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HIDDEN PHONE TAX A BAD WAY TO PAY FOR INTERNET ACCESS

A new de facto tax on telephone users is going into effect in 1998. The Federal Communications Commission has used language in the 1996 Telecommunications Act to require the nation's telephone companies to contribute to a "Schools and Libraries Fund" to provide "universal access" to the internet for schools and libraries. The cost of this subsidized access will, of course, be passed on to business and household telephone customers.

The universal internet access program is bad policy for four reasons. First, the program is of questionable value. Second, it is not an appropriate federal concern. Third, the tax being imposed to finance the program is a distortionary cross-subsidy of internet users by telephone users. Fourth, the government tried to hide the tax from the public as an unspecified charge in the nation's telephone bills.

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The initial contribution was an estimated $2.25 billion a year, or about $25 per household phone customer. However, after several phone companies declared that they would reveal the tax as a separate line item on the phone bill, the FCC trimmed the tax by about 40%. Households may expect an increase in their annual telephone bills of about $15. Unfortunately, the FCC may have prevailed upon the phone companies, which it regulates, to hide the remaining tax from households, although the companies may list the tax as a separate item on business phone bills.

Many schools and libraries are already connected to the internet, using their own money. We skip over the question of whether hooking up the rest is the best use of the marginal federal or local education dollar. Our concern, rather, is with the question of whether a hidden tax on telephone service is the appropriate way to pay for such a program. The answer is, "No."

Government subsidies should be explicit on-budget outlays, debated and appropriated annually, and funded by explicit taxes, so that 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 internet hook-up subsidy phone tax fails on both counts.

First, the multi-year program is being run through an obscure "Fund" with a hidden, dedicated revenue stream. The FCC's intent was that the telephone charge should not be broken out on the phone bill as a separate item, so that no one would realize what was happening. Hiding outlays and taxes is a big public policy no-no in a democracy.

Second, instead of general revenues, the telephone charge is effectively a narrowly-based new excise tax on telephone services (in addition to the current explicit long distance excise tax, which is itself an unreasonable levy). Selective excise taxes on specific products or services distort output

Institute for Research on the Economics of Taxation

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and consumption, and reduce economic welfare. An excise tax raises the cost of obtaining the product above its actual cost of production, and relative to the cost of other goods and services. The result is that consumers under-utilize that product, and over-consume other products, for a net loss in economic efficiency and satisfaction compared to raising 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, regardless of income.

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If excise taxes are a bad way to pay for subsidies, why was a de facto selective excise tax used in this case? Perhaps the excise tax was chosen as a matter of legislative and political convenience, and justified by empty word-play. A telecommunications bill was at hand; the internet is a form of telecommunications; why attempt an explicit tax hike in an explicit tax bill when a hidden "non-tax" tax could be slipped into the telecommunications act instead?

Another possibility is the excuse offered by the former head of the Federal Communications Commission, Reed Hundt, who stated that the telephone tax was a good source of ready money, 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.

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Most charitably, perhaps the term "universal access" triggered a mental throwback to the days of telephone monopolies. The FCC and state regulators used to allow AT&T and the handful of regional phone companies to charge more than cost for long distance and business service to hold down the cost of, and encourage "universal access" to, local telephone service for the poor. That unnecessary and distorting policy was rendered inoperative by the break-up of AT&T and the advent of long distance telephone competition. Apparently, however, the concept of cross-subsidizing one form of telephone hook-up by tampering with the pricing of another refuses to die.

In fact, there is no need to tamper with the price of a product to bring about "universal access" to it. For example, the government provides universal access to food by giving needy people food stamps and welfare checks. This assistance is funded out of general federal revenues, not by an excise tax on groceries or a mandated "contribution" by food stores to a "Food Fund".

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

Consider all the other things that internet users have in common with other people. Internet users use computers. Why not tax computers instead of telephone calls? Why not tax computer chips, which go into many other products as well and have an even larger tax base? 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?

If cross-subsidies only failed the test of logic, they would be harmless and laughable. Unfortunately, they have done and continue to do real economic damage, and the telephone industry has by no means been the only one affected.

In the old days before airline deregulation, 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.

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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. If it were good national policy to subsidize direct air travel between small cities, the subsidy should have come out of general revenues, not by further distorting prices and consumption by increasing the cost of travel on other air routes.

Congress and the President should stick to sound budget and tax principles when they wish to make something happen. The program should be an explicit outlay in the federal budget, ... funded by general revenues collected by a broadly-based non-distorting tax. There should be no mandates, no cross-subsidies, no hidden taxes, and no nonsense.

Ultimately, this destructive air travel policy was eliminated through deregulation. Similar errors in rail, truck, and bus transportation were also corrected by decontrol, to the great benefit of consumers and the economy.

The Postal Service monopoly on first-class mail to support a flat rate of postage between any two points in the country and to subsidize other classes of mail is another example of economically inefficient and blatantly unfair cross-subsidization. This situation is being eroded at the edges by private express-mail companies and the growing use of the internet, but it still imposes unnecessary costs on the country.

Unfortunately, Congress keeps finding new uses for cross-subsidies, to the detriment of whatever market they are imposed in. Recent health insurance legislation has mandated increased portability of insurance and limited risk rating of individuals. The move toward community rating and guaranteed issue is a form of mandated 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.

Congress and the President should stick to sound budget and tax principles when they wish to make something happen. The program should be an explicit outlay in the federal budget, readily visible for all to see. The program should be funded by general revenues collected by a broadly-based, non-distorting tax. There should be no mandates, no cross-subsidies, no hidden taxes, and no nonsense. Unfortunately, current government policies are a "long distance" from that ideal.

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Note: Nothing written here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before Congress.