsy way to help low-income individuals obtain phone service. A widow in urban New York City or Boston scraping by on Social Security pays a federal line fee that helps to subsidize below-cost phone service to ski chalets in rural Aspen or Vail. Urban dwellers may generally be richer than "back-woods" phone users; whether they are generally richer than commuters in "countrified" suburbs or prosperous ranching, mining, timber, or resort operators is another matter. As for the bias against business subscribers, the higher phone costs imposed on businesses are borne by their owners, workers, and customers in the form of lower profits and wages, and higher costs of goods and services, with no way to track the income distribution of the implicit tax.

The rationale for the universal service program is a presumed social goal of having a telephone available to every household, including the poor. By overcharging some customers to subsidize others, the program discourages phone use by some of the poor, and promotes it for others. It is possible that the program has been structured to hold down the cost of basic service by enough to raise the number of households with phone service. However, its charges on incremental use (more message units and long distance calls, caller ID, call forwarding, additional lines, etc.) limit the use of such services. It is difficult to determine the net effect of the program on total demand for phone services, nationwide. The same increase in access to basic phone service for the poor could have been achieved by an explicit federal subsidy or voucher for phone services for the needy, funded out of general revenues, without the distortions and the hit-or-miss nature of the income redistribution of the current program.

Another rationale for universal service is that phone service is more valuable to everyone if everyone is connected to the system. One can then call more people. Universal hook-up is certainly a boon for telemarketers. It is not necessarily the case, however, that the widow in Boston thinks that being able to call a beaver trapper in northwest Montana or a blacksmith in the Texas panhandle is worth paying an extra $8 a month for her phone service.

The geographically-based universal service program is an extremely clumsy way to help low-income individuals obtain phone service. A widow in urban New York City or Boston scraping by on Social Security pays a federal line fee that helps to subsidize below-cost phone service to ski chalets in rural Aspen or Vail.

If the universal service program is viewed as a regional development plan, rather than a poverty program, it is even more misguided. The universal service program hides from subscribers some of the real resource cost of providing telephone service in out-of-the-way places. If people want to live in high-cost areas, and to command the extra resources required for services there, they should bear those costs, not shift them onto others. If it is determined to be good public policy to encourage more people to live in Alaska, Wyoming, rural Appalachia, and the Four Corners region, surely it makes more sense to give them a cash bounty based on need, rather than to hold down their phone bills.

The universal service program is unworkable in its current form following the move to deregulate local phone service in the Telecommunications Act of 1996. It is possible to mandate price distortions in a tightly regulated or monopoly market. It is not possible to do so in a competitive market.

Competition and Efficiency

The 1996 Telecommunications Act sought to increase competition in the provision of telephone services for local service as well as long distance, and for residential service as well as business service. The Act called for an overhaul of the universal service program, and for making the fees associated with the program more explicit, so that the consumers/feepayers would have a better understanding of the program.

The FCC is working to restructure the universal service program.... It is a tall order to craft a system to promote competition and efficiency while interfering with market prices; it may be impossible, like being in two places at once.

The universal service program is unworkable in its current form following the move to deregulate local phone service in the Telecommunications Act of 1996. It is possible to mandate price distortions in a tightly regulated or monopoly market. It is not possible to do so in a competitive market.

So-called "incumbent" local service carriers are required by regulation to provide subsidies under the universal service plan. Long distance carriers are required to pay pick-up and drop-off charges to the local carriers for access to their switchboards. Providers of wireless services have been given access to local switchboards by the FCC under the 1996 Act to foster competition. They are not required, however, to take on residential customers; to do so, they would need to file as eligible service providers to receive the subsidies for supplying service to residential customers (and for collecting universal service charges). The 1996 Act would allow wireless companies to participate as eligible providers, but the definition of eligible providers is left to state rules. One large wireless company is reportedly in the process of filing to participate in the universal service program. Others may follow suit if conditions warrant.

In a competitive market, companies that attempt to charge some customers more than the cost of the service (in order to subsidize others) will lose the overcharged customers to competitors who do not have the same subsidy burden. Thus, new wireless phone service providers who remain outside the universal service program could undercut incumbent local service companies for business subscribers.

On the other hand, potential competitors will not challenge established companies for customers who are being serviced at less than cost. Thus, new suppliers cannot compete for subsidized residential business without joining the universal service program and becoming eligible to receive transfers from the fund. In some low-cost areas, however, even residential customers may be paying more than the cost of their service. New suppliers might be interested in competing for their business. However, uncertainty over the nature of possible reforms to the universal service program may be deterring competitors from entering even these local residential phone markets, because they do not know what they may end up having to pay. The current arrangements clearly interfere with the intent and goal of the 1996 Act.

An efficiency issue arises when the subsidy applies to an old-fashioned, high-cost technology that might otherwise be displaced by a new, lower-cost technology. Wireless ground-based phone systems have been growing in availability and falling in cost for some years, and satellite-based systems are emerging. If land lines were not subsidized by the universal service fund, wireless systems might already have displaced land line service in some hard-to-reach areas. Until the universal service program is reformed to put wireless and incumbent land line providers on an equal footing, real economies in providing service may be unutilized.

The FCC is working to restructure the universal service program to deal with these issues. The agency is far behind schedule in ironing out the problems. To fully reflect the intent of the 1996 Act, the FCC, working with the states and the industry, must develop a set of charges that are explicit and competitively neutral, and consumer subsidies that are portable between carriers and sufficient to the attainment of universal service. It is a tall order to craft a system to promote competition and efficiency while interfering with market prices; it may be impossible, like being in two places at once.

A better solution would be to phase down the universal service system of charges and transfers in favor of prices that more nearly reflect the marginal cost of service. Much of the rural infrastructure is already in place, having been paid for by past transfer payments. New technologies have altered the relative cost of serving remote areas. Consequently, the cost of additional service in remote locations should be falling, resulting in less need for the universal service program.

The Schools, Public Libraries and Rural Health Care Providers Fund

At the urging of Vice President Gore, the 1996 Telecommunications Act made schools, libraries, and rural community or non-profit health care providers eligible for universal service program subsidies for hook-ups to the Internet and other advanced telecommunications access. Several types of services are eligible, such as: Internet hook-ups and file server and access fees (but not the computers used by the students nor fees for the information content of various web sites or services), telecommunications connections such as local area networks linking classrooms, and satellite transmission charges and distance learning access fees (but not payments for content of the programs transmitted).

The Act authorized the subsidy for these newly-covered services, but did not specify revenues for that purpose. The FCC initially thought to run the program through a set of corporations separate from the general universal service program, funded through a new federal line access charge on long distance phone bills totalling an estimated $2.25 billion a year. The charges would have come to about $25 per household per year. The FCC hoped that the additional line charges would not be broken out on the phone bill as a separate item, so as not to antagonize phone subscribers.

The 1996 Telecommunications Act made schools, libraries, and rural community or non-profit health care providers eligible for universal service program subsidies for hook-ups to the Internet and other advanced telecommunications access.

Fortunately, to the dismay of some supporters of the program, some telephone companies have decided to make the additional line charge an explicit item on the phone bill, so that the public will know there is a specific added fee. Unfortunately, the labels attached to these line items (e.g., federal line charge, line access fee, etc.) do not clearly tell the public what is going on or whom to blame.

In the face of controversy over the new charges, and the salaries proposed for the heads of the new corporations, the program has since been revamped to be directed by the industry through the regular universal service fund, and the annual cost may have been somewhat reduced. (The projected increases in the FCC budget for universal service give reason for skepticism on that point. The charges may merely have been stretched out.)

The Congressional Budget Office estimates that universal service program subsidies to schools, libraries and rural health care providers will cost nearly $21 billion over twenty years.

The Congressional Budget Office estimates that universal service program subsidies to schools, libraries and rural health care providers will cost $21 billion over twenty years. The program will pay for 20 percent to 90 percent of covered costs (about 60 percent on average). The subsidy for each school will be based on location and the percentage of its students eligible for the school lunch program.[5]

A hidden tax on long distance telephone service is a bad means of carrying out the program, and represents bad budget and tax policy. ... There is no logical reason why people should be taxed in proportion to their telephone use to pay for Internet hook-ups by schools, libraries and rural health care providers. The connection is purely semantic.

There are very real questions (not addressed here) of whether hooking up schools and libraries not yet connected to the Internet is the best use of the marginal federal education dollar, or why this should be a matter for federal as opposed to local funding. This paper focuses on the issue that, given the federal decision to intervene, the hidden tax on long distance telephone service is a bad means of carrying out the program, and is bad budget and tax policy.

The former head of the Federal Communications Commission, Reed Hundt, stated that the telephone tax was a good source of ready money for the hook-up program, since telephone use is so widespread. This is the Willie Sutton school of tax policy — go where the money is, regardless of whether it is good tax or economic policy.

There is no logical reason why people should be taxed in proportion to their telephone use to pay for Internet hook-ups by schools, libraries and rural health care providers. The connection is purely semantic. True, people who make long distance telephone calls to their friends, relatives, customers, or suppliers use the telephone lines. Internet users also use long distance telephone lines. But that is no reason to tax long distance telephone users to subsidize Internet users.

Internet users have many things in common with other people. Internet users use computers. Why not tax computers instead of telephone calls? Computer monitors have screens. So do TVs, windows, porches, and movie theaters. Why not tax TVs, wire mesh, and movie tickets? Computers sit on desks, and computer users sit on chairs. Why not tax furniture?

[5] For more detailed cost forecasts and a fuller description of the operations of the program, see *Federal Subsidies of Advanced Telecommunications for Schools, Libraries, and Health Care Providers*, Congressional Budget Office, January 1998.

Proposed Remedial Legislation

Several bills have been introduced in the Congress to repeal or scale back the telephone excise tax or the universal service line fees, and to make any fees that remain more visible to telephone customers.

Representative Lynn Rivers (D-MI) has introduced H.R. 2677, and Representative Tom Bliley (R-VA) has introduced H.R. 3011. Both bills seek to reveal more clearly the many obscure taxes and charges imposed on phone users. Both bills would require telephone companies to provide their customers a clearly labeled, itemized list of all telephone taxes, and all line fees imposed for universal service support mechanisms, by name and dollar amount. The Bliley bill would also require listing the governmental authority whose rules require or authorize the levy. These bills would not remove the excise tax or trim the programs directly, but they might raise public awareness of these levies and encourage opposition to them.

Senator John McCain (R-AZ) has introduced a bill (S. 94) to eliminate the three percent telephone excise tax. In his floor statement accompanying the bill, he points out that the old universal service charges and the fees for the new schools and libraries access program have been driving up the cost of phone service. He suggests that ending the federal telephone excise (which is unrelated to these programs) would be one way to offset some of the higher telephone costs of these programs for consumers. However, his bill does not eliminate either the universal service program or the schools and libraries program which are the sources of the rising fees.

Representative Thomas G. Tancredo (R-CO) has introduced H.R. 692 to repeal the school and library portion of the internet access program, which should eliminate the associated fees unless the FCC devises some other rationale and use for them.

Representatives Ron Klink (D-PA), J. W. Dickey (R-AR), Timothy Holden (D-PA), Robert Brady (D-PA), Gene Green (D-TX), and Philip S. English (R-PA) have introduced the Telecommunications Trust Act, H.R. 727. The bill would alter the source of funding for the federal portion of the universal service programs (including the schools, and libraries, and rural health care providers program). It would eliminate the universal service charges imposed on interstate phone service providers (and their customers). In place of these charges, it would substitute the (smaller) revenues collected by the federal telephone excise tax, placing them in a newly created Telecommunications Trust Fund from which they would be allocated to the states under regulations prepared by the FCC. The bill would limit the funds available for these programs to the amount collected by the excise tax, and make clear that Congress, not the FCC, is the only source of taxing authority. It would end the threat of open-ended de facto tax increases imposed by FCC regulations. The drawback to the bill is that it would continue the old-style universal service programs and the schools and libraries program indefinitely, and would not end or reduce the excise tax.

More fundamentally, the universal service program itself needs to be eliminated. As long as the universal service program remains in place, it will be a tempting platform on which to erect other tax/transfer programs.

Senator Conrad Burns (R-MT) and Representative W. J. Tauzin (R-LA) introduced the Schools and Libraries Internet Access Act (S. 1004 and H.R. 1746) to eliminate the FCC's authority to require federal line charges for the schools, libraries, and health provider hook-up program, reduce the federal telephone excise tax from three percent to one percent as of January 1, 2000 through October 1, 2003, and eliminate the excise tax as of

October 1, 2004. (Presumably, the rate would bounce back up to three percent for the last year.) The excise tax revenue would be dedicated to a telecommunications trust fund to pay for the hook-up program through October 1, 2004. Beyond that date, any further funding for the program would have to be authorized by the Congress out of general Treasury revenue in competition with other federal spending; the bill puts an upper limit of $500 million a year on such funding. The Secretary of Commerce would approve grants from the trust fund to the states to support the telecommunications projects for schools, libraries, and health care providers. The bill would cut total outlays for the program by about half, saving phone subscribers about $10 billion over twenty years. The bill is a significant advance, although it authorizes the hook-up program to continue indefinitely. It does not address the older universal service subsidies.

Governor James Gilmore (R-VA), chairman of the Advisory Commission on Electronic Commerce, has proposed elimination of the federal telephone excise tax. The recommendation is contained in his broader proposal to eliminate and prohibit all internet taxes.[6] (This includes a ban on new telephone or cable taxes imposed on access to the internet via any type of service provider.) The Governor proposes that the federal telephone tax be reduced immediately from three percent to one percent, saving phone customers about $3.4 billion a year initially, rising to about $6.7 billion annually after ten years. The one percent rate would remain for three years, after which the federal tax would be eliminated.

Under the Gilmore plan, the federal government would use the one percent residual federal tax to encourage states to simplify their state telecommunication tax structures within three years. Currently, states and localities impose many different telephone excise tax rates in various jurisdictions within their borders, requiring phone service providers to file some 40,000 tax returns. The complexity greatly increases compliance costs of phone service providers, and raises the cost of phone service to their customers. The proposal would cede the residual one percent federal excise tax to states that shift to a single telephone excise tax rate and single collection point before the three years are up. (The federal government would cease to collect the tax in participating states, while the states would impose the one percent fee instead. Nationwide, a one percent tax would collect about $1.7 billion a year; that revenue would double in ten years as phone use grows.) States that pick up the one percent fee would receive revenue now going to the federal government without raising taxes on their voters. The revenue would more than compensate participating states for money now being lost by foregoing internet taxation (assuming the states continue to impose the fee). States that did not act within three years to simplify their telecommunication taxes would find that the federal tax was gone, and imposing their own tax at that point would show up as a tax hike on their voters' phone bills.

These proposals are an improvement over the current situation. However, none goes far enough. Keeping the telephone excise tax for any length of time for any purpose invites its permanent retention. Allowing the schools and libraries hook-up program to proceed risks establishing a new entitlement and interest group. It would be better to cancel the excise tax, the hook-up fees and the hook-up program immediately. More fundamentally, the universal service program itself needs to be eliminated. As long as the universal service program remains in place, it will be a tempting platform on which to erect other tax/transfer programs.

[6] Available on the internet at www.state.va.us/governor/newsre/nitprop.html.

Cross-Subsidies Pervade Public Policy

If cross-subsidies only failed the test of logic, they would be harmless and laughable. Unfortunately, they do real economic damage. Furthermore, the government keeps finding new uses for cross-subsidies, to the detriment of whatever market they are imposed in. For example, recent health insurance legislation has mandated increased cross-subsidization of the sick by the healthy, and the old by the young, regardless of the incomes and ability to pay of any of the parties. Many young people have been priced out of the insurance market as a result.

Cross-subsidies are among the oldest federal policies. The United States Postal Service (formerly the Post Office Department, founded in 1789) is one of the oldest federal agencies and one of the largest practitioners of cross-subsidization in the economy. Its monopoly on first-class mail (dating back to the private express statutes of the 1840s) has supported a flat rate of postage between any two points in the country (since 1863), and subsidizes other classes of mail and other lines of business in a profoundly inefficient manner.

If cross-subsidies only failed the test of logic, they would be harmless and laughable. Unfortunately, they do real economic damage.

Fortunately, it is possible to roll back this form of government intervention. Prior to the deregulation of the airlines in the 1970s, the Civil Aeronautics Board controlled routes and mandated services. It sheltered airlines from competition on popular, low-cost routes to get them the money to sustain losses on less traveled, higher cost routes. The result was under-utilization of the airways, lost travel opportunities and higher costs for millions of travellers, shippers, and consumers. The resulting price structure was also unfair and unrelated to actual costs. Grandmothers eking out a living on Social Security were overcharged to fly from New York to Chicago to visit their grandchildren so that affluent businessmen could fly at less than full cost between Fargo and Sioux City. Ultimately, this destructive air travel policy was eliminated through deregulation. Rail, truck, and bus transportation were also decontrolled, to the great benefit of consumers and the economy.

Conclusion

Congress and the President should stick to sound budget and tax principles when they wish to make something happen. Government revenues should be collected through broad, non-distorting taxes, not through selective excise taxes. Subsidies should be avoided as much as possible. Where subsidies are deemed necessary, they should be provided through explicit outlays in the federal budget, readily visible for all to see, funded through general revenues, and based on individuals' needs. There should be no mandates imposed on private industry, no cross-subsidies of one consumer by another, no hidden taxes, and no nonsense.

Unfortunately, current government policies in the telecommunications area are a "long distance" from these principles. Several steps should be taken to improve the government's interaction with the telecommunications market. The federal telephone excise tax should be eliminated. The schools, library, and rural health provider telecommunications access program and its associated fees should be eliminated. Any remaining charges and subsidies under the universal service program should be made explicit on people's phone bills. The universal service program should be replaced by a more rational system of assistance that focuses on boosting the income of needy individuals rather than attempting to regulate the price of telephone services by geography, provider, and type of consumer. These changes will not happen overnight. It has taken 65 years to get into the current universal service mess. It is time to start getting out of it.

About the Tax Foundation

In 1937, civic-minded businessmen envisioned an independent group of researchers who, by gathering data and publishing information on the public sector in an objective, unbiased fashion, could counsel government, industry and the citizenry on public finance.

Six decades later, in a radically different public arena, the Tax Foundation continues to fulfill the mission set out by its founders. Through newspapers, radio, television, and mass distribution of its own publications, the Foundation supplies objective fiscal information and analysis to policymakers, business leaders, and the general public.

The Tax Foundation's research record has made it an oft-quoted source in Washington and state capitals, not as the voice of left or right, not as the voice of an industry or even of business in general, but as an advocate of a principled approach to tax policy, based on years of professional research.

Today, farsighted individuals, businesses, and charitable foundations still understand the need for sound information on fiscal policy. As a nonprofit, tax exempt 501(c)(3) organization, the Tax Foundation relies solely on their voluntary contributions for its support.

About the Author

Stephen J. Entin is executive director and chief economist of the Institute for Research on the Economics of Taxation (IRET). He advised the National Commission on Economic Growth and Tax Reform (the Kemp Commission), assisted in the drafting of the Commission's report, and was the author of several of its support documents. He was Deputy Assistant Secretary for Economic Policy at the Department of the Treasury from 1981 to 1988. Prior to joining Treasury, he was a staff economist at the Joint Economic Committee of the Congress, where he developed legislation for tax rate reduction and incentives to encourage saving. He is a graduate of Dartmouth College and has an M.A. from the University of Chicago.

He originally prepared this manuscript for the Tax Foundation Excise Tax Symposium held on Amelia Island, Florida, January 14, 1999. The opinions expressed here are the views of the author. They do not necessarily reflect the views of IRET or the Tax Foundation, and they are not to be construed as an attempt to aid or hinder the passage of any bill before the Congress.