



**LOCAL GOVERNMENT PERSPECTIVE  
ON TELECOMMUNICATIONS TAXES**

*A Response to Industry's 2004 COST Study*

Summer 2006

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## 1.0 Introduction

The telecommunications industry is conducting a multipronged effort to reduce the level of taxes it pays to local governments. Large sums of money are being poured into national and local advertising in a highly targeted media and lobbying campaign. In addition, the telecommunications industry is litigating against local governments to contest taxes and fees. The industry is also lobbying the federal and state governments to obtain favorable legislation to accomplish the same result.

As with any business, telecommunications companies need to pay their fair share of taxes.

As with any business, telecommunications companies need to pay their fair share of taxes. Recognizing the convergence among different types of telecommunications services, local governments generally favor the imposition of taxes on a nondiscriminatory basis, regardless of the technologies used, on competing communications service providers that offer functionally equivalent services. They also favor reforms that will create a level playing field for competition among existing and new service providers. Further, they favor simplifying the administration of state and local taxes on communications services to encourage continued investments and innovations.

In this context, it is critical that industry viewpoints be carefully scrutinized. The industry commissioned a study, published in March 2005 by the Telecommunications Tax Task Force of the Council on State Taxation (COST), titled *2004 State Study and Report on Telecommunications Taxation* (the COST Study).<sup>1</sup>

As it states, the COST Study is intended to persuade policymakers to lower the tax burdens on the telecommunications industry:

The state and local tax laws continue to impose high levels of industry-specific taxation on telecommunications services. While some states have begun the process of reforming the state and local tax structure, much more is needed to reduce the high levels of telecommunications taxation...<sup>2</sup>

The COST Study summarizes its most important finding as follows:

The 2004 State Study shows that the average effective rate of state and local transaction taxes is 14.71%, compared to only 6.12% for general businesses nationwide.<sup>3</sup>

<sup>1</sup> The following companies participated in the study: ALLTEL Corporation, AT&T Corporation, BellSouth Corporation, Cingular Wireless LLC, Level 3 Communications, Nextel Communications, Qwest Communications, SBC Communications, Sprint Corporation, Telephone and Data Systems, Inc., T-Mobile USA, Verizon Communications, and Verizon Wireless.

<sup>2</sup> *2004 State Study and Report on Telecommunications Taxation*, Council on State Taxation, 2005, p. 7.

<sup>3</sup> *Ibid.*, pp. 3-4.

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The COST Study contains serious methodological flaws that make it an inappropriate basis for policy decisions.

This White Paper presents a preliminary response from local governments to the 2004 COST Study and that core finding. The COST Study contains serious methodological flaws that make it an inappropriate basis for policy decisions, especially the industry's proposals to make widespread changes to local tax structures. The COST Study presents a selective summary of state and local fees and taxes that omits important analytic issues. Moreover, it neglects to highlight parts of the tax system that favor telecommunications companies compared to other businesses.

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## 2.0 Local Government Response to 2004 COST Study: A Summary

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The following problems were identified by the local government organizations that examined the 2004 COST Study:

- ❖ **“Transaction Taxes:”** The COST Study's analysis of “transaction taxes” is flawed because it mixes *taxes*, which apply to a broad range of businesses, with *user fees*, which are the charges that local governments levy for use of public rights-of-way by private users such as telecommunications companies. The COST Study fails to define “transaction taxes” consistently for telecommunications companies and other businesses.
- ❖ **Income Taxes:** The COST Study fails to disclose that telecommunications companies pay significantly lower corporate income taxes than other businesses.
- ❖ **Property Taxes:** The COST Study's analysis of property taxes shows, by its own numbers, that there is no discrimination against telecommunications companies in real property taxes and little disparity, if any, in other property taxes.
- ❖ **Overall Impact on Local Governments:** Because of the flaws of the COST Study with respect to (1) user fees and other fees and (2) income taxes, its estimates of relative tax burdens are incorrect. However, even if taken at face value, the COST Study's data show a tremendous impact on the ability of local governments to provide needed services to their constituents due to lost revenue if the telecommunications industry's recommendations were followed.
- ❖ **The Effects of Changing Technology:** Currently, technological convergence is creating new forms of competition among different types of telecommunications as voice, data, and video are offered over a much broader range of media, including traditional land lines, wireless, cable, satellite, and voice-over-Internet-protocol (VoIP) services. Each of these services is subject to a different set of state and local taxes. In addition, the federal government is showing a disturbing pattern of intervention in state and local revenue policy that has the potential to exacerbate rather than reduce these tax differentials. In this context, negotiations among state and local government groups and telecommunications companies represent the best way to reduce administrative burdens and promote equitable taxation.

The sections that follow consider each of these points in turn.

### 3.0 “Transaction Taxes”

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As stated above, the COST Study’s analysis of “transaction taxes” mixes *taxes*, which apply to a broad range of businesses, with *user fees*, which are the charges that local governments levy for use of public rights-of-way by private users such as telecommunications companies. The COST Study raises significant methodological issues when it fails to define “transaction taxes” consistently for telecommunications companies and other businesses. The result of this shortcoming is that the numbers produced by the COST Study indicate much heavier relative burdens on telecommunications companies, compared to other business companies, than are actually the case.<sup>4</sup>

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The COST Study as a whole is based on a fallacious argument.

Before discussing these individual issues, however, it should be noted that the COST Study as a whole is based on a fallacious argument. The COST Study argues that tax burdens should be applied consistently across different companies. Of course, this is not really true. The Supreme Court has repeatedly upheld the power of state legislatures to classify taxpayers according to local needs and conditions. In the 1983 case of *Regan v. Taxation With Representation*, the court reiterated that “legislatures have especially broad latitude in creating classifications and distinctions in tax statutes.”<sup>5</sup> Indeed, many types of businesses are subject to their own special taxes, including not only the so-called “sin taxes” of tobacco and alcohol but also travel, hotel, entertainment, petroleum distribution, transportation, and non-telecom public utilities.<sup>6</sup> Therefore, claiming that the tax burden for the telecommunications industry should be comparable with other businesses is not a valid argument. Nevertheless, this White Paper considers the COST Study’s other claims.

#### 3.1 Significant Portions of So-Called “Taxes” Are User Fees

The COST Study creates an artificial construct that it calls “transaction taxes.”<sup>7</sup> It applies this term to the tax burden on telecommunications companies compared to the tax burden on other businesses.

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The COST Study defines “transaction taxes” inconsistently.

The COST Study undercuts its own call for consistency by defining “transaction taxes” differently for telecommunications companies and for other businesses. The COST Study defines “transaction taxes” on telecommunications companies as the total of “any state and local taxes applied to the cost of service or the

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<sup>4</sup> This methodological shortcoming also means that the COST Study includes user fees in its calculations for telecommunications companies to produce a higher total *number* of transaction taxes compared to the calculation for other businesses, where the definition of “transaction tax” does not include user fees.

<sup>5</sup> 461 U.S. 540, 547 (1983). The court went on to quote with approval the following language from *Madden v. Kentucky*, 309 U.S. 83, 87 -88 (1940):

The broad discretion as to classification possessed by a legislature in the field of taxation has long been recognized.... [T]he passage of time has only served to underscore the wisdom of that recognition of the large area of discretion which is needed by a legislature in formulating sound tax policies. Traditionally classification has been a device for fitting tax programs to local needs and usages in order to achieve an equitable distribution of the tax burden. It has, because of this, been pointed out that in taxation, even more than in other fields, legislatures possess the greatest freedom in classification.

<sup>6</sup> Tillman L. Lay, “Some Thoughts on Our System of Federalism in a World of Convergence,” *Law Review of Michigan State University-Detroit College of Law*, Spring 2000, pp. 223-237, at p. 231-2.

<sup>7</sup> 2004 *State Study and Report on Telecommunications Taxation*, Council on State Taxation, 2005, pp. 3-4.

provision of the line to the consumer.” By contrast, the COST Study defines transaction taxes on general businesses much more narrowly, as merely “the traditional sales tax imposed on sales of tangible personal property and comparable transaction taxes.”<sup>8</sup>

Thus, “transaction taxes” for telecommunications include not only sales taxes but also user fees that states and localities may impose on companies in return for their use of public rights-of-way. Other businesses—in general—do not use the public rights-of-way to nearly the extent that telecommunications companies do.

### 3.2 User Fees

For telecommunications companies, user fees are required when a company uses streets or overhead wires or other parts of public rights-of-way in its business. These user fees include payments for use of public rights-of-way that sometimes, but not always, may be denominated as “taxes.” User fees may be assessed as franchise fees, permit fees, infrastructure maintenance fees, or gross receipts taxes, for example, depending on the jurisdiction. Other businesses that use public rights-of-way, such as gas and electric companies, also pay user fees.

In addition to charging for use of public rights-of-way, federal law permits states and localities to impose 911 emergency system surcharges or universal service fees. Both of these are used to help build and maintain the public telecommunications network. They directly benefit the users of telecommunications services. This is similar, for example, to the use of gasoline taxes to help build and maintain the network of roads and other infrastructure that are needed to serve automobile traffic.

In preparing this White Paper, officials from a number of local and state governments and local government associations contributed their insights to help identify which charges were improperly categorized in the COST Study as taxes instead of user fees.

As can be expected from the different revenue policies adopted across the country, the results vary from state to state and locality to locality. New York State published a study in 2001 that shows the gap between sales taxes and other transaction revenues that can be considered user fees rather than taxes. That study concluded as follows:

Computations from governmental sources indicated that the total amount of local telecommunications taxes and fees was slightly over \$1 billion [in 1998]. Nearly two-thirds of these revenues came from two sources—the sales tax and the real property tax.<sup>9</sup>

Setting aside the \$306.5 million in property taxes from the \$1.039 billion in local fees and taxes that year, this means that New York State’s local governments collected some \$732 million from telecommunications companies that year, of

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<sup>8</sup> *Ibid.*, p. 4.

<sup>9</sup> New York State Department of Taxation and Finance and New York State Office of Real Property Services, *Local Telecommunications Taxes and Fees in New York State*, report to Governor George E. Pataki and the New York State Legislature, January 2001, p. 3.

which the state attributes only \$350 million, or 47 percent, to sales taxes.<sup>10</sup> The remainder of the revenues collected can be attributed to user fees rather than the kind of tax revenues paid by other businesses.

In another example, data from the State of Florida indicate a significant but somewhat lower percentage of user fees. In 2000, the Florida legislature passed the Communications Services Tax Simplification Law.<sup>11</sup> The legislation created a new tax structure for communications services, combining seven different state and local taxes or fees and replacing the revenues with a two-tiered tax composed of a state tax and a local option tax on communications services. According to one estimate, somewhat less than 25 percent of the new Communications Services Tax represents user-fee revenues while the remainder represents tax revenues.<sup>12</sup>

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User fees reflect the special burdens that telecom companies impose on the public and local governments.

Thus, in two major jurisdictions that have reviewed this question, it has been found that a substantial fraction of local government revenues comes from user fees rather than taxes on telecommunications companies. User fees, especially for the public rights-of-way, reflect the special burdens that telecommunications companies impose on the public and local governments. Telecommunications companies also derive special benefits from the use of the public rights-of-way.

### 3.3 Impact on Constituents

Telecommunications companies burden the public in ways that general business does not. For example:

- ❖ Telecommunications companies frequently cut open sections of street pavements either to install new services or to access existing infrastructure. Even though the companies fill in the cuts, the pavement within and beside the cuts often fails prematurely. For example, a City of Cincinnati study found that “street pavements with cuts exhibit a 33% loss in their remaining service life.”<sup>13</sup>
- ❖ Installation of telecommunications infrastructure, such as cables, causes lane closures and significant delays to the traveling public.
- ❖ Closing of street lanes due to installation of telecommunications infrastructure costs both public and private revenues (e.g., parking meter revenues, disruption of private commercial businesses).
- ❖ Installation of telecommunications infrastructure has led to serious accidents and damage to water mains, power lines, gas lines, phone lines, steam lines, and sewers.<sup>14</sup>

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<sup>10</sup> See Table 1, *ibid.*, p. 4. The distribution of a small amount of listed taxes and fees collected by New York City is not clear from this table.

<sup>11</sup> Codified at Chapter 202, Florida Statutes.

<sup>12</sup> Interview with Christian Weiss, Chief Economist, Office of Tax Research, Department of Revenue, State of Florida, October 2005.

<sup>13</sup> Arudi Rajagopal, “A Rational Permit Fee Structure for the Street Right-of-Way Permit Program,” *Public Works Management and Policy*, vol. 8, no. 3, January 2004, pp. 203-215, at p. 210.

<sup>14</sup> See, e.g., TeleCommUnity, “The Case for Rights-of-Way Management: A Collection of Illustrative Incidents Arising from Street Cuts,” available at <http://www.TeleCommUnityAlliance.org>.

Occupation of public rights-of-way by infrastructure of a telecommunications company denies use of that space, and potentially space above and below it, for other uses. For example, the need for access to underground cables and other infrastructure limits the location of light rail lines, transit-related infrastructure such as stations and shelters, foundations for overpasses, streetlight foundations, etc.

In other words, it is entirely appropriate for local governments to charge user fees for use of the public rights-of-way. The portion of “transaction taxes” attributable to user fees should be deducted from the COST Study numbers to make the comparison consistent between telecommunications companies and other businesses that do not impose the same burdens on the public.

### **3.4 User Fees and Taxes Are Enacted for Different, Legitimate Purposes**

The point is well settled that taxes and fees are quite different sources of revenue. In a case involving a gross receipts tax that the City of St. Louis imposed on telegraph companies, the Supreme Court decided over a hundred years ago that it is legitimate for a locality to impose such user fees:<sup>15</sup>

All that we desire or need to notice is the fact that this use is an absolute, permanent, and exclusive appropriation of that space in the streets which is occupied by the telegraph poles. To that extent it is a use different in kind and extent from that enjoyed by the general public. Now, when there is this permanent and exclusive appropriation of a part of the highway, is there in the nature of things anything to inhibit the public from exacting rental for the space thus occupied? Obviously not.<sup>16</sup>

The court had little difficulty with the fact that the rental fee had been denominated as a gross receipts “tax.” It clearly distinguished the difference between taxes and fees on analytical grounds, something that the 2004 COST Study fails to do:

“A tax is a demand of sovereignty; a toll is a demand of proprietorship.” [citations omitted] If, instead of occupying the streets and public places with its telegraph poles, the company should do what it may rightfully do, purchase ground in the various blocks from private individuals, and to such ground remove its poles, the section would no longer have any application to it. That by it the city receives something which it may use as revenue does not determine the character of the charge or make it a tax. The revenues of a municipality may come from rentals as legitimately and as properly as from taxes.<sup>17</sup>

It should be added that the distinction between taxes and user fees remains a feature of current law. For example, *TCG Detroit v. City of Dearborn*, 206 F 3d 618 (6th Cir, 2000) upheld a franchise fee imposed by the City of Dearborn on a telecommunications company as “fair and reasonable” under the terms of the Federal Telecommunications Act of 1996.<sup>18</sup>

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<sup>15</sup> *City of St. Louis v. Western Union Tel. Co.*, 148 U.S. 92 (1893)

<sup>16</sup> 148 U.S. at 99

<sup>17</sup> 148 U.S. at 97

<sup>18</sup> The 1996 Act, as codified at 47 U.S.C. Section 253, provides in pertinent part that:

(a) In general: No State or local statute or regulation, or other State or local legal requirement, may prohibit or have the effect of prohibiting the ability of any entity to provide any interstate or intrastate telecommunications service.

Following the established legal distinction, the U.S. Government Accountability Office (formerly the General Accounting Office) has rendered an opinion that distinguishes the immunity of the U.S. government from local taxes under the Supremacy Clause of the U.S. Constitution and rights-of-way charges that the U.S. government is obligated to pay when they are imposed by the District of Columbia government.<sup>19</sup>

### 3.5 *User Fees Are Not Limited to Cost*

The question then becomes whether it is somehow improper for localities to impose user fees that are higher than the locality's own costs for use of public rights-of-way. Here too the answer is well settled: The owner of property, whether a private owner or a governmental one, may charge market rates for the use of its property.

Similar to the state and local governments that are the focus of the 2004 COST Study, the federal government also has spoken clearly in this regard. The U.S. Office of Management and Budget (OMB) issued Circular No. A-25 in 1998, establishing federal policy regarding fees assessed for government services and for sale or use of government goods or resources. That circular prescribes:

Except [for exceptions as a courtesy to foreign governments or as may be approved by OMB], *user charges will be based on market prices...* when the Government, not acting in its capacity as sovereign, is leasing or selling goods or resources, or is providing a service (e.g., leasing space in federally owned buildings). Under these business-type conditions, *user charges need not be limited to the recovery of full cost and may yield net revenues.*<sup>20</sup> (emphasis added)

In summary, the 2004 COST Study fails to add to the policy debate because it inappropriately mixes user fees and state and local taxes when calculating the “transaction tax” burden on telecommunications companies and other users of public property for private gain. User fees, especially when collected on the basis of market prices, are a substantial part of the revenues that local governments collect from telecommunications companies. These user fees, as the U.S. Supreme Court observed long ago, are as legitimate as tax revenues; similar to tax payments, telecommunications companies may either pass these costs of doing business on to their customers or deduct them from their income taxes.

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(b) State regulatory authority: Nothing in this section shall affect the ability of a State to impose, on a competitively neutral basis and consistent with section 254 of this title, requirements necessary to preserve and advance universal service, protect the public safety and welfare, ensure the continued quality of telecommunications services, and safeguard the rights of consumers.

(c) State and local government authority: Nothing in this section affects the authority of a State or local government to manage the public rights-of-way or to require fair and reasonable compensation from telecommunications providers, on a competitively neutral and nondiscriminatory basis, for use of public rights-of-way on a nondiscriminatory basis, if the compensation required is publicly disclosed by such government.

<sup>19</sup> U.S. General Accounting Office, “911 Emergency Surcharge and Right-of-Way Charge,” B-288161, April 8, 2002.

<sup>20</sup> U.S. Office of Management and Budget, “User Charges,” OMB Circular A-25, July 8, 1993.

## 4.0 Income Taxes

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The COST Study fails to disclose that telecommunications companies pay significantly lower corporate income taxes than other businesses.

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Telecommunications companies on average pay substantially lower corporate income taxes than other companies.

The 2004 COST Study concedes in the section on methodology and assumptions that it “does not include income taxes.”<sup>21</sup> This glaring omission undermines the usefulness of the COST Study, since it fails to provide an accurate picture of state and local taxation of telecommunications companies. Importantly, it omits a significant benefit that telecommunications companies receive under current tax policy. Telecommunications companies on average pay substantially lower corporate income taxes than other companies.

Many telecommunications companies own substantial infrastructure. They claim income tax deductions on the basis of those assets. Because of income tax treatment that permits the telecommunications companies to claim depreciation and investment tax credits on their property, some major telecommunications companies pay far less income taxes, as a percent of income, on average than do other businesses. The 2004 COST Study, which seeks to compare telecommunications tax burdens with those of other businesses, omits this important aspect of state and local taxation.

A look at the public reports of Verizon Communications, a major company with both land-line and wireless lines of business, shows the corporate income tax benefits received by this participant in the 2004 COST Study.

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In 2004, Verizon reported that its state and local tax burdens amounted to an effective rate of only 2.9%.

Verizon’s 2004 Form 10-K filed with the Securities and Exchange Commission reports the company’s tax burdens.<sup>22</sup> In 2004, the company reported that its state and local tax burdens amounted to an effective rate of only 2.9 percent. The company reported a total income tax expense of \$2.851 billion for 2004.<sup>23</sup> Moreover, the lion’s share of this—\$1.850 billion—was deferred. Deferred taxes are much less costly than taxes one must pay immediately.<sup>24</sup>

Verizon reported that much of its state and local income tax burden is deferred. In 2004, the company owed \$335 million in state and local taxes; however, \$123 million was deferred. These are tax revenues for current services, which will not be received by state and local governments for many years to come.

## 5.0 Property Taxes

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The COST Study analysis of property taxes shows, by its own numbers, that there is no discrimination against telecommunications companies in real property taxes and little disparity, if any, in other property taxes.

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<sup>21</sup> 2004 State Study and Report on Telecommunications Taxation, Council on State Taxation, 2005, p. 19.

<sup>22</sup> 2004 Form 10-K for Verizon Communications, Inc., Note 17, “Income Taxes,” pp. 192-193 (Internet version), March 2005

<sup>23</sup> The company’s income statement, also found in the Form 10-K, shows that Verizon’s net income that year was \$7.8 billion.

<sup>24</sup> If a company can defer paying taxes, it can invest the money and obtain investment income for years before the money must actually be paid to the tax authorities. As a result, government is deprived of this money during the intervening years. Other taxpayers such as general businesses generally must pay their full taxes promptly and therefore lose the benefit of deferral.

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The COST Study shows that telecommunications companies pay roughly the same percentage of property taxes as do other businesses.

The 2004 COST Study itself shows that telecommunications companies on average pay roughly the same percentage of property taxes as do other businesses. The COST Study finds that telecommunications companies pay an effective tax rate on real property (i.e., land and buildings) of 2.26 percent, compared to an effective tax rate for other businesses of 2.19 percent.<sup>25</sup> In other words, there is virtually no difference in real property tax burdens.

The effective tax rate for telecommunications companies on tangible property (e.g., furniture, fixtures, equipment) is 1.85 percent, compared to an effective tax rate for other businesses of 1.70 percent.<sup>26</sup> Again this difference, if statistically significant, is small. Taken together, the effective tax rates for real and tangible property are essentially the same between telecommunications companies and other businesses.

The COST Study does show that about one-third of the states, mostly in the Midwest and West, impose taxes on intangible property (e.g., patents, copyrights, licenses, trademarks) at somewhat higher effective rates for telecommunications companies. However, the study also shows that tax rates for intangible property are on average across the country much lower than the other property tax rates on real and tangible property.<sup>27</sup>

In addition, there is the problem of tax avoidance behavior by telecommunications companies that allows them to reduce their property tax burdens even further. As *The Boston Globe* reported,

In total, telecoms have cut their city tax bills by over \$14 million since 2003, through moves such as transferring legal title to equipment to paper companies based in Bermuda and Delaware that get more favorable tax treatment...Verizon Wireless, for example, shifted legal ownership of assets to a Bermuda-based corporation to get more favorable tax treatment and cut its Boston tax bill by 99 percent, to \$9,307 this year from over \$3 million two years ago, according to city figures.<sup>28</sup>

The different tax treatment of telecommunications companies and other utility companies also creates significant inequities:

In the case of thousands of roadside poles jointly owned by Verizon and the local electric utility, the utility pays tax on its half-interest in the pole, but Verizon doesn't. In many cases wireless companies don't pay tax on computerized switches, but they do on backup electrical generators sitting just feet away from the switches.<sup>29</sup>

Boston's Mayor Thomas M. Menino is backing a bill in the Massachusetts legislature to tax telecommunications equipment the same as the property of electric utilities and other industrial companies. This bill would raise \$140 million in revenues statewide.<sup>30</sup>

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<sup>25</sup> *2004 State Study and Report on Telecommunications Taxation*, Council on State Taxation, 2005, p. 12.

<sup>26</sup> *Ibid.*

<sup>27</sup> *Ibid.*

<sup>28</sup> Peter J. Howe, "Telecoms Slash Their Property Tax Burden," *The Boston Globe*, June 10, 2005.

<sup>29</sup> *Ibid.*

<sup>30</sup> *Ibid.*

## 6.0 Overall Impact on Local Governments

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Because of the flaws of the COST Study with respect to (1) user fees and other fees and (2) income taxes, its estimates of relative tax burdens are incorrect. However, even if taken at face value, the COST Study's data show a tremendous impact on the ability of local governments to provide needed services to their constituents due to lost revenue if the telecommunications industry's recommendations were followed.

In addition to the 2004 COST Study, the Telecommunications State and Local Tax Coalition (an industry group) prepared a study in 2001. The 2001 study quantified the amount of state and local revenues that the telecommunications industry seeks to eliminate:

An estimated 39 percent of all telecom taxes, \$7.0 billion, are *excess taxes that exceed taxes generally imposed on other businesses and their customers...*<sup>31</sup> (emphasis in original)

In other words, as of the year 2001, the telecommunications industry was suggesting that their taxes to state and local governments should be reduced by \$7 billion. If we accept the flawed study and its outcomes, as well as project the 39 percent reduction to the telecommunications industry's current state and local taxes, around \$20 billion annually, that number has now grown to around \$8 billion.

To offset the loss of \$8 billion, governments would be faced with difficult choices. They could (1) increase rates on all other taxpayers, (2) cut services, or (3) undertake a combination of both. In today's environment of resistance to increased taxation, budget cuts are the more likely scenario. There are already fiscal pressures on cities. For example, nearly one-half of all city finance officers in 2005 increased fees and charges for services to offset revenue shortfalls.<sup>32</sup>

The magnitude of these cuts is seen in the potential impact on four of the largest and most essential categories of local government employees: police officers, firefighters, elementary school teachers, and high school teachers. Figure 1 shows the median salaries and the number of each that would correspond to the financial impact of the type proposed by COST.

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It would be foolhardy to enact federal laws based upon the flawed and incomplete information in the COST Study.

In other words, if governments lost \$8 billion in revenue, they would need to shift tax burdens from telecommunications companies to other taxpayers or else cut budgets by an amount equal to the combined salaries of more than 150,000 teachers, police, and firefighters. It would be foolhardy to enact federal laws with the kind of impact that the telecommunications industry seeks, especially if based upon the flawed and incomplete information provided in the COST Study.

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<sup>31</sup> *Telecommunications Taxes: 50-State Estimates of Excess State and Local Tax Burden*, prepared by Ernst & Young LLP for the Communications State and Local Tax Coalition, November 2001, p. 1.

<sup>32</sup> Michael A. Pagano, Christopher W. Hoene, *City Fiscal Conditions in 2005*, National League of Cities, January 2006.

**Figure 1: Potential Impacts of an \$8 Billion Reduction in Telecommunications Taxes**

	Elementary School Teachers <sup>a</sup>	Secondary School Teachers <sup>a</sup>	Police Officers <sup>b</sup>	Firefighters <sup>c</sup>
<b>Median salary</b>	\$45,658	\$46,119	\$34,738	\$32,162
<b>Median salary plus benefits<sup>d</sup></b>	\$59,584	\$60,185	\$46,896	\$40,524
<b>No. corresponding to a \$0.25 billion revenue reduction</b>	4,196 teachers	4,154 teachers	5,331 police officers	6,169 firefighters
<b>No. corresponding to a \$1 billion revenue reduction</b>	19,850 teachers, police officers, and firefighters			
<b>No. corresponding to an \$8 billion revenue reduction</b>	158,800 teachers, police officers, and firefighters			

a. Source: *Mini-Digest of Education Statistics 2003*, National Center for Education Statistics, U.S. Department of Education, October 2004, Table 16, p. 20.

b. Source: *2004 Municipal Yearbook*, International City/County Managers Association (ICMA), 2004, Table 3/5. The median is for the entrance salary for police officers.

c. Source: *2004 Municipal Yearbook*, ICMA, 2004, Table 3/6. The median is for the entrance salary for firefighters.

d. Figures for police and fire benefits, as a percentage of salary, are calculated from ICMA's *Police and Fire Personnel, Salaries, and Expenditures, 2005*; figures for teacher benefits are projected to be the average, as a percent of salary, of the police and fire benefits.

## 7.0 The Effects of Changing Technology

Technological convergence is creating new forms of competition among different types of telecommunications as voice, data, and video are offered over a much broader range of media, including traditional land lines, wireless, cable, satellite, and VoIP services. Each of these services is subject to a different set of state and local taxes. In addition, the federal government is showing a disturbing pattern of intervention in state and local revenue policy that has the potential to exacerbate rather than reduce these tax differentials. In this context, negotiations among state and local government groups and telecommunications companies represent the best way to reduce administrative burdens and promote equitable taxation.

### 7.1 Shifting Technologies

This analysis would be incomplete without recognition of the larger context of the COST Study. There is no question that telecommunications companies are under serious pressure from competing technological applications that are rendering old business models increasingly vulnerable. As *The Wall Street Journal* reported, “more Americans now have cellular phones than traditional phones in their homes. Cable companies are selling phone service, while phone companies

plan to offer video in coming years. And high-speed connections make it possible to use computer software to make calls over the Internet.”<sup>33</sup>

Consider, for example, voice communications. In the interviews conducted for this White Paper, a number of respondents commented on the rapid reduction in access lines in their jurisdictions. This trend is borne out by the statistics. For example, the Federal Communications Commission reports that from year-end 2000 to year-end 2004 the number of mobile wireless telephone subscribers increased by almost 80 percent, from 101 million to 181 million subscribers.<sup>34</sup> Many of these subscribers formerly were land-line customers. The result, perceptible to local and state governments, has been a reduction in revenues that previously had been received by land-line companies and ultimately by the governments that tax those companies.

These trends are accelerating with new technologies, and especially the Internet, forcing further changes in business models. *The Economist* magazine published two reports that essentially conclude that, “There is no longer any question of whether VOIP (“voice over Internet protocol,” i.e., telephone services provided via Internet) will wipe out traditional telephony, but a question of how quickly it will do so.”<sup>35</sup>

The result of this pressure is being felt not only by telecommunications companies but also by state and local governments that are trying to adjust their tax base to take account of the migration of telecommunication services from traditional forms. State and local governments have begun to levy taxes on cell phones in addition to sales taxes, leading to industry complaints that wireless telephone services are subject to special taxes.<sup>36</sup>

## 7.2 *Shifting Tax Burdens*

On the other side, telecommunications companies are able to use the new technologies and other techniques to try to avoid their traditional tax burdens. In Massachusetts, for example, telecommunications companies, including several that participated in the 2004 COST Study, have engaged in special corporate transactions that permit them to avoid paying their usual share of property taxes. *The Boston Globe* reported:

Making aggressive use of fine print in Massachusetts tax law, telecommunications companies have managed to get \$1.3 billion in property off local tax rolls in the last two years, including \$438 million worth in Boston alone.<sup>37</sup>

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<sup>33</sup> Anne Marie Squeo, “Phone Companies Push Telecom Overhaul; Industry Wants Revamp of 1996 Act to Level Playing Field, but Cable Firms Are Cautious,” *The Wall Street Journal*, January 18, 2005, p. A4.

<sup>34</sup> Federal Communications Commission, *Local Telephone Competition: Status as of December 31, 2004*, July 2005, Table 13 (“Mobile Wireless Telephone Subscribers”).

<sup>35</sup> “How the Internet killed the phone business,” *The Economist*, September 15, 2005, p. 11. See also, “The meaning of free speech,” *ibid.*, pp. 69-71).

<sup>36</sup> Ken Belson, “The Cellphone Becomes a Taxpayer,” *The New York Times*, May 14, 2005.

<sup>37</sup> Peter J. Howe, “Telecoms Slash Their Property Tax Burden,” *The Boston Globe*, June 10, 2005.

Of course, to the extent that telecommunications companies shed their tax burdens, other businesses and consumers must pick up the slack if local governments try to avoid draconian cuts in services:

The tax-minimizing moves by companies, including Verizon Communications Inc. and its wireless affiliate, MCI Inc., Sprint Corp., and AT&T Corp., mean Boston businesses are paying 2 percent higher property tax bills, and the average single-family homeowner is paying \$185 more each year, city Assessor Ronald Rakow said yesterday.<sup>38</sup>

The impact on local and state revenues of tax avoidance behavior by these companies is exacerbated by an increasing pattern of federal intervention to preempt state and local tax systems. The most recent example is the so-called Internet Tax Nondiscrimination Act,<sup>39</sup> which expanded an earlier federal moratorium on state and local taxation of Internet access and other taxes on electronic commerce.

Selectively omitting certain services within the telecommunications sector from taxation does nothing to improve the quality or consistency of our tax policies nationwide. Technology will cause enough disruption; artificial discrimination, through yet further expansion of the Internet Tax Nondiscrimination Act,<sup>40</sup> will add to that problem.

## 8.0 Conclusion

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Both the federal and local governments are considering how to levy taxes fairly, without discriminating among companies that provide different forms of the same service. These debates are appropriate, and local government has been a willing partner in attempting to consider potential reforms that would continue to ensure continued growth of technology use and development. However, these goals cannot be achieved if the telecommunications industry continues to produce and circulate among members of Congress findings such as those set forth in 2004 COST Study, which contains serious methodological flaws and omits essential analytic information, and to focus more on obtaining inappropriate advantages than on creating rational tax policy.

First, the study fails to reduce the calculated “transaction taxes” by the substantial amount that is attributable to the user fees. Second, it fails to reduce the calculated “transaction taxes” by the amount used to fund the 911 emergency system and universal service. These help the public telecommunications network (and the profits of telecommunications companies). None of these are separated out from the study’s comparisons with the tax burdens borne by general businesses. Moreover, the COST Study fails to include a comparison of corporate income tax burdens, where other businesses pay more on average than telecommunications companies. Policymakers would be foolhardy to undertake major policy shifts of the type urged by COST on the basis of the weak COST Study.

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<sup>38</sup> Ibid.

<sup>39</sup> Public Law 108-435, enacted December 3, 2004.

<sup>40</sup> See, e.g., S. 849 and H.R. 1684, both introduced April 19, 2005, in the U.S. Senate and House of Representatives, respectively.

## From the Sponsoring Organizations

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