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Anachronism — defined by the American Heritage Dictionary as something out of its proper order or time. Anachronism is the best possible description of the federal telephone excise tax. The Congress levied the tax for the first time in 1898 at a time when telephones were a luxury, owned only by wealthy individuals and prosperous businesses. This new excise taxed telephone usage at the rate of one cent for each call valued at 15 cents or more, and it was an important source of government revenue in those days before the income tax.

Explaining Excise Taxes

The telephone excise tax has always suffered from serious policy deficiencies. To begin with, it does not fall into either of the categories that are generally considered to justify a tax on policy grounds.

The Excise Tax As User Fee

A common justification offered for excise taxes is that they act as user fees. The federal government provides a wide range of services, and wherever practical it is reasonable to require the users of a service to bear some or all of the service's cost. The best known example of an excise-cum-user fee is the federal gasoline excise tax that goes primarily to fund the national highway system. Other user fees, such as the fee for entering Yellowstone National Park, are indistinguishable in form and function from a classic user fee excise.

The essential criteria in this regard are that the fee or tax be imposed on the beneficiary of

A Tax in Search of a Rationale

The Congress enacted and repealed the telephone excise tax repeatedly between 1898 and 1941. In 1941 the tax went into effect permanently at the rate of 10 percent, but it was soon increased to 25 percent to help pay for the Second World War. It was reduced after the war, and in 1969 it was slated to drop from 10 percent to 3 percent before finally disappearing altogether. This phase-down from 10 percent was delayed until 1973. Throughout the 1980s the repeal of the tax was repeatedly delayed until the tax was made permanent again in 1991 at its current rate of 3 percent. Thus the justification for the telephone tax has evolved from that of a luxury tax to a war tax to a deficit-reduction tax; none of these justifications apply today.

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Today's information age has made telephones a necessity for everyone, no matter how poor. Yet, over a hundred years later the "Tax on Talking" remains, generating about $5.5 billion for the federal government in fiscal year 1999 and rising toward $10 billion by the end of the next decade. The one modernization of the telephone excise has been to add a new E(ducation)-rate tax on telephone usage. Even more than the original telephone excise, this new E-rate tax raises serious tax policy questions.
The government-provided service, that the use of the service not be mandatory, and that the fee or tax bear some close relationship to the cost of providing the service. The federal telephone excise tax fails this test because it does not compensate the government for providing any specific service related to telephone use.

The Excise Tax As Market Correction

A second, theoretically valid justification for an excise tax is that it corrects an market imperfection arising when one individual or group's use of a good or service imposes a cost, or "externality," on some other and unrelated individual or group. Such an externality would arise, for example, when one neighbor plays loud music late in the evening, disturbing the peace and quiet of the surrounding neighbors. In this case, the event is sufficiently specific that local ordinances can correct the problem, but often this is not possible.

For example, a manufacturing facility may pump clean, hot water into a local river, raising the river's temperature for many miles downstream. The higher water temperature could change the environment enough that the river could become choked with algae and other plant life, depleting the oxygen from the water and driving fish away. More importantly, the increase in algae could create an environment in which mosquitoes and the like would thrive, accelerating the local transmission of disease.

The effect of the manufacturing facility's operation in this example is to reduce the quality of life and, in all likelihood, property values of the people downstream. In an ideal world, civil courts would handle the matter through enforcement of property rights. Theoretically, a good approximation to the same result can obtain by imposing a properly calibrated excise tax on the facility's output, but only if the proceeds of the tax are remitted to those who suffer the loss. In practice there can be daunting pitfalls in using an excise tax to compensate for an externality, but at least theoretically the externality argument can be used to justify an excise tax.

Just as the telephone excise cannot be justified as a user fee, so too the externality argument cannot be applied. There are no noted external costs imposed either locally or socially to the creation, maintenance, or use of a telephone system. As Freud is quoted as saying, "Sometimes a cigar is just a cigar." Sometimes a tax is just a tax. The sole motivation for the federal telephone excise tax is to raise revenues to pay for government programs.

The Telephone Excise and the Economy

In addition to lacking a sound policy justification as an excise tax, the telephone excise violates two basic principles of sound tax policy. First, taxes should be economically neutral or non-distortionary so as to minimize the disruptions they impose on the economy. Secondly, well designed taxes do not fall disproportionately on one group in society.

The Inefficiency of the Telephone Excise

Every tax distorts how the nation uses its resources. A tax is distortionary to the extent that it alters the relative prices between the various goods, services, and activities. For example, a classic income tax raises the price of saving relative to consumption. A general sales tax raises the price of work relative to leisure. A specific excise raises the price of the taxed item relative to all other goods and services.

While all taxes distort prices, some taxes are more distortionary than others. A selective excise necessarily distorts relative prices the most per dollar of tax revenue raised. Suppose, for example, that Congress imposed an excise tax of $100 on all white automobiles sold at retail. Such a tax would distort the price of white cars relative to all other cars. It would also distort the price of white cars relative to all other goods, services, and activities in the economy.

Suppose Congress reduced the tax on white cars but extended it to red cars so that the total amount of revenue raised was held constant. To a first approximation, the overall distortion of the prices of white and red cars vis-a-vis all other cars, and all other goods, services, and activities would be the same— with one exception—as when the tax was imposed on white cars only. While the amount of each distortion would decline, the total number of distorted prices would almost double. The one exception, of course, is that when the tax fell on both white and red cars, then the relative price between white and red cars would be unchanged.

Thus the broader tax can be expected to have fewer distorting effects than the narrower tax. Extending this principle to its logical conclusion, the broader the sales tax the less will relative prices be distorted, everything else held constant. This principle also implies that the most distortionary of taxes per dollar of revenue raised is the selective excise.
Relative prices are the vital economic signals that guide individuals in their allocation of the nation’s resources. As wages rise the return to work rises, as does the price of leisure. If the price of coal increases, users of coal will tend to shift to lower cost fuels. If the price of imports increases due to a decline in the exchange value of the dollar, then consumers will shift some of their purchases from imports to domestically produced goods and services. In general, when relative prices are unaffected by government policies, then individuals and companies will make the best use of the nation’s resources.

By distorting relative prices an excise tax distorts the allocation of the nation’s resources, thereby reducing national output. An excise tax also distorts the relative prices of national output, thereby reducing the gain in welfare from that output. To be sure, in the case of the federal telephone excise tax, the extent of the misallocation of resources is not large in absolute terms simply because the total amount of the tax currently collected is around $5.5 billion, a large amount in isolation, but small relative to a $10 trillion economy. However, the amount of the distortion is quite significant compared to the amount of money raised.

**The Regressivity of the Telephone Excise**

Telephone use is nearly universal, and the amount of use tends to decline as a share of income as the level of income rises. For these reasons, the telephone excise tax is regressive, that is, it falls disproportionately on low- and middle-income customers. This regressivity is a trait that the telephone excise shares with most excises, and it violates a basic cultural principle of tax policy: taxes should either fall as evenly as possible across the spectrum of earners or increase more than proportionately with rising incomes, i.e., be progressive.

In recent years the federal government has placed a very high premium on maintaining and even increasing the progressivity of the overall federal tax system. Congress has increased upper-income marginal income tax rates significantly, from 31 percent to 39.6 percent, and many tax proposals to improve the investment and saving climate in the United States have been cast aside because they would have reduced progressivity. Even those proposals to encourage savings that have been enacted have included complex income level phase-outs, the sole purpose of which is to prevent upper-income taxpayers from taking advantage of them.

There have been lapses, to be sure, such as the 1993 increase in the federal gasoline excise and frequent and popular proposals to increase the highly regressive tobacco excise, but for the most part, progressivity has been the byword of tax policy. In fact, recent expansions and enactments of tax credits, some of them refundable, which apply only to low and middle-income taxpayers have turned the federal income tax into a key component of the welfare system, all in the name of reducing taxes on low- and middle-income citizens while increasing the overall progressivity of the tax system. With such a sustained interest in progressivity, the apparent continued acceptability of the telephone excise’s inherent regressivity is all the more puzzling.

**The E-Rate Tax and Program**

With so little in its favor, it is curious the telephone excise tax has not come under harsher criticism. In an era of budget surpluses such a regressive, antiquated tax would seem a ripe target for repeal. Instead, in 1996 the Congress opened the door for the Federal Communications Commission (FCC) to levy a new Education-rate collection as an add-on to the existing federal telephone excise.

The Telecommunications Act of 1996 mandated that the FCC provide universal service discounts for telecommunications services to schools and libraries. In compliance with the Telecommunications Act, in May of 1997 the FCC established the Schools and Libraries Corporation (SLC). In its report accompanying the creation of the SLC, the FCC stated it was expanding the list of school and library activities receiving discounts to include internal internet connections, computer networking, network servers, and server software — the E-rate program. The report also announced the creation of a Universal Service Fund (USF) to collect revenue including the E-rate tax from telecommunications carriers. Disbursements from the USF include subsidies to the schools and libraries program. In January of 1999 the FCC changed the name of the SLC to the Schools and Libraries Division (SLD), one of
three divisions of the Universal Service Administrative Company, which is now responsible for administering all telecommunications universal service programs for the FCC.

Under the E-rate program eligible schools and libraries receive discounts averaging 60 percent (ranging from 20 percent to 90 percent depending on the area’s poverty level and rural location) on telecommunications services, internet access, and internal connections. The schools and libraries do not receive direct funding from the program. Instead, monies from the SLD are used to reimburse vendors that supply the services to the program’s recipient. Funding commitment letters for the first year resulted in a total funding level of $1.66 billion, which went to 25,785 recipients.

To fund the program federal law requires interstate telecommunications service providers such as paging companies like Celpage, long-distance providers like ATT and MCI, local providers like Bell Atlantic, and cellular service providers like CellularOne to make mandatory “contributions” to the E-rate program to underwrite program activities. These contributions are based on a percentage of both interstate and intrastate revenues. The contribution level is set quarterly by the FCC’s Common Carrier Bureau depending on the anticipated funding needs of the SLD. In May of 1999 the FCC announced the tax would increase to reach the maximum amount allowed by rule of $2.25 billion.

The “Universal Access” Roots of the E-Rate Program

The E-rate program is an extension of the universal access regulatory regime designed to ensure that educational institutions, libraries, and health care facilities have access to advanced telecommunications services. In 1985 the FCC implemented a regulatory regime to promote “universal access” to telephone service. The two main purposes of universal service were to subsidize telephone service in (1) high cost rural areas, and (2) low-income subscribers. Universal service support was essentially an intra-industry transfer of income from low-cost local exchange carriers and interexchange carriers to high-cost local carriers, especially those small local carriers serving rural areas. Funding was determined using elaborate cost allocation rules and was reflected in the rates charged to the interexchange carriers. An important consequence of this system was that neither the subsidy payors, namely the customers of the low-cost local carriers and the interexchange carriers, nor the beneficiaries, namely the customers of the high-cost carriers, were generally aware of the income transfers. Beyond obvious equity arguments, proponents of subsidization assert that the telephone network becomes more valuable as more people connect to it and that many people who currently receive the subsidy would not be on the network without the subsidy.

The 1996 Telecommunications Act significantly rewrote the federal telecommunication law. An important consequence of the Act was that the hidden transfer payments arising out of the 1985 Act were made explicit in the 1996 Act. Another important consequence was that the 1996 Act codified and expanded the concept of universal access so that implementation would be guided by the following principles:

1. Qualified services should be available at just, reasonable, and affordable rates;
2. Access to advanced telecommunications and information services should be provided in all regions;
3. Consumers in all regions, particularly those in rural, insular, and high-cost areas, should have access to telecommunications and information services on a similar basis (including rates) as that available in urban areas generally;
4. All telecommunications providers should make “equitable and nondiscriminatory” contributions to the preservation and advancement of universal service;
5. There should be specific and supportable federal and state mechanisms to preserve and advance universal service; and
6. Elementary and secondary schools and classrooms, health care providers, and libraries should have access to advanced telecommunications services.

The main expansion of universal service was its extension to public and non-profit elementary and secondary schools, public and certain other research libraries, and rural health care providers. In other words, the E-rate program. The source of the funds for the E-rate program would be “equitable and nondiscriminatory contributions” by telecommunications carriers. This contribution was established as a
"principle" in the Act. In effect, the Congress appears to have established an intent to fund this expansion of universal service through an excise tax without giving the FCC the authority to do so, without directing the FCC to do so, and without enacting the tax itself.

On the basis of this "principle" the FCC proceeded to enact the E-rate tax. At the time it did so many observers believed service providers would pass the tax onto their customers through a higher rate structure, just as they had done with previous universal service obligations. As expected, service providers passed the tax forward, but they also quickly moved to earmark the universal service charge on subscribers' bills, thus giving the entire program a much higher public profile.

**A Tax by Any Other Name**

The funding mechanism for the E-rate program represents a creative new dimension in taxation. In most cases, the federal government receives revenue from a tax and uses the revenue to fund federal programs. The E-rate tax, in contrast, is imposed by an agency, the FCC, on telecommunications service providers and received by a "Fund" for distribution by employers to fund the Social Security program. Whatever it is called officially, it is known as the Social Security payroll tax because it is a tax. Similarly, despite its label as a "contribution," the E-rate contribution is a tax.

The E-rate tax is different from the federal government’s many fees, which involve payment for a specific good or service. For example, the Securities and Exchange Commission imposes various fees on companies relating to their securities filings. Neither the collectors of the E-rate tax nor the ultimate payors of the tax, the service providers and the customers, respectively, receive a benefit from the payment of the tax related to telephone use. Thus, the E-rate tax is not a fee in disguise.

**The E-Rate As Tax Policy**

The E-rate tax is subject to the same standards as any other tax, such as efficiency and equity. As mentioned above in the discussion of the telephone excise, a tax is neutral, or economically efficient, if it leaves relative prices of goods and services undistorted. To the extent relative prices are distorted, resources are misallocated and output suffers. The value of the lost output is sometimes called the "economic cost" of a tax.

Virtually all taxes impose some economic costs aside from compliance and administrative costs and the amount of the tax itself. A recent, independent analysis put the cost to the economy of raising $2.25 billion annually through the E-rate tax at $2.36 billion. In other words, in addition to the tax revenue raised, the E-rate tax imposes a cost to the economy in terms of lost output of $1.05 for every $1.00 of tax revenue. This compares with estimates of the cost of raising additional revenues through the general U.S. tax system ranging between 26 cents on the dollar to 40 cents on the dollar. These estimates imply the E-rate tax is a very inefficient revenue source for the federal government.

Secondly, the E-rate ultimately falls on telecommunications service users, i.e., telephone company customers. Like the federal telephone excise, therefore, the E-rate tax is inherently regressive in the sense that the burden of the tax as a percent of income falls much more heavily on lower-income taxpayers than it does on upper-income taxpayers, as demonstrated in the accompanying table.

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While the appropriate degree of progressivity in the tax system is a subject of never ending debate, there is no policy justification for imposing a regressive excise that is not even in the nature of a user fee.

**Constitutionality and the E-Rate**

The importance of the language and the substance of the E-rate “contribution” is critical to the constitutionality of the manner in which the program came into being. While a full discussion of the point is beyond the scope of this paper, the essential issues are straightforward. Under Article I, Section 8 of the United States Constitution, Congress alone, through legislation originating in the House of Representatives, has the power to enact a tax. This responsibility and privilege are not delegable to any other entity, including an agency of the federal government. Proponents of the E-rate program argue the Congress gave the FCC the authority to pursue a policy, including the imposition of the E-rate “contribution.” However, if the “contribution” is truly a tax, then under the Constitution it would seem the Congress itself must enact the tax under specific legislation. Further, the FCC would not have the authority to change the level of the tax as it now has the authority to change the level of the “contribution” to fit annual funding needs.2

On the other hand, the Supreme Court has ruled that the Congress can, in certain circumstances, delegate to agencies of the federal government the authority to impose and collect fees, where the fees bear some relation to a service provided to the fee payor. Because the E-rate “contribution” is not a fee, it does not fall within this exception. Thus it appears the E-rate “contribution” could well be found to be unconstitutional on the grounds that it is not a fee but rather a tax not expressly enacted by Congress.

**Conclusion**

The federal telephone excise tax is an unfortunate relic of tax policy. Originally enacted as a luxury tax it evolved to being a war tax and then to a deficit-reduction tax. Today it cannot be justified on any of these grounds. Nor can it be justified on the usual grounds supporting an excise tax (user fee and externalities) and it violates two essential principles of tax policy—equity and efficiency. The only justification for the “Tax on Talking” is that it raises revenues for the federal government. Even this justification is weak, however, in an era of budget surpluses.

Rather than reduce or eliminate the telephone excise, the Congress recently suggested the tax be increased by the FCC through the E-rate program. The E-rate tax suffers from the same policy deficiencies as the original excise, and it suffers from the additional flaw that the FCC created the tax as a mandatory “contribution,” thus raising questions about its constitutionality. Thus, the E-rate’s constitutionality is very much in doubt, and, indeed, it has been challenged in court with a decision pending in the Fifth Circuit Court. If the tax is ultimately found to be unconstitutional, schools and libraries that relied on support from the Universal Service Fund for their internet expansions may see their plans derailed. Worse, if the Supreme Court rules the tax to be unconstitutional, then previous collections of the tax may need to be rebated to the payors. This would mean that libraries and schools districts that entered into contracts expecting discounts through the E-rate program may see those discounts vanish.

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2 Further evidence that the E-rate “contribution” is a tax as the term is normally used is that the Congressional Budget Office treats receipts from the contribution as federal revenues indistinguishable from those arising under the income tax or the Social Security tax.