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THE ISSUE

The maze of telecommunications taxes is as hard on consumers' pocket-books as it is difficult for them to understand. Texans pay an average of 25.29 percent in state and local telecom transaction taxes—third highest in the nation. This includes state and local sales taxes, municipal franchise fees, and charges for the Texas Universal Service and Texas Telecommunications Infrastructure funds.

The average Texas local telecom tax rate is 11.32 percent and the average state tax rate is 13.97 percent. Adding federal taxes to the mix means that the average Texan's total telecom tax bill is just under 30 percent, almost one third of the cost of telecommunications services. In comparison, the general transaction (or sales) tax rate in Texas is 8.25 percent.

These average tax rates are representative of the tax burden on traditional local phone service. Cellular service in Texas is taxed less because it is not subject to the municipal franchise fee. Cable service has an average rate in Texas of about 14 percent, though cable companies offering traditional phone service generally face a similar level of taxes and fees on that service as phone companies do. Satellite service faces an even lower burden, having to pay only state and local sales taxes.

The Legislature needs to address both the high overall telecom tax burden and the disparate tax treatment of the different technologies. The Foundation has identified over \$382 million of telecommunications tax cuts that could be implemented by the 80th Texas Legislature, to address both of these issues.

THE FACTS

- ★ The Telecommunications Infrastructure Fund (TIF) fee is a gross receipts tax intended to fund the installation of communications infrastructure at public institutions. With that goal achieved, the fee was scheduled to expire. However, the Texas Legislature extended it through 2011 at a cost of about \$200 million per year.
- ★ The Universal Service Fund (USF) is funded by a charge on the monthly phone bill equal to about 5.65 percent of local and intrastate phone service, costing consumers over \$500 million a year. While the Fund helped promote the transition to a market-based system, today the fund is often more a hindrance than a help in fostering competition, essentially subsidizing some consumers and businesses at the expense of others.
- ★ Municipal franchise fees have become divorced from paying for the cost of managing the right-of-way, and turned into just another revenue source for cities.



- ★ The sales tax levied on telecommunications services function as taxes on a tax, since they are levied on several other telecom taxes, including the Federal USF charge, the Texas USF charge, the TIF fee, the Utility Gross Receipts Assessment, and Municipal Franchise Fees. This tax on a tax costs Texas consumers over \$90 million a year.

RECOMMENDATIONS

- ★ Eliminate the tax on a tax aspect of the state and local sales taxes. Taxpayer Savings: \$90 million per year.
- ★ Eliminate the Telecommunications Infrastructure Fund (TIF) fee. Taxpayer Savings: \$200 million per year.
- ★ Universal Service. Bring rates for all basic residential phone service to parity with urban rates and provide for a corresponding reduction in Universal Service charges. Taxpayer Savings: \$90 million per year.
- ★ Municipal Franchise Fees. Restructure these fees to reflect the marginal costs of placing facilities in the right-of-way. Taxpayer Savings: Unknown.
- ★ Private Network Service. Eliminate mandated provision of Private Network Service. Taxpayer Savings: \$2 million per year.

RESOURCES

- *Texas Telecommunications Taxes: An Overview* by Bill Peacock, Texas Public Policy Foundation (Feb. 2006) <http://www.texaspolicy.com/pdf/2006-02-PP-telecom1-BP.pdf>.
- *Texas Telecommunications: Everything Is Dynamic Except The Pricing* by Robert W. Crandall and Jerry Ellig, Texas Public Policy Foundation (Jan. 2005) <http://www.texaspolicy.com/pdf/2005-01-telecom.pdf>.
- *2004 State Study And Report On Telecommunications Taxation* by the Telecommunications Tax Task Force of the Council On State Taxation (COST), May 2005.
- *Should a Tax Tax a Tax? Citizens for a Sound Economy* by Kent Lassman (Feb. 2001) http://www.freedomworks.org/informed/issues_template.php?issue_id=764.
- *Tax Match: The States vs. the Services* by Marvin Kirsner, *Telecommunications Online: Americas Issue* (Oct. 2005) <http://www.gtlaw.com/pub/articles/2005/kirsnerm05c.pdf>.

THE ISSUE

Telephone subsidies are a way of life in Texas. However, their usefulness is rapidly drawing to an end. Subsidies have been used to help the state achieve its policy goal of providing universal, low cost telephone service for citizens across the state, particularly in rural Texas.

Under the previous heavily regulated telephone system, subsidies could be used to transfer wealth without major economic distortions. However, now that the transition of the telecommunications market to a competitive marketplace is well under way, they are often more a hindrance than a help in fostering competition. The two largest subsidies in place today are the Texas Universal Service Fund and intrastate long distance access rates.

Texas established the Universal Service Fund in 1987 to pay for a number of programs intended to enable all state residents to obtain basic telephone service at low prices. The vast majority of the funding is for subsidies in high-cost/rural areas, but it also subsidizes Lifeline and Linkup service for low-income customers and low-cost Internet access for certain state agencies and institutions of higher education (Private Network Service).

Up until 2006, the average intrastate access rate in Texas, which is set by the Legislature, was approximately 6 cents per minute, compared to about 1 cent per minute for interstate access. This began to change this year, as some companies—most notably AT&T—started reducing their access rates on July 1 under the provisions of SB 5, passed by the Texas Legislature in 2005.

THE FACTS

- ★ Because of subsidies, we estimate that only 281,000 out of 5.5 million residential lines we examined are priced at rates that cover their long-run incremental costs.
- ★ Charges for basic phone service run from \$13.82 per month in rural areas to \$16.72 in urban areas, but long-run incremental costs for service range from \$11.84 per month in urban areas to more than \$250 per month in rural areas.
- ★ Texas USF payments for FY 2004 were estimated to be \$586 million.
- ★ Almost 90 percent of the USF payments currently go toward high-cost and small rural carriers—not to low-income households that might not be able to afford phone service.
- ★ USF assessments on long-distance and wireless service reduces consumer and producer welfare in Texas by about \$166 to \$173 million annually.



- ★ Though intrastate access charges are not a traditional tax, this regulated charge functions as a hidden tax on consumers of intrastate long distance. If this charge were deregulated, intrastate long distance rates would surely decrease.
- ★ While information is not available for the entire state, large incumbent carriers' (AT&T, Verizon, Central, and United) revenue from intrastate long-distance access charges might exceed the cost of providing the service by \$172 million.

RECOMMENDATIONS

- ★ Bring rates for all basic residential phone service to parity with urban rates and provide for a corresponding reduction in Universal Service charges. This would reduce USF assessments on local phone bills by \$90 million per year.
- ★ Eliminate mandated provision of Private Network Service, at a savings to consumers of \$2 million per year.
- ★ Provide more careful targeting of USF programs to those who truly need them.
- ★ Firm timelines should be put in place to remove the relics of monopoly regulation—such as price caps and floors—from the current system. As companies are given more pricing flexibility, both USF assessments and intrastate access rates can be reduced at the same time.

RESOURCES

- *Q&A on the Texas Universal Service Fund* by Bill Peacock, Texas Public Policy Foundation (Aug. 2006) <http://www.texaspolicy.com/pdf/2006-08-PP-USF-Q&A-bp.pdf>.
- *Texas Telecommunications Taxes: An Overview* by Bill Peacock, Texas Public Policy Foundation (Feb. 2006) <http://www.texaspolicy.com/pdf/2006-02-PP-telecom1-BP.pdf>.
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- *Crisis Looms in Universal Service* by Joseph Kraemer, Richard Levine, and Randolph May, published by the Heartland Institute (June 2005) <http://www.heartland.org/Article.cfm?artId=17030>.

THE ISSUE

Municipal franchise fees are levied on telecommunications services by cities for the use of the public right of way (ROW). These fees, which average from 4 to 6 percent of a typical telephone, cable, or video bill, make up a significant portion of the high telecommunication taxes levied on Texans.

There are three different forms of telecommunications franchise fees: 1) franchise or licensing fees for telephone service, 2) cable franchise fees, and 3) the new statewide video franchise fee created by SB 7 in 2005.

Though courts (and local governments) have said that franchise fees are “essentially a form of rent: the price paid to rent use of public right of ways,” it is wrong to think of them in this way. Governments are not private landlords seeking to extract maximum profits from private property, but guardians of the public interest in public lands. As such, they should not seek to extract maximum rents from the public for the use of the ROW, but instead should facilitate orderly public access to the ROW by imposing access prices equal to marginal costs. Rates higher than this disrupt the most efficient use of the ROW by imposing monopoly pricing on consumers via franchise fees that reduce the quality and availability of services to the public.

THE FACTS

- ★ Franchise fees have become divorced from paying for the cost of managing the right of way and have instead become just another revenue source for cities.
- ★ In 2005, 182 certified telecommunications providers paid approximately \$222 million in telephone franchise fees to 1,128 cities.
- ★ Telecom franchise fees for Houston, Dallas and Austin are about \$50 million, \$20 million and \$15 million, respectively.
- ★ Local governments, which have many other sources of revenue, have sufficient “budget bandwidth” to accommodate reduced franchise fees.
- ★ State and local governments are scrambling to maintain franchise fee revenues they feel are being threatened by new technologies. Services like satellite video and VoIP are threatening revenues, because in many cases they do not have to pay franchise fees.
- ★ Franchise fees do not include payments or costs incurred to relocate, remove or alter facilities in the right of way. One provider estimated that over the last year it spent an additional \$20 to \$25 million to relocate its facilities for road straitening and widening projects.



RECOMMENDATIONS

- ★ Franchise fees should be priced not to extract maximum rents from the public for the use of the ROW, but instead to facilitate orderly public access to the ROW by imposing charges equal to the marginal cost of providing access.
- ★ Franchise fees should be based on the physical occupation of the public right of way and the associated costs, not on the provision of individual services.
- ★ To assist in the transition to facilities-based franchise fees, new, emerging technologies, such as VoIP, should be exempt from franchise fees.
- ★ Incumbent providers are currently required to maintain their existing municipal franchise agreements until they expire. They should be allowed to opt out of them in order to utilize the new statewide video franchise.

RESOURCES

- *Paying for the Use of the Public Right of Way* by Bill Peacock, Texas Public Policy Foundation (June 2006) <http://www.texaspolicy.com/pdf/2006-06-PP-telecomROW-bp.pdf>.
- *Texas Telecom Deregulation: Seeking a Level Playing Field* by Bill Peacock, Texas Public Policy Foundation (Apr. 2006) <http://www.texaspolicy.com/pdf/2006-04-27-testimony.pdf>.
- *Texas Telecommunications Taxes: An Overview* by Bill Peacock, Texas Public Policy Foundation (Feb. 2006) <http://www.texaspolicy.com/pdf/2006-02-PP-telecom1-BP.pdf>.
- *Cable TV Franchises As Barriers To Video Competition* by Thomas W. Hazlett, George Mason University (June 2006) http://ssrn.com/abstract_id=889406.
- *Tax Match: The States vs. the Services* by Marvin Kirsner, *Telecommunications Online: Americas Issue* (Oct. 2005) <http://www.gtlaw.com/pub/articles/2005/kirsnerm05c.pdf>.

THE ISSUE

For most of the last century, cheap and universally available local residential phone service was the primary telecommunications goal of policymakers across the country. The resulting regulatory regime kept competition at bay in order to maintain an elaborate web of subsidies that supported artificially low local service prices.

In the 1970s, when it became clear to everyone that consumers were demanding services that the regulated system couldn't deliver, the country began to move into the new era of telecommunications deregulation.

Texas has recently been one step ahead of the rest of the country, passing major telecom reform legislation in both 1995 and 2005. Thanks to the most recent legislation—Senate Bill 5—local telephone service for more than 15 million Texans was significantly deregulated as of January 1, 2006. This was a major step forward in reducing costs and bringing new technologies and services to millions of Texans.

But there is still room for improvement. Even though more than 15 million Texans live in areas where telephone service has been significantly deregulated, only three incumbent phone companies serve those people and there are still price controls in effect in those areas. For instance, companies cannot raise rates for basic service in deregulated markets until September 1, 2007. In addition, companies must apply rates evenly across a deregulated market, consistent with pricing flexibility that was available on August 31, 2005. Companies are also subject to price floors for all services set at the service's long run incremental cost. Finally, they are also subject to applicable PUC rules relating to discriminatory and predatory pricing under Chapter 60 of the Public Utilities Code.

The vast majority of phone companies continue to operate in regulated markets serving over 7 million Texans located mostly in rural Texas. In these areas, companies are subject to price caps, price floors and/or tariffs.

THE FACTS

- ★ Competition ALWAYS brings consumers the best products at the best prices. The history of telecommunications deregulation proves this time and again.
- ★ When the telecommunications equipment market was deregulated in the 1970s, the prices for phone handsets, key telephones, and private branch exchanges declined at a real rate of between six and seven percent per year between 1972 and 1987.
- ★ From 1984 to 1995, when there were just two cellular providers per market, inflation adjusted rates fell by an average of only 3 to 4 percent annually. However, in 1993, the government allowed up to six competitors in each market, resulting in declines in wireless rates averaging 17 percent annually from 1995 to 1999. A cellular phone call which



averaged 50 cents per minute in 1984 has declined to 8 cents per minute today.

- ★ Upon deregulation, interstate long distance rates fell 68 percent from 1984 to 2003, while intrastate rates fell 56 percent. The slower decline of intrastate rates is due largely to state regulators who have kept intrastate access charges artificially high in order to maintain subsidies of local phone rates.
- ★ The dual system in Texas of deregulated urban markets and regulated rural markets could create a “digital divide” between urban and rural customers.
- ★ The urban/rural digital divide could have a significant impact on taxpayers as it builds political pressure to increase, rather than decrease, telecommunications subsidies through the Texas Universal Service Fund.

RECOMMENDATIONS

- ★ The relics of monopoly regulation—such as price caps and floors—should be removed from the current system. Texas telecommunications policy should reflect the ongoing vibrant competition in many markets by immediately removing all price controls in deregulated markets to provide a positive incentive for companies to choose deregulation.
- ★ Firm timelines should be set for the deregulation of the currently regulated suburban and rural telecommunications markets. It is clear that technology brings real competition in telecommunications to every part of the state. A phased-in approach to deregulation in mid- and small-sized markets would encourage competition by ensuring that market participants (current and potential) understand that competition is inevitable.
- ★ Pricing flexibility that comes with deregulation should be paired with reductions in subsidies.

RESOURCES

- *Texas Telecom Deregulation* by Bill Peacock, Texas Public Policy Foundation (Apr. 2006) <http://www.texaspolicy.com/pdf/2006-04-27-testimony.pdf>.
- *Texas Telecommunications: The Road Ahead* by Bill Peacock, Texas Public Policy Foundation (Oct. 2005) <http://www.texaspolicy.com/pdf/2005-11-telecom-pp.pdf>.
- *A Telecommunications Policy Primer* by Dianne Katz, Texas Public Policy Foundation (Jan. 2005) <http://www.texaspolicy.com/pdf/2005-01-tele.pdf>.
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- *Communications Without Commissions: A National Plan for Reforming Telecom Regulation* by Braden Cox and Clyde Wayne Crews, Jr., Competitive Enterprise Institute (Oct. 2005) <http://www.cei.org/pdf/4911.pdf>.