

REPEALING THE TELECOM EXCISE TAX An Economic Primer

by Joseph J. Cordes

I. INTRODUCTION

Telecommunications has become one of the most dynamic sectors of the economy and will continue to be so for the foreseeable future. Much of this dynamism has been fueled by a combination of technological innovation and competition, spurred by the transition of telecommunications from a regulated monopoly to a more competitive industry.¹

The taxation of telecommunications services has failed to keep pace with both the technological and the regulatory changes that are rapidly blurring the lines between different telecommunications providers. Traditional telecommunications services not only face the full range of federal, state and local taxes imposed on other businesses, but are also subject to a broad array of taxes and tax-like fees that are levied only on them. Some of these are relics of the telecommunications industry's regulated past, while others are rooted in the budgetary politics of the 1980s and early 1990s. These taxes are not only outdated; they can also be bewildering and, as noted in a recent article in *The Washington Post*, many phone bills would be a "lot cheaper if there weren't a stack of fees bundled into even the most straightforward local and long-distance charges."²

Experts who have examined the issue generally agree that there are sound reasons for replacing much of the current system for taxing telecommunications with a

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¹ For a useful overview of recent developments in the telecommunications sector, see Council of Economic Advisers, *Progress Report: Growth and Competition in U.S. Telecommunications 1993-1998*, at <http://www.ntia.doc.gov/ntiahome/press/ceafinalrpt.htm>.

² *The Washington Post*, February 4, 2000. Phone bills are sufficiently arcane that the Congressional Research Service was actually asked to prepare a report explaining telephone bills. See James Riehl, *Telephone Bills: Charges on Local Telephone Bills*, November 16, 1999, Congressional Research Service.

simpler, fairer and more rational approach.³ This sentiment was most recently evident in widely reported debates of the Advisory Commission on Electronic Commerce. Despite disagreement among several commission members about the merits of taxing Internet commerce, there was general agreement on the desirability of reforming state and local telecommunications taxes and repealing the federal excise tax.⁴ And proposals to repeal the tax have been introduced in the U.S. Congress.⁵

Proposals to repeal the federal telephone excise tax predate the deliberations of the Advisory Commission on Electronic Commerce. In the 1980s, the Treasury Department issued a report recommending that the tax, which had its origins as a temporary luxury tax to help finance the Spanish American War, should be allowed to expire as scheduled at the end of 1987.⁶

On balance, there are no strong arguments in favor of the communications excise tax. In addition, there are reasonably strong efficiency and moderate equity arguments against the tax. Further, although reasonably simple in itself, the tax contributes to the complexity of the tax system as a whole. *For these reasons the tax should be allowed to expire at the end of 1987 as scheduled under current law.* (emphasis added)

Nonetheless, the federal communications excise tax was extended in 1987, mainly because large and persistent budget deficits made it difficult, if not impossible, at the time, to enact tax cuts. Today, however, with sizable actual and projected federal budget surpluses, the fiscal equation has changed, and the time has come to give serious consideration to implementing the original Treasury Department recommendation.

II. THE FEDERAL EXCISE TAX ON TELECOMMUNICATIONS

The federal telecommunications excise tax (FET) is levied at a rate of three percent of the amount paid by individuals and businesses for local and toll (long distance) telephone (as well as telewriter) services. Local telephone service is defined as “access to a local telephone system and the privilege of telephonic quality

³ For example, see Martin Sullivan, “Will the Tax on Talking Take a Walk?” *Tax Notes*, April 15, 1999, *National Tax Association Communications and Electronic Commerce Tax Project Final Report*. Washington, D.C.: National Tax Association, 1999, at <http://www.ntanet.org/>. The National Governors’ Association also recently issued a report acknowledging the complexity of the current tax structure for the telecommunications industry and called on the states to undertake a thorough review of their telecommunications tax structure. See Scott Paladino and Stacy Mazer, *Telecommunications Tax Policies: Implications for the Digital Age*. Washington, D.C. : National Governors’ Association, 2000, at <http://www.nga.org/Pubs/IssueBriefs/2000/Sum000202TeleCom.asp>.

⁴ Elliot Zaret, “Commission Can’t Agree on Net Tax Plan,” CNBC, March 21, 2000, at <http://www.cnn.com/>.

⁵ Legislation in the House of Representatives to repeal the tax has been introduced by Representatives Robert Matsui (D – California) and Rob Portman (R – Oregon). Legislation in the Senate to repeal the tax has been introduced by Senators William Roth (D – Delaware), John Breaux (D – Louisiana), Don Nickles (R – Oklahoma), Frank Murkowski (R – Alaska), Connie Mack (R – Florida), and Chuck Robb (D – Virginia).

⁶ U.S. Department of the Treasury, *Report to the Congress on Communications Services Not Subject to Federal Excise Tax*. Washington D.C.: Office of Tax Analysis, U.S. Department of the Treasury, 1987.

communication with substantially all persons having telephone or radio telephone stations constituting a part of the local system.” Toll telephone service is defined to be a “telephone quality communication for which there is a toll charge that varies with the distance and elapsed transmission time of each communication and the charge for which is paid in the United States.”⁷ The “amount paid” on which the excise tax is applied includes mandated federal charges, such as the Federal Subscriber Line Charge, as well as certain state and local fees such as right-of-way and 911 charges.

As can be seen from Table 1, among general excise taxes collected by the federal government, the FET ranks second after the federal tax on cigarettes in terms of tax collections. Roughly half of this total is paid by consumers on their phone bills.⁸ Based on information about annual expenditures for telecommunication services from the Consumer Expenditure Survey, the amount of FET directly paid by households is estimated to range from approximately \$18 per year for households with incomes of less than \$20,000 to \$36 per year for households with incomes greater than \$70,000.⁹ The other half of the FET is paid by businesses. Although this portion of the FET is not directly paid by households, the burden of the “business half” of the FET is nonetheless ultimately borne by households in their role as business owners and employees (see discussion below).

Table 1: Federal Excise Taxes

Actual and Projected Revenue from Federal General Fund Excise Taxes: (Billions of Dollars)							
Alcohol	1998	1999	2000	2001	2002	2003	1998-2003
Distilled Spirits	3.6	3.6	3.5	3.5	3.5	3.5	21.2
Beer	3.4	3.4	3.4	3.4	3.4	3.4	20.3
Wine	0.7	0.7	0.7	0.7	0.7	0.7	4.1
Total	7.4	7.4	7.4	7.4	7.5	7.5	44.7
Tobacco							
Cigarettes	5.6	5.2	6.4	7.0	7.6	8.0	39.9
Other	0.1	0.1	0.1	0.1	0.1	0.1	0.9
Total	5.7	5.3	6.6	7.2	7.8	8.2	40.7
Telecommunications	5.2	5.6	5.9	6.3	6.7	7.1	36.8

Source: U.S. Congress, Joint Committee on Taxation, 1999. *Schedule of Present Federal Excise Taxes (As of January 1, 1999)*, Table B. (U.S. Government Printing Office, Washington, D.C.)

⁷ Ibid., p. 8.

⁸ See Julie-Ann Cronin, *U.S. Treasury Distributional Analysis Methodology*, OTA Paper 85. Washington, D.C.: Office of Tax Analysis, U.S. Department of the Treasury, Sept. 1999, p. 28, at <http://www.ustreas.gov/ota/ota85.pdf>.

⁹ See U.S. Department of Labor, at <http://stats.bls.gov/csx/1998/Aggregate/income.pdf>.

III. ASSESSING TELECOMMUNICATIONS TAXES AS SOURCES OF REVENUE

From a broad tax policy perspective, the question is whether the FET is a good way of raising public revenue. In 1987, the Treasury Department concluded that the FET earned relatively low marks on the standard tests that are used to gauge whether particular taxes are “good” revenue sources.

- The FET generally did not distribute tax burdens fairly.
- The FET was found to add additional complexity to the federal tax system.
- The FET encouraged businesses and consumers to change their behavior in ways that were economically costly.

These concerns are perhaps even more valid now than they were in the 1980s.

A. FAIRNESS

An important principle of public finance is that taxes should distribute the burden of financing government fairly. Two broad principles of fairness in taxation are generally used to judge the fairness of taxes: the *benefit principle* and the *ability-to-pay principle*.¹⁰

1. *Benefit Principle*

The benefit principle holds that the burdens of raising public revenue should be distributed according to the benefits that taxpayers receive from the public goods and services provided by government. One way of seeing that those who benefit from specific public services also pay for them is to assess fees and other beneficiary charges for the use of specific public services. Alternatively, one can tax goods or activities whose use or conduct bears some identifiable relation to benefits received from government. For example, federal and state taxes on gasoline are seen as providing a rough kind of tax fairness by distributing the burden of paying for public roads according to how much people drive.¹¹

The benefit principle provides no rationale for a federal communications excise tax. There is no basis for presuming that telecommunications providers and their customers derive distinctive benefits from the range of goods and services financed in the federal budget that would justify subjecting telecommunications services to an additional layer of taxation not faced by other businesses.

¹⁰ For an explanation of the benefit and the ability to pay principles, see the relevant entries in Joseph J. Cordes, Jane G. Gravelle, and Robert Ebel, eds., *Encyclopedia of Taxation and Tax Policy*, Washington, D.C.: Urban Institute Press, 1999.

¹¹ Joseph J. Cordes, “Benefit Principle,” in Cordes, Gravelle, and Ebel, *op. cit.*

2. *Ability to Pay*

The other widely used principle of tax fairness is the ability-to-pay principle, which holds that tax burdens should be distributed among taxpayers in line with their ability to pay taxes, as typically measured by their annual income. This criterion is often applied in practice by measuring how the percentage tax burden changes as a taxpayer's income rises. A tax is said to be regressive if the percentage of income paid in tax falls as income rises, proportional if the percentage of income paid in tax stays the same as income rises, and progressive if the percentage of income paid in taxes rises as income rises. Many public finance scholars agree that taxation on the basis of ability to pay requires that the tax burden be distributed at least somewhat progressively. There is even more widespread agreement that tax burdens should not be regressive.

As noted in a recent Treasury Department working paper on the distributional analysis of taxes, the overall distribution of the burden of taxes and charges on telecommunication services depends on the separate distribution of the burden of the share of telecommunications taxes and charges that is paid by businesses, and the share that is paid by individual consumers. In the case of telephone taxes and charges that are paid by businesses, it is plausible to assume that the incidence of these taxes is comparable to a broad-based consumption tax, that is borne by households in proportion to capital and labor income.¹²

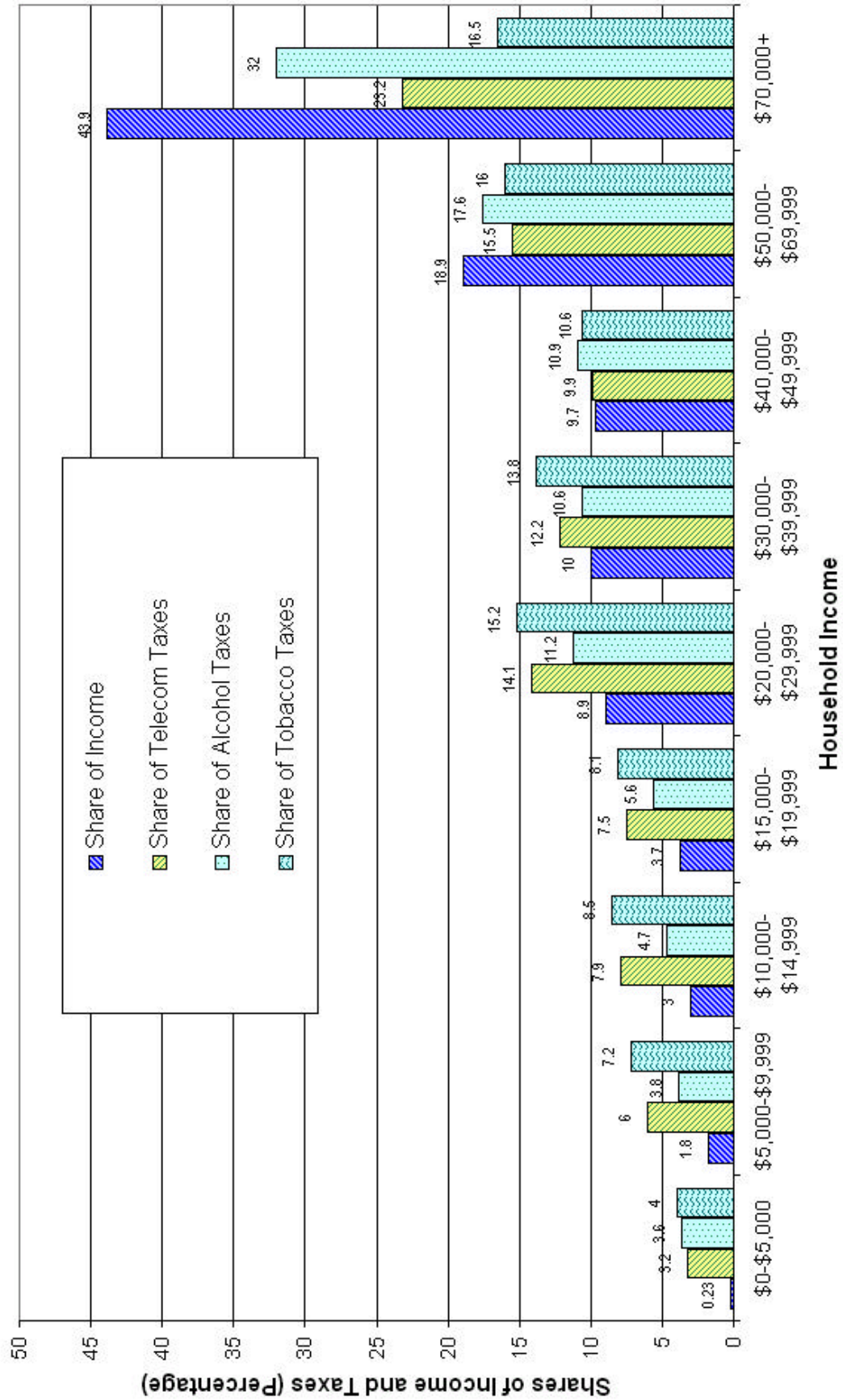
Telecommunications taxes and charges that are paid directly by households on their phone bills are distributed regressively with respect to income. As is shown in Figure 1, the estimated share of telecommunications taxes paid by households with annual incomes less than \$40,000 exceeds these households' shares of total income -- in some cases by a considerable margin.¹³ Figure 1 also shows that the burden of telecommunications taxes paid directly by consumers is distributed more regressively than federal taxes on alcoholic beverages.¹⁴

¹² Cronin, *op. cit.*, pp. 27-31.

¹³ The shares of the tax burden shown in Figure 1 were derived by assuming that the burdens of the portion federal excise taxes that are paid directly by consumers are borne in proportion to each household's share of spending on the taxed good. These spending shares, along with the income shares, are taken or derived from data reported on the Consumer Expenditure Survey, and tabulated in Table 46 at <http://stats.bls.gov/csx/1998/Aggregate/income.pdf>.

¹⁴ This result is broadly consistent with the findings of a 1987 Congressional Budget Office study that the burden of the federal telephone excise tax is distributed at least as regressively as the burden of taxes on alcohol and tobacco. See U.S. Congress, Congressional Budget Office, *The Distributional Effects of an Increase in Selected Federal Excise Taxes*, Staff Working Paper, January 1987. (As cited in U.S. Department of the Treasury, *op. cit.*)

Figure 1: Regressivity of Telecommunication Taxes



B. TAX SIMPLICITY

Society has an interest in keeping its tax system as simple as possible. Government, businesses and individuals often must spend considerable time and effort to administer and comply with taxes. Some of the time and money needed to collect taxes is an unavoidable consequence of raising public revenue. But, it is also wasteful because scarce economic resources that could otherwise be used more productively are used to transfer resources to the government. It is thus considered good public policy to design revenue systems that are relatively simple to comply with and to administer.

On its face, it would seem that the FET is fairly simple to administer. Yet, while the 1987 Treasury Department report noted that “[the FET] is familiar, and there appears to be no great administrative or compliance difficulties with the tax...”, it tempered this conclusion with the observation that “the telephone tax is not entirely simple due to the various exemptions and definitional problems, and any attempt to tax private communications services could further complicate the tax...”.¹⁵ These complexities remain, and an important new set of complexities are posed by the pace of technological change that is rapidly changing the nature of telecommunication services, and the way in which these services are provided.

In the 1980s, for example, it was still a relatively simple matter to determine what was a telecommunications service. A telecommunications service was a service offered by the phone company. But in the new millennium, the intertwining of data services, including but not limited to Internet access, with traditional telephone services, raises important and potentially difficult questions of what is and is not a telecommunications service.

For example, in August of 1999, the U.S. Court of Appeals for the District of Columbia granted the FCC’s request to remand an August 1998 order determining that “advanced” telecommunications services (including Internet access) are either “telephone exchange” or “telephone access” services, indicating that the FCC itself may be uncertain. This uncertainty was mirrored in the final report issued by the National Tax Association’s Communications and Electronic Commerce Project, which was unable to reach a consensus on how to define telecommunications services to reflect recent changes in the market for communications.¹⁶

The same uncertainties confronting the FCC confront the Treasury. For example, a fairly immediate question is raised about how to treat newly emerging broadband technologies that allow a standard phone line to be converted into a high-speed data line, e.g. Digital Subscriber Line (DSL) technology. Like an additional phone line, a DSL line allows the user to have simultaneous access to both Internet and telephone communications. But, unlike a phone line, a DSL line allows the user much

¹⁵ U.S. Department of the Treasury, *op. cit.*, p. 15.

¹⁶ National Tax Association, *op. cit.*, section on telecommunications tax issues.

broader and more rapid access to the Internet. What portion of such a bundled service should be subject to the FET? One possible answer might be that providers would need to develop methods for apportioning the monthly bill between taxable and nontaxable usage. Yet, the need for such apportionment raises complexities not unlike those raised in connection with the need to develop rules for taxing private communications services as discussed at some length in the 1987 Treasury report.¹⁷

Lastly, there is a political sense in which retention of the FET might contribute to maintaining the current complexity of the overall system of telecommunications taxation in the United States. The web of state and local telecommunications taxes and fees is much more arcane and complex than the FET, and there are potentially large gains from simplification at the state and local level. Removing the federal layer of taxation would be a tangible step that the federal government could take to show leadership in this important area.

C. ECONOMIC EFFICIENCY

It is widely recognized that most taxes affect how resources are allocated in the marketplace, and that this normally imposes costs on the economy in excess of the amount of tax revenue that is collected. Two broad issues are involved.

1. Demand for Telephone Service and Internet Access

Telecommunications taxes and charges raise the price of telecommunications services to households and businesses compared with other goods and services. Making telecommunications services relatively more expensive has the effect of discouraging the use of such services compared with other, less-heavily-taxed goods and services. This response of consumers prevents resources from being allocated between production and consumption of telecommunications services and other goods and services in the most efficient possible manner, and results in an overall loss of economic well-being, termed excess burden, that exceeds the amount of taxes collected. This situation may be contrasted with the case of excise taxes which are intended to discourage people consuming goods that are believed to be socially harmful, such as tobacco, and to a lesser extent alcohol.¹⁸

The 1987 Treasury Department study noted that perhaps one of the most compelling arguments for retaining the federal telecommunications excise tax was the widely-held belief that demand for telephone service as a consumption good was relatively unresponsive to changes in its price so that any associated excess burden associated with telecommunication taxes was likely to be small. Yet, that report also noted that even though this claim had some validity, it was not a fully accurate

¹⁷ U.S. Treasury Department, *op. cit.*, Ch. 4.

¹⁸ See, U.S. Congress, Congressional Budget Office, *Federal Taxation of Tobacco, Alcoholic Beverages, and Motor Fuels*. Washington, D.C.: U.S. Government Printing Office, 1990.

description of the demand for telephone service in the 1980s. It seems even less applicable today in a rapidly changing market offering services such as Internet access and wireless telephony in addition to traditional telephone service.

2. *Access to Basic Telephone Services*

Although the estimated response is small, studies of the demand for telephone service have found that the decision of whether or not to pay for basic telephone access is sensitive to price. For example, elasticities reported in Taylor (1994) indicate that a 100 percent increase (decrease) in basic access charges would reduce (increase) the percentage of households with telephones by roughly three to five percentage points. *These estimates imply that abolishing the FET, which would cut the cost of basic access by three percent, would increase the number of households with telephones by between 90,000 and 125,000.*¹⁹

This estimate may seem like a relatively small number, but it needs to be put into context. As noted by Hausman, the FCC was reluctant to increase the subscriber line charge in order to finance increased Internet access because it would reduce the number of households with telephones by 39,000, a number that is between a third and a half as large as the estimated increase in telephone penetration if the FET were repealed.²⁰ Moreover, FCC data also show that, not surprisingly, the vast majority of households without telephone access also tend to be lower-income households. Thus, even low price elasticities for telephone access mean that current levels of taxation have a measurable effect on the likelihood of telephone access by low-income households.

3. *Demand for Long Distance and Wireless*

In addition, telecommunications taxes affect a range of services whose demand, unlike the demand for basic access, has been found to be fairly sensitive to price. One is long distance service, which has consistently been found to have a price elasticity of demand that is on the order of -0.7. Another is the demand for wireless service, where the estimated price elasticity is roughly -0.5.

In these cases, the FET, along with state and local telecommunications taxes, has a measurable effect on consumer demand for these services. For example, a recent study has estimated that the combined effect of the FET and state and local telecommunications taxes is to generate economic costs – in the form of reduced production and consumption of wireless telecommunication services – that equals almost \$2.6 billion, or roughly half of the total federal, state and local revenue raised from taxing wireless telephony.²¹

¹⁹ Lester D. Taylor, *Telecommunications Demand in Theory and Practice*, Ch. 5, Tables 3 and 7. Dordrecht/London/Boston: Kluwer Academic Publishers, 1994.

²⁰ Jerry Hausman, *Taxation by Telecommunications Regulation*, p. 45. Washington D.C.: American Enterprise Institute, 1998.

²¹ Jerry Hausman, "Efficiency Effects on the U.S. Economy From Wireless Taxation," National Bureau of Economic

Eliminating the FET would, of course, eliminate only a relatively modest portion of these total estimated costs, but it would be a useful first step. One reason is that the estimated (average) excess burden *per dollar* of federal revenue raised from taxing wireless services is relatively high. Some very rough calculations, based on those presented in Hausman, suggest that the FET imposes an excess burden per dollar of revenue raised that is on the order of \$0.40.²² Applying this number to an estimate of the total amount of tax revenue collected from applying the FET to wireless telecommunications indicates that repealing the FET would eliminate an excess burden from taxation on wireless services that equals almost two hundred million dollars.²³

4. Internet Access

The effects of telecommunications taxes on access to the Internet are potentially as important as their effects on telephone access and usage, but are also difficult to quantify at this point. Currently, the principal means of access to the Internet for many households is through traditional phone lines. Data compiled by the FCC indicate that almost 19 million households now have second phone lines in addition to their primary lines, and recent survey evidence confirms that many, if not most households, are prompted to have these extra lines as a means of being able to access both the Internet and use the telephone at the same time.²⁴

Recent estimates suggest that the price elasticity of demand for second phone lines is roughly -0.5 at prices in the range of \$20-\$25 per month. *This elasticity suggests that the three percent FET reduces the number of households that have second phone lines by 1.5 percent or almost 300,000 households.*²⁵

There is also evidence that household demand for new broadband technologies, such as the DSL lines mentioned above, is at least as sensitive to price as the demand for second phone lines. Thus, if existing telecommunications taxes are applied to these

Research Working Paper no. 7281, August 1999. One reason why the average excess burden is relatively large is that prices faced by consumers for telephone services exceed the marginal cost of those services by a fairly large margin.

²² These calculations are made using information presented on pp. 6-8, and the approximation formula for excess burden on p. 6. presented in the Hausman paper cited immediately above.

²³ According to data from the FCC, the wireless services accounted for 15 percent of total telecommunications revenue. Applying this ratio to the revenue collected from households through the FET yields estimated FET revenues attributable to wireless services of roughly \$450 million. Multiplying this number by an average excess burden of \$0.40 per dollar of revenue raised yields an estimated excess burden to households from applying the FET to wireless services of \$180 million. See James Eisner, "State by State Telephone Revenue and Universal Service Data," Table 2.1, Industry Analysis Division, Common Carrier Bureau, FCC, January 2000. The table may be downloaded from the FCC Website at <http://www.fcc.gov>.

²⁴ Carol Cassel, "The Demand for and Use of Additional Lines by Residential Customers," in David G. Loomis and Lester D. Taylor, eds., *The Future of the Telecommunications Industry*, Boston/Dordrecht/London: Kluwer Academic Publishers, 1999.

²⁵ Paul N. Rappoport, Lester D. Taylor and Donald Kridel, "An Econometric Demand for Access to the Internet," unpublished manuscript, November 1997.

emerging technologies, one would expect these taxes to impede the diffusion of these new and improved modes of Internet access.²⁶

5. *Competitive Neutrality*

In a closely related vein, the issue of competitive neutrality between different types of communications providers may loom at least as large as the question of whether and by how much existing telecommunications taxes reduce the use of long distance and wireless services and slow the rate of Internet access. A basic principle undergirding the Treasury Department's landmark reform of the federal income tax in 1986 was that tax systems should be neutral, and avoid giving a market advantage to some producers over others. But it is hard to envision how such competitive neutrality would be achieved in a world in which "traditional providers" of telecommunications services, such as telephone companies, are subject to the full range of existing federal, state, and local communications taxes, while "new entrants" to the market, such as cable providers, are either subject to none of these taxes, or to different taxes.

Indeed, unless the current system is reformed and simplified, it would seem that those responsible for tax policy may find themselves on the horns of a dilemma. The playing field between competing providers could be leveled by imposing the current, inefficient system of telecommunications taxation on "new" and "old" providers and/or technologies alike, which would potentially mean a significant, and somewhat hard to justify increase in taxes collected on communications services. This particular concern was echoed by some members of the National Tax Association's Electronic Commerce Project, who expressed the concern that broadening the definition of telecommunications services to include nontraditional forms of electronic communications would simply subject these emerging services to the already tangled web of existing telecommunications taxes and fees.²⁷

Alternatively, competitive neutrality among communications providers could be achieved by substantially lowering taxes and fees on traditional telecommunications taxes and providers to enable them to fairly compete with technologies and/or providers that are not subject to these taxes. Indeed, a similar issue prompted the Treasury Department to issue its 1987 report. At that time, the issue was how to treat the growth of private communications services, which enjoyed an exemption from the FET. The report noted changes in the tax law that would need to be made in order to reduce the differential tax treatment arising from the exemption of private communications service. But instead of recommending that an existing tax, that by then had outlived its usefulness, be extended to a new area, the report recommended that the existing FET be abolished.²⁸

²⁶ See Jeff Eisenach, "The High Cost of Taxing Telecom," Progress and Freedom Foundation, November 1999, at <http://www.pff.org/taxingtelecom.htm>.

²⁷ See, National Tax Association, *ibid.*

²⁸ U.S. Department of the Treasury, *op. cit.*, pp. 2-3.

IV. SUMMARY AND CONCLUSIONS

The analysis above demonstrates that the FET falls short of the benchmarks that are routinely used to assess the appropriateness of raising government revenue through various forms of taxation. The Treasury Department concluded in 1987 that “there is no policy rationale for retaining communications excise tax.” The basis for drawing this conclusion is at least as strong today as it was in 1987. In the final analysis, perhaps the most important policy rationale for keeping the current FET is that “the tax is already in place, and brings in a steady stream of tax revenue.” This argument may have had some practical merit in the 1980s when the country was facing large and, at the time, growing federal budget deficits, but it is hardly a compelling rationale for retaining the tax at a time when both the Congressional Budget Office and the Office of Management and Budget are projecting sizable budget surpluses. At a minimum, a “tax cut for telecommunications” deserves the same serious consideration being given to a wide range of other proposals to cut taxes.

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