ILLINOIS ECONOMIC
AND
FISCAL COMMISSION

TELECOMMUNICATIONS DEREGULATION ISSUES and IMPACTS

A SPECIAL REPORT

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703 STRATTON BUILDING
SPRINGFIELD, ILLINOIS 62706

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EXECUTIVE SUMMARY

The advancement of telephones, pagers, cellular phones, cable television, etc. has made the telecommunications industry an all but unavoidable part of most people's daily existence. This new technology has changed the communication landscape of our world. However, with this change in technology comes a need for changes of the laws that assist in protecting the telecommunications consumer. Five years ago, a step was taken by the federal government to alter the laws governing the telecommunications industry to keep up with these advances. This step came in the form of the Telecommunications Act of 1996 (1996 Act).

The State of Illinois' laws regarding telecommunications are set to expire on July 1, 2001. Therefore, legislative action is necessary to either extend the sunset date of the current telecommunication laws, or to make changes. Many believe that this is the time for the State to begin implementing some of the provisions of the 1996 Act.

The Illinois Economic and Fiscal Commission created the following report in an effort to assist in the understanding of the current status of telecommunications in the State of Illinois and to explain the reasoning behind deregulation. This report will present a brief history of telecommunications and the laws that have governed the telecommunications industry. In addition, it will address the provisions of the 1996 Act and its affect on the Illinois telecommunication industry. The highlights of the report are summarized below.

- As the telecommunications industry grew, the federal government passed numerous statutes intended to regulate the industry's various components. These statutes included the Radio Act of 1927, the Communications Act of 1934, the Cable Communications Act of 1984, and the Cable Television Consumer Protection and Competition Act of 1992.

- The industry currently is governed by the Telecommunications Act of 1996. The 1996 Act is intended to increase competition in the telecommunications industry by promoting rivalry in local telephone markets, long-distance telephone markets, and cable television markets.

- The 1996 Act granted federal, state, and local governments a portion of the regulatory authority. This Act reduced the role of the federal government and transferred additional responsibilities to the states. Municipal authority to regulate telecommunications continues to be limited by federal and state law.

- The 1996 Act rendered monopoly franchises illegal for local exchange carriers, permitted Regional Bell Operating Companies (RBOCs) to provide long-distance telephone service, and allowed local telephone companies to enter the cable television market.

- Although competition has increased between local telephone service providers, most consumers have not experienced lower rates. This is due to the fact that competitive local exchange carriers (CLECs) have focused their efforts in areas in which they achieve the most profit while incurring the least expense. While this competition reduces business rates, it fails to address consumer rates. This appears to contradict the intent of the 1996 Act.

- Since the passage of the 1996 Act, the FCC has approved three RBOC applications to provide long-distance telephone service. These approvals include Bell Atlantic's (now Verizon) request to provide long distance service in New York State, Verizon's bid in Massachusetts and SBC's request in Texas, Oklahoma, and Kansas.

- Although the 1996 Act introduced competition into cable television markets, it has not been successful in decreasing cable rates. In areas where decreasing rates are present, evidence indicates that the price constraint is based less on the competition between competing cable service operators and more on the competition from direct broadcast satellite providers.

- The 1996 Act has been followed by a number of telecommunications mergers. These mergers include: 1) SBC's acquisition of Pacific Bell and Ameritech; 2) Bell Atlantic's purchase of Nynex and GTE; 3) WorldCom's acquisition of MCI; 4) Qwest's purchase of LCI; and 5) AT&T's acquisition of Teleport and TCI. The economic impact of these mergers will depend on whether or not the given benefits outweigh the likely costs, or vice versa.

- Illinois is not alone in the tackling of legislation dealing with the deregulation of the telecommunications industry. Ten states enacted some type of legislation dealing with the deregulation of telecommunications in 2000.

- To date, the State has not fully addressed telecommunications deregulation. This is due to the fact that the current Illinois Telecommunications Act does not sunset until July 1, 2001. However, this date is quickly approaching. Therefore, Illinois legislators need to decide whether or not to update the Act or simply extend the sunset to a later date.

- Three distinct groups, the incumbent local exchange carriers (ILECs), the CLECs, and the Citizen's Utility Board, have proposed legislation addressing several different telecommunications issues. The intent of each group's respective bill is not surprising, that is, to use the 1996 Act in a way that best benefits them. However, if a provision is beneficial for one group, chances are that it is at the expense of another group.

- The actual impact that telecommunication deregulation legislation would have on State revenue receipts depends on the provisions of the final bill. If deregulation reduces consumer rates, a reduction in the tax base and subsequent tax revenues would result. However, the potential loss in revenue may be offset by increased usage. Deregulation may impact property tax, corporate income tax and sales tax, revenues as well.

- If competition reduces consumer rates, then the goals of telecommunication deregulation have been achieved. Regardless of the effects that lower rates will have on State revenue, if the concepts of deregulation work as planned, Illinois citizens will be the direct recipients of an increase in choices for telecommunication services at a lower rate.

GLOSSARY OF TERMS

Acronyms are used throughout this report to describe various industry concepts and terms. The following list contains the definitions for several of these acronyms.

Competitive Local Exchange Carrier (CLEC): A new term used to describe independent data and voice telecommunication service companies who, after the deregulation of local telephone service, were free to compete with incumbent local telephone service providers. McLeod USA and Gallatin River Telephone Company are examples of competitive local exchange carriers.

Federal Communications Commission (FCC): The FCC is an independent U.S. government agency, directly responsible to Congress, that regulates interstate and international communications by radio, television, wire, satellite and cable.

Illinois Commerce Commission (ICC): The ICC is an independent body of five appointed commissioners. In addition to their other services, the commission is responsible for assuring that Illinois citizens receive safe, efficient, and reliable service from investor-owned public utilities at reasonable prices.

Incumbent Local Exchange Carrier (ILEC): A new term that describes traditional local telephone companies that, prior to deregulation of the telephone industry, had the exclusive right and responsibility to provide local telephone service. The Regional Bell Operating Companies and GTE are examples of incumbent local exchange carriers.

Regional Bell Operating Companies (RBOC): The seven companies that were established to take over the local exchange operations of AT&T, following the 1984 AT&T divestiture. These companies are commonly referred to as "Baby Bells," and include Ameritech, Bell Atlantic, Bell South, Nynex, Pacific Bell, Southwestern Bell, and U.S. West.

TELECOMMUNICATIONS INDUSTRY

Background

Merriam-Webster's College Dictionary defines telecommunications as communication at a distance. Applying this definition, the telecommunications industry is the sector of the business community that provides interstate and international communications via television, radio, wire, satellite and cable. Although these services are all examples of telecommunications, each service emerged by different means and, therefore, faces distinct challenges. Therefore, each component is subject to a specific set of government regulations.

Although the telecommunications industry incorporates all of the previously-mentioned mediums to transmit information, this report will focus primarily on local telephone service, long-distance telephone service, and cable television service. The following sections provide a brief history of these sectors of the telecommunications industry.

Local and Long-Distance Telephone Service

In 1875, Alexander Graham Bell invented the telephone. Following his invention, Bell established the American Bell Telephone Company. By 1882, the company acquired a controlling interest in the Western Electric Company and issued the licenses by which most municipalities installed local telephone exchanges. In 1885, American Bell incorporated the American Telephone and Telegraph Company (AT&T) and assigned it the duty of building and operating the first long-distance telephone system. In 1899, AT&T acquired the assets of American Bell and became the parent company of the Bell System. Although other telephone service providers emerged, Bell's invention and development of the telephone system allowed AT&T (long-distance) and its Bell System (local) to function as a regulated monopoly.

New technologies, introduced between the 1940s and the 1970s, reduced AT&T's technological and economic advantage in the area of long-distance telephone service. These changes increased competition in long-distance service, and eventually let the U.S. government to file an antitrust suit against AT&T. The suit began in 1974 and was settled in 1982, when AT&T agreed to divest itself of the wholly-owned Bell Operating Companies. This divestiture eliminated the Bell System on January 1, 1984, and replaced it with a new AT&T and seven Regional Bell Operating Companies (RBOCs). (The RBOCs included Pacific Bell, U.S. West, Southwestern Bell, Bell South, Bell Atlantic, Nynex, and Ameritech.) As a result, AT&T was forced to compete with other companies in the highly competitive long-distance service market, while the RBOCs maintained a natural monopoly over their local service areas.

Cable Television Service

According to the Federal Communications Commission (FCC), cable television is defined as "…a video delivery service provided by a cable operator to subscribers via a coaxial cable or fiber optics." It was introduced originally as Community Antenna Television (CATV) in 1948. CATV was designed as a service for communities unable to receive television signals because of mountainous terrain or distance from local television stations. As cable operators began using microwave to pick up signals from greater distances, access to these signals changed the focus of cable's role from one of transmitting local broadcast signals to one of providing additional programming choices. These additional offerings resulted in cable subscriber growth, which eventually brought cable into the cities from which local programming originated.

As cable operators expanded their programming options, local television stations began complaining about the new competition. In response to these concerns, the FCC expanded its jurisdiction and placed restrictions on the ability of cable systems to import distant television signals. The Supreme Court recognized the FCC's jurisdiction over cable in the case of the *United States v. Southwestern Cable Company* (1968). The Court ruled that the FCC had reasonably concluded that regulatory authority over CATV was imperative. The FCC continued its restrictive policies in the early 1970s by enacting regulations that limited the programming offered by cable operators. This policy was replaced in 1972 by a policy focusing on gradual cable deregulation, which led to a modification of the restrictions on the importation of distant signals; a trend that continued throughout the 1970s.

TELECOMMUNICATIONS LEGISLATION

As the telecommunications industry grew, the federal government passed numerous statutes intended to regulate the industry's various components. These pieces of legislation shaped the development of the telecommunications industry and serve as the foundation of the U.S. telecommunications market. The following list highlights the most significant federal statutes related to the telecommunications industry. (See Appendix 1 for a summary of each act.)

- *The Radio Act of 1927* created the Federal Radio Commission and authorized it to regulate the communications industry so as to prevent chaotic interference over the airwaves.

- *The Communications Act of 1934* created the Federal Communications Commission (FCC) and centralized interstate telephone regulation and spectrum allocation regulation within this new commission.

- *The Cable Communications Policy Act of 1984* amended the Communications Act of 1934, and gave the FCC jurisdiction over cable television and preempted local regulation of cable television rates.

- *The Cable Television Consumer Protection and Competition Act of 1992* focused on cable television rate regulation and included a number of changes regarding cable television regulation.

- *The Telecommunications Act of 1996* sought to increase competition in the telecommunications industry by promoting new rivalry in local telephone markets, long-distance telephone markets, and local cable television markets.

WHY WAS THE TELECOMMUNICATIONS ACT OF 1996 NECESSARY?

The 1996 Act updated the Communications Act of 1934, and the other previous telecommunication acts. It was conceived to untangle the web of laws originally intended to protect the consumer, but which prior to the law tended to protect the individual industries from competition. The Act's stated purpose was "to provide for a pro-competitive, de-regulatory national policy framework designed to accelerate rapidly private sector deployment of advanced telecommunications and information technologies and services to all Americans by opening all telecommunications markets to competition, and for other purposes."

WHAT DID THE TELECOMMUNICATIONS ACT OF 1996 DO?

The 1996 Act sought to increase competition in the telecommunications industry by promoting new rivalry in local telephone markets, long-distance telephone markets, and local cable television markets. The Act hoped to achieve this through the accomplishment of three major steps. These steps:

- opened local telephone markets for the first time in over 80 years
- allowed the Regional Bell Operating Companies (RBOCs) to provide long-distance telephone service as a means of increasing competition in long-distance telephone markets
- provided additional competition in the cable television market by allowing telephone companies to compete

Local Telephone Service

In order to introduce competition into local telephone markets, the 1996 Act removed statutory, regulatory, and operational barriers to potential competitors by making three changes:

- Competitive local exchange carriers (CLECs) were allowed to resell the services of incumbent local exchange carriers (ILECs).
- CLECs were permitted to make use of ILEC facilities. (An example of this arrangement can be seen when CLECs lease ILEC unbundled network element (UNE) loops for use in combination with their own switching capabilities, and/or when CLECs lease the so-called UNE-platform that combines the loop with ILEC switching services.)

- CLECs were given the authority to build the facilities necessary to compete with the incumbent service providers.

Although ILECs are allowed to charge CLECs for using their facilities, ILECs must set their prices at reasonable rates. In fact, the Act states that ILECs have "the duty to provide, to any requesting telecommunications carrier for the provision of telecommunications service, nondiscriminatory access to network elements on an unbundled basis at any technically feasible point on rates, terms, and conditions that are just, reasonable, and nondiscriminatory…" The Act further states that "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." This provision was included to eliminate the local service monopoly franchises that existed in most states.

Long-Distance Telephone Service

The major change that the 1996 Act had on the long distance telephone industry was the allowance of RBOCs into long-distance telephone markets. However, the RBOCs were only allowed to compete in the long distance market if they met certain conditions. Section 271 of the Act outlined the conditions that a RBOC must meet prior to being allowed to provide long-distance telephone service within its local phone service region. For entry, a RBOC must prove it has met the requirements of either "Track A" or "Track B," satisfy a 14-point competitive checklist and prove that its entry serves the public interest. A detailed summary of these requirements follows.

In order to meet the Track A requirement, a RBOC must "demonstrate that it has an interconnection agreement with at least one competing provider which is providing local service to residential and business customers at least predominantly over the competitor's own facilities." Track B allows a RBOC to "enter in-region long distance even if competitors are not seeking to offer local service in a state, if the RBOC has provided a written offer to comply with the Act's interconnection requirements provided in the checklist."

The second condition a RBOC must meet, the 14-point checklist, must be provided in adequate quantities through automated systems that allow competitors to process new customers, including pre-order, provisioning, ordering, billing, and repairs. The provisions of the checklist are listed below:

1. Provide interconnection at any technically feasible point
2. Provide access to unbundled network elements
3. Provide access to poles, conduits and rights of way
4. Provide unbundled loops
5. Provide unbundled local transport
6. Provide unbundled switching

7. Provide access to 911 services, directory-assistance services and operator call-completion services
8. Offer White Page listings for competitors' customers
9. Provide access to telephone numbers for assignment
10. Provide access to databases and signaling as necessary for call-routing and call-completion
11. Comply with number-portability requirements
12. Comply with local dialing parity requirements
13. Participate in reciprocal compensation agreements
14. Sell local services at wholesale rates (retail minus avoided costs) to competitors wanting to sell these services

The third condition that an RBOC must meet is that the entry must be in the public interest. The public interest test is a two-part test. It includes consideration of whether premature long distance entry by a Bell company would harm competition in either the local or long-distance market and an evaluation of the extent of local competition (meeting the checklist requirements is not sufficient).

Cable Television Service

The 1996 Act affected the cable television industry by creating provisions designed to facilitate the entry of telephone companies into the cable television market. The Act repealed many of the major provisions of the Cable Act of 1992, which regulated cable television rates. It allowed cable companies with annual revenues less than $25 million to have their rate caps repealed. Any cable system could have their rate caps repealed, regardless of their annual revenues, once it faced “effective competition” from a local telephone service providing comparable video programming. The Act authorized local telephone companies to offer video services either by distributing programming as a cable television system or by establishing an “open video system” to deliver video programming to the home. State and local governments are prohibited to regulate telecommunications services provided by cable systems.

WHAT ARE THE ROLES OF THE VARIOUS GOVERNMENT ENTITIES IN RESPONSE TO THE 1996 ACT?

The Telecommunications Act of 1996 granted federal, state, and local governments a portion of the regulatory authority. The following sections detail each governmental unit's role.

The Federal Government

At the federal level, the FCC regulates the telecommunications industry. The FCC's mission is to encourage competition and to protect the public interest. It is the role of the Congress to direct the FCC to develop and to implement policy concerning telecommunications. Noticing a need for more competition in the telecommunications market, the federal government created the 1996 Act. The Act reduced the role of the FCC, as the industry was deregulated in several areas. However, the FCC continues to implement and, where necessary, clarify the language of the 1996 Act to protect the interests of the telecommunications consumer. In short, the Act states that the FCC is directed to implement specific regulations governing the provisions of interconnection of incumbent local exchange carrier (ILEC) facilities with new competitive local exchange carriers (CLECs) and the competitive entry of Regional Bell Operating Companies (RBOCs) into previously-prohibited long-distance service markets.

State Governments

The 1996 Act increased state government's regulatory authority over the telecommunications industry. The Federal Government made this change because it felt that the states would be more capable of addressing the steps by which a "fair marketplace" could be created in each state. Therefore, much of the authority that had previously been granted to the federal government was transferred to state legislatures, utility commissions, and regulators.

Under the provisions of the 1996 Act, the states are now responsible for numerous regulatory tasks. State commissions are responsible for defining the term "affordable" as it relates to the provision that "basic telephone service should be available at "affordable" rates." State regulators have been given the authority to determine the competitiveness of local telephone markets and the privilege of commenting to the FCC regarding whether or not they believe that a RBOC has satisfactorily completed the 14-point checklist. Furthermore, the states are now responsible for determining the steps that carriers must take to inform consumers about the discounts for which they are eligible, and serving as the first line of defense for consumers who suffer any adverse effects from deregulation.

In addition, state commissions are responsible for clarifying the rules by which libraries, schools, and non-profit organizations are allowed to form consortiums in order to buy telecommunications services in bulk. As the telecommunications industry advances, it is important for these organizations to maintain modern technology. However, technology costs money. Therefore, by involving themselves in the rules that affect these organizations, the state commissions could "improve the quality of the services they can buy, and extend affordable telecommunications services to more community-based organizations."

Local Governments

At the local level, municipal authority to regulate telecommunications is limited by both state and federal law. The 1996 Act prohibits any state or local law that prohibits or has the effect of prohibiting the provision of telecommunication services. CLECs have used this statute to strike down local regulations that impose burdensome requirements on those CLECs building local networks. The 1996 Act does allow municipalities to "set rules for construction and street cuts in the right-of-way, establish appropriate bonding, insurance and indemnity requirements, and generally ensure that public streets and rights-of-way are kept in good repair – but cannot regulate a CLEC's provision of service."

Federal courts have ruled that municipal authority to impose franchise fees is limited. There is controversy as to whether gross-revenue-based fees are an appropriate way to recover the costs of managing the rights-of-way, because they are considered a barrier to entry. While most rulings have been against these fees, there has not been a definitive ruling that clearly limits municipal franchise fees to the recovery of management costs. According to www.clec.com, "although the courts have tried to limit the type of fee that municipalities may charge… CLECs should anticipate that communities will continue to attempt to impose a telecommunications franchise fee.

WHAT HAS BEEN THE NATIONAL IMPACT OF THE 1996 ACT?

Local Telephone Service

The 1996 Act rendered monopoly franchises illegal for local exchange carriers, thereby "opening-up" local telephone service for the first time in 80 years. This change was designed to reduce consumer prices by encouraging competition into local telephone service. Despite this effort, current technology makes it much easier to transmit information over a greater distance than it does to transmit that same information into a recipient's home or business. This fact affected the 1996 Act's ability to create competition for local telephone service. This is a serious concern, as it is this competition that is required for the Act to achieve its far-reaching goals.

Although deregulation has been difficult, the 1996 Act introduced competition into local telephone service by allowing numerous competitive local exchange carriers (CLECs) to compete with the Regional Bell Operating Companies (RBOCs). In November of 1998, the CLECs serviced one percent of the 180 million local telephone lines in the U.S. By June of 2000, the CLECs increased this percentage to 6.7 percent of the 192 million nationwide local telephone lines. Between 1998 and 1999, the CLECs also increased their local telephone revenues from $3.5 billion to $6.3 billion. As a result, the CLECs increased their share of nationwide local telephone service revenues from 3.5 percent in 1998 to 5.8 percent in 1999. These statistics reveal that the Act has made some progress in moving the U.S. toward a more competitive marketplace.

Although competition increased between local service carriers, most consumers have not experienced lower local telephone rates. Recent FCC figures reveal that more than 60 percent of CLEC local telephone lines served medium and large businesses, institutional, and government customers. By contrast, nearly 80 percent of incumbent local exchange carrier (ILEC) local telephone lines served residential and small business customers. These figures indicate that competitive local exchange carriers have focused their efforts in areas in which they achieve the most profit while incurring the least expense. While this competition reduces the rates paid by these "businesses," it fails to address the rates paid by the majority of consumers. In addition, it appears to contradict the intent of the 1996 Act.

Long Distance Telephone Service

The 1996 Act enabled the RBOCs to initiate long-distance telephone service only after their local telephone markets were opened to "meaningful competition." The Act further stipulated that the FCC was responsible for certifying that state regulators and the RBOC met a series a specified requirements. These requirements included the satisfaction of a 14-point checklist regarding interconnection with competitors and a public interest ruling.

The previously-mentioned requirements hindered competition in long-distance telephone service. This conclusion is based on the fact that these provisions applied only to the RBOCs and not to the other local exchange carriers, who already were free to integrate into long-distance markets within their local service territories. In the first three years following the Act, the FCC denied several such petitions submitted by various RBOCs, and granted none.

Since that time, however, the FCC has approved three applications – Bell Atlantic's (now Verizon Communications) request to provide long distance service in New York state, Verizon's bid in Massachusetts and Southwestern Bell's (now SBC) request in Texas, Oklahoma, and Kansas. The approval of Verizon's application in Massachusetts was the FCC's first approval under new chairman, Michael Powell who has acknowledged that he would like to make it easier for the "Baby Bells" to offer long-distance telephone service. In response, Verizon is expected to submit applications seeking regulatory approval for Pennsylvania, Connecticut and Rhode Island, while SBC and BellSouth are seeking applications for California, Arkansas, Nevada, Florida, Georgia, South Carolina, and North Carolina.

The fact that RBOCs are entering long-distance service markets is ironic, especially in light of the provisions of the 1984 AT&T divestiture. At that time, the federal government sought to end AT&T's natural monopoly by separating the local and long-distance components. The government reasoned that this separation was necessary so as to maintain the natural monopoly where it appeared necessary (the local exchanges) and introduce competition into those parts where it was deemed appropriate (long-distance). Having successfully completed this goal, the federal government appears to be using the former Bell Companies as a means of creating additional competition in long-distance service markets, thereby placing "Ma Bell" in direct competition with the "Baby Bells."

Cable Television Service

Although "token" competition existed prior to the Telecommunications Act of 1996, most cable operators enjoyed a virtual monopoly in their specified service areas. In response, the Act included numerous provisions intended to facilitate the entry of telephone companies into cable television markets. Furthermore, the Act prohibited state and local governments from regulating telecommunications services provided by cable systems.

The 1996 Act increased cable television competition, but has not been as successful at reducing cable television rates. Provisions within the 1996 Act eliminated the ban that prohibited telephone companies from providing video service, resulting in the emergence of numerous cable television rivals. These rivals include Ameritech with over 300,000 subscribers and RCN with over 325,000 subscribers. Although the 1996 Act successfully introduced competition into the cable television market, it has not been successful in decreasing cable television rates. In areas where decreasing rates are present, evidence indicates that the price constraint is based less on the competition between competing cable service operators and more on the competition from direct broadcast satellite providers. This is an important distinction because the satellite television industry was largely bypassed by the 1996 Act.

Unintended Consequences

No discussion of the 1996 Act is complete without addressing the recent wave of telecommunications mergers. Many of the most well documented mergers involved a number of the RBOCs that were created following the 1984 AT&T divestiture. Examples of these mergers include SBC's acquisition of Pacific Bell and Ameritech, and Bell Atlantic's purchase of Nynex and GTE. (The merger between Bell Atlantic and GTE, the largest independent (non-RBOC) local exchange carrier, resulted in a new company: Verizon Communications.) Long-distance telephone service has been affected by WorldCom's acquisition of MCI and Qwest's purchase of LCI. Furthermore, AT&T's acquisition of Teleport and TCI was its first steps in its effort to enter the local telecom market.

When examining the impact that these mergers will have on competition and pricing, the answer depends on whom you ask. Supporters of these business arrangements argue that mergers produce greater efficiency in creating and distributing products to consumers. As a result, advocates believe that this efficiency eventually will lead to decreased prices. On the other hand, critics contend that the industry's desire to compete has been replaced with an urge to merge. A number of these critics believe that these companies are seeking mergers as a means of solidifying their control over their current operations rather than challenging competitors in other markets; in spite of the fact that such market concentration could result in increased rates. The economic impact of these mergers will depend on whether or not the given benefits outweigh the likely costs, or vice versa.

WHAT HAVE OTHER STATES DONE REGARDING TELECOMMUNICATIONS DEREGULATION?

Since the passage of the 1996 Act, states have been forced to reevaluate their telecommunication laws. This process has been undertaken in an attempt to coordinate their statutes as a means of maximizing the benefits of the 1996 Act for their citizens. The Act allowed states greater input in the telecommunication process, which many consider a positive decision. However, an increase in state responsibility is accompanied by an increase in headaches. This is due to the fact that crafting a piece of legislation that compliments a federal statute and appeases all "stakeholders" (in this case…citizens, CLECs, ILECs, etc.) is difficult.

For this reason, many states have avoided taking the "next step" in altering their current telecommunication laws. Illinois is in this position as the State's Telecommunication Article is set to repeal on July 1, 2001. Although the State could simply extend its deadline to a future date, the "players" in the telecommunications industry are pushing for a change.

Illinois is not alone in the tackling of legislation dealing with the deregulation of the telecommunications industry. In fact, ten states enacted some type of legislation dealing with the deregulation of telecommunications in 2000. The following sections include a brief overview of some of these new laws.

Michigan

During the 2000 legislative session, the State of Michigan addressed its telecommunications act, which was set to expire on January 1, 2001. Besides extending the sunset date of the Act, Michigan looked to provide a new framework for regulating the telecommunications industry. The result was Public Act 295, which became effective on July 17, 2000. The new Act:

- Capped rates for certain telecommunications services
- Prohibited basic local exchange service providers from assessing or imposing intrastate subscriber line charges or end-user line charges
- Authorized Michigan's utility commission (PSC) to ensure that long-distance telecommunications providers comply with requirements to reduce customer rates when the toll access service rate is reduced
- Granted the PSC regulatory authority over all directory assistance services, rather than just local directory assistance services,
- Prohibited toll service providers from charging a mandatory minimum or flat-rate charge
- Granted the PSC jurisdiction over federal telecommunications services delegated to the State, including area code changes

- Extended Michigan's Telecommunication Act's January 1, 2001, sunset to December 31, 2005

The fiscal impact of these changes has yet to be seen. However, Michigan's Senate Fiscal Agency estimated that the elimination of the end-user line charge and the freezing of telephone rates will reduce use tax collections by an estimated $18.0 million in FY 2000-2001. The other provisions are expected to diminish the value of the real property owned by the telecommunications industry, resulting in an estimated loss of $4.6 million in the State's utility property tax receipts.

Colorado

On April 14, 2000, the Governor of Colorado approved SB 0012, which made several changes to the telecommunications laws of that state. The new act:

- Removed directory assistance from the regulatory definition of operator services
- Required the public utilities commission (PUC) to adopt a single statewide benchmark rate applicable to non-optional operator services
- Exempted the retail directory assistance services from regulation under the "Public Utilities Law"
- Removed the PUC's authority to regulate the terms and conditions under which private line services, other than analog private line service with a capability of less than 24 voice-grade circuits, are offered and provided at retail
- Removed a provision for PUC review of private line services

Kentucky

The State of Kentucky Acts Chapter 511 amended the telecommunications laws in their State with HB 897 (Acts Chapter 511). The new Act, signed into law on April 21, 2000:

- Prohibited regulated utilities from subsidizing a nonregulated activity and prohibited inclusion of expenses of unregulated affiliates in the rate base
- Required the state's Public Service commission to ensure fair, just and reasonable rates for utility service
- Directed a committee study of prevention of cross-subsidization of non-regulated telecommunications services

Ohio

On January 4th, 2001, the State of Ohio passed SB 235, a bill that redefines what is included as a "basic local exchange service" for the purposes of the regulatory frameworks of the State's alternative regulation law. According to an analysis from the Ohio Legislative Service Commission, the general effect of the act was to:

> *"narrow what constitutes 'basic local exchange service' and expand what constitutes 'all other public telecommunications services' (non-basic services). Thus, as to alternative regulation, the act authorizes a prospective change in how different types of public telecommunications services could be provided and priced. The specific nature of the act's effects will depend upon the extent to which different companies in Ohio operate under alternative regulation and what the terms and conditions of the regulation are, including alternative regulation under any future revised policies adopted by the PUCO (Public Utilities Commission)."*

Tennessee

Public Chapter No. 665 became law in the State of Tennessee on April 25, 2000. The Act:

- Granted electric cooperatives the opportunity to acquire, construct, own and operate systems to provide telephone, telegraph or provide telecommunications service
- Specified that provision of such services is subject to regulation by the Tennessee Regulatory Authority
- Prohibited cooperatives from providing such services in any area were an existing telephone cooperative is operating with fewer than 100,000 total lines

A fiscal note for the new law stated that it was assumed that local governments would experience increased revenues from increased property tax collection on physical plant investment made by electric cooperatives to provide telecommunications services. They estimated that the resulting revenues would be less than $100,000.

Utah

On March 16, 2000, Utah's governor signed HB 338 (Chapter 291) into law. The new law:

- Provided definitions and conditions for pricing flexibility for incumbent telephone corporations
- Provided limits of the price index

- Enacted provisions related to quality of service

A fiscal note for the bill stated that the provisions of the bill could prevent residential telephone rates from being lowered in some areas of the State. For the rest of the State, it was not known whether rates would be lowered or by what amount.

Vermont

State Act no. 67 amended Vermont's utility law. The Act, which became effective on February 23, 2000:

- Allowed the Public Service Board to deregulate nondominant providers of telecommunication service
- Mandated that the Public Service Board adopt a rule for the protection of telecommunications customers
- Established a registration of billing agents for telecommunications providers

Other states have attempted to pass legislation dealing with the deregulation of telecommunications in their state, but have failed. In fact, according to the Illinois Telecommunication Association, a bill that failed in the State of Maryland dealing with telephone deregulation, is being used as the framework for a bill that is currently in the State Senate. (An analysis of this proposed bill will be discussed later in the paper.)

WHAT IMPACT HAS THE 1996 ACT HAD ON ILLINOIS?

As stated earlier, the 1996 Act created more work for individual states and Illinois is no exception. The State is now responsible for monitoring the Illinois telecommunications industry, which includes oversight of industry operations. State legislators and the Illinois Commerce Commission (ICC) must continuously reevaluate the status of the State's telecommunications market to ensure that the public interest is being served. If these interests are not met, State officials must utilize the 1996 Act to alter the State's telecommunication landscape and create additional competition in order to reduce prices.

Legislation

Up to this point, Illinois legislators have not fully addressed telecommunications deregulation. This is due to the fact that the Illinois Telecommunications Act does not sunset until July 1, 2001. However, since this date is quickly approaching, Illinois legislators need to decide whether or not to update the Illinois Act or simply extend the sunset to a later date. State leaders, the ICC, and representatives from the telecommunications industry are in the process of proposing several pieces of legislation that are intended to improve all aspects of telecommunication for Illinois citizens.

Mergers

Although the Illinois General Assembly has not passed any significant new telecommunications legislation, the Illinois telecommunications industry has been affected by the 1996 Act. In fact, the State has been directly affected by two of the previously-mentioned mergers.

- SBC/Ameritech: On September 23, 1999, the Illinois Commerce Commission approved the merger of Ameritech and SBC (formerly, Southwestern Bell). The ICC conditioned the merger on the basis that the company increase network infrastructure investments, allocate merger-related savings to ratepayers, offer shared transport of competitive local exchange carriers (CLECs), and improve the operational support system.

- GTE/Bell Atlantic: On October 29, 1999, the Illinois Commerce Commission approved the merger of GTE and Bell Atlantic. (This merger resulted in the creation of a new company—Verizon Communications.) The ICC approved this merger with twenty-eight conditions, including requirements that will improve operational support system collaboration, reduce rates, and insure quality of service.

These mergers are important, because they link two of the nation's largest incumbent local exchange carriers (ILECs) with the State's two largest ILECs. SBC/Ameritech is the largest ILEC in Illinois serving most of the larger urban population centers in Illinois. According to the ICC's 1999 Annual Report, the company provided approximately 5.8 million access lines (comprised of 4.2 million residential lines and 1.6 million business lines) representing roughly 82.3 percent of the State's total access lines. Based on total lines served, Verizon North (formerly, GTE North) is the State's second largest ILEC. It provided 783,000 access lines (comprised of approximately 658,000 residential lines and 124,000 business lines) representing an estimated 11.1 percent of the State's total access lines. Although it is too early to determine the impact of these mergers, the ICC conditions seek to provide Illinois consumers with increased quality of service at reduced rates.

Trends

The provisions of the 1996 Act allowed telecommunications providers to enter other segments of the telecommunications industry. In Illinois, and throughout the U.S., telecommunications providers are utilizing these provisions as a means of expanding their current services to include local and long-distance telephone service, cable television service, and internet service. In this effort, incumbent and competitive carriers are attempting to become comprehensive telecommunications companies. As these companies develop, the State needs to address this issue so as to ensure that the telecommunications industry remains competitive with comprehensive providers competing with other comprehensive providers. This is an important issue, because one potential alternative to this trend is a return to monopoly control of the entire industry.

WHAT LEGISLATION IS BEING PROPOSED TO ADDRESS DEREGULATION?

Although there are numerous stakeholders seeking input regarding the update of the Illinois telecommunications act, competition should remain the basis of the rewrite. Proponents agree that the updated act should promote competition in the telecommunications industry as a means of granting Illinois consumers with the ability to choose a telecommunications provider that best meets their needs. In order to achieve this goal, the State needs to address the topic of leveling the playing field for all telecommunications providers. Given this background, the following paragraphs address legislation that is currently being considered by the Illinois General Assembly.

Three distinct groups, the incumbent local exchange carriers (ILECs), the competitive local exchange carriers (CLECs), and the Citizens Utility Board, have proposed legislation addressing several different telecommunications issues. Each group has created legislation that they hope will improve the telecommunications industry in the State of Illinois. The following sections provide a brief summary of those bills.

Proposal #1

The incumbent local exchange carriers are promoting a bill that makes several changes to the Public Utilities Act and the Telephone Company Act regarding telecommunications. The bill reduces from 45 to 30 days the notice required before rate changes. It expands the scope of the record upon which ICC decisions may be based. It requires parties to report communications with ICC personnel. The bill establishes a mandatory dispute resolution process for retail customer complaints.

This bill also excludes various services from the scope of telecommunications services regulated by the ICC. It eliminates the classification of telecommunications services. The bill provides for the deregulation of optional residential services and all business services. It limits the ratemaking authority of the ICC. It also provides for the repeal of the Telecommunications Article on July 1, 2006 rather than July 1, 2001.

Proposal #2

The competitive local exchange carriers support a bill that amends the Telecommunications Article of the Public Utilities Act by creating the Telecommunications Consumer Choice Law of 2001. The bill provides that all interconnection agreements between an ILEC and any other telecommunications carrier must be filed with the ICC as a tariff. The bill allows any telecommunications carrier to order any offering from an interconnection agreement or any other tariff regardless of whether or not that telecommunications carrier has its own interconnection agreement.

This bill also establishes criteria for classification of a service as competitive. The bill prohibits alternative forms of regulation (non-ratemaking) for ILECs that do not comply with structural separation requirements that require separate subsidiaries for the provision of competitive services. The bill also removes the exemption from the enforcement procedures applicable to certain Bell operating companies.

It also increases authorized penalties from $30,000 to $1,000,000 and imposes obligations upon ILECs with respect to interconnection, collocation, and network elements of service. The bill also changes the sunset date of the Article from July 1, 2001 to July 1, 2007. It also provides that a violation of interconnection obligations by an ILEC is a prima facie violation of the Act. Finally, the bill abolishes an exemption for certain telecommunications activities under the Public Utilities Act.

Proposal #3

The Citizens Utility Board (CUB) is also supporting a bill that is currently being debated by the Illinois General Assembly. Although the specific content of the bill is not known, CUB has traditionally stressed the importance of consumer rights and the impact of competition on consumer issues. They contend that competition has been good for business, but bad for residential customers. They advocate a reordering and redefining of the term "competition" to benefit all consumers, not just business customers.

Outlook

The intent of each group's respective bill is not surprising, that is, to use the 1996 Act in a way that best benefits them. However, if a provision is beneficial for one group, chances are that it is at the expense of another group. For example, the competitive local exchange carriers (CLECs), along with MCI/Worldcom and AT&T, support legislation that allows them to be more competitive with the incumbent local exchange carriers (ILECs), in particular Ameritech, in offering local telephone services. These companies believe that the ICC needs greater authority to force access to Ameritech's network through punitive sanctions. They want more regulation for Ameritech because they argue that Ameritech is a "monopoly." However, ILECs, such as Ameritech, believe that these additional rules allow other companies to take over their local telephone business.

On the other hand, the ILECs seek legislation that deregulates optional residential services and all business services to allow them to remain competitive in this market. They feel that CLECs already have an unfair advantage over ILECs, in that, they are not regulated by the laws of the ICC, therefore, allowing them to provide cheaper rates, which regulated ILECs cannot match. CLEC's would not favor such an idea, because they feel that the ILEC's huge majority in the industry already gives them an unfair advantage. In their viewpoint, the passing of this kind of provision would go against the idea of creating a competitive market.

To make things even more complicated the Citizens Utility Board watches over each side's legislation to make sure that Illinois citizens are being treated properly. Several members of the telecommunications industry feel that CUB can go a little "overboard on consumer protection," which makes legislation hard to advance. Regardless of who is right and who is wrong, the different viewpoints of these three groups make the task of creating new provisions for the State's Telecommunications Act a very complicated process.

WHAT IMPACT COULD TELECOMMUNICATIONS DEREGULATION HAVE ON ILLINOIS?

From a fiscal perspective, the actual impact that telecommunication deregulation legislation would have on State revenue receipts depends on the actual provisions of the bill. However, if the goal of such legislation is to promote competition, thus, lowering rates, some assumptions can be made. In order to understand these potential impacts, an understanding of the affected taxes is needed.

The State telecommunications tax is one of Illinois's oldest taxes. Beginning in 1937, the Public Utilities Revenue Act imposed a 3 percent tax on businesses transmitting messages in Illinois. In 1945, a separate Messages Tax Act was established. The tax rate fluctuated during the 1960s, moving from 4 percent in 1965 to 3.92 percent in 1966 and to 5 percent in 1967. In 1985 the Telecommunications Tax Act was established, replacing the Messages Tax Act. Under the new State Act, the tax rate remained at 5 percent and expanded the tax base to include not only intrastate, but also interstate activity. Finally, in 1998, the telecommunications excise tax rate was increased to its current rate of 7 percent.

Under the old law, the telecommunications tax was imposed on businesses transmitting "messages." The new act, however, imposes the tax on the privilege of transmitting or receiving telecommunications. The distinction between "messages" and "telecommunications" is important because of the broader implication of telecommunications. During the rewrite, definitions were created to include emerging technologies. The word, “telecommunications” was defined in such a way as to capture a broad array of both "messages" and "information" transmitted over a wide variety of mediums. The methods of communication that are now subject to the telecommunication tax include any form of mobile or stationary communication such as computer exchange services, paging services and cellular services. Mediums now include cable, wire, fiber optics, microwave, laser, radio, satellite or similar facilities.

Revenues from the telecommunications tax have steadily increased over the last decade. In FY 1990, $243.6 million in general funds were collected from this tax. In FY 1998 this amount increased to $460.3 million. After the inception of the increased tax rate, revenues increased to $602.5 million in FY 1999 and $639.4 million in FY 2000. The IEFC estimates that approximately $670.0 million will be collected from the telecommunications tax in FY 2001.

Revenues from the tax are distributed in the following manner:

Of the original 5 percent tax:	(a) $12 million/year to the Common School Fund
	(b) remainder to the General Revenue Fund
Of the additional 2 percent:	(a) 50 percent to the School Infrastructure Fund
	(b) 50 percent to the Common School Fund

In addition to the State's telecommunication excise tax, there is also a federal tax equal to 3 percent of the amount billed. Also, municipalities can impose an occupation tax based on gross receipts of businesses transmitting messages, at a rate up to 5 percent. A municipality that does not impose such an occupation tax may levy a 5 percent municipal telecommunications tax. Municipalities may exempt other local governments, school districts, and persons 65 or older, or may offer persons 65 or older reduced rates.

The growth associated with the telecommunications tax depends on technological advances, increased use of those technologies, and prices. Much of the recent growth in tax collections can be attributed to the surge in telecommunications use and the nature of the tax.

Although revenues generated via the telecommunications industry have risen steadily over the last several years, the trend may be about to change. More and more people are using the internet to communicate with other people across the country through the use of email, "instant messages" and other similar formats. As the internet industry continues to grow and becomes more easily accessible, more people are choosing this tax-free means of communication, as opposed to the telephone. In fact, a recently released Verizon study concluded that the internet is responsible for millions of dollars of lost revenue every year.

Financial Impact

What effects, then, would occur if telecommunication deregulation legislation were passed? Industry advocates believe that deregulation would allow telecommunication companies to be more competitive, causing a reduction in consumer's telecommunication rates. A reduction in rates equates to a reduction in the tax base and subsequent tax revenues. However, that potential loss in revenue may be partially or fully offset by increased usage as a result of lower rates. As a result, the impact on telecommunications tax revenue due to competitively lower prices cannot be precisely determined.

Proponents of deregulation feel that not only will lower rates due to competition allow telephone companies to compete with other phone companies, but also will allow them to compete with internet providers as well. If lower rates create an increase in telephone usage, the State would be receiving revenues originally lost due to the internet industry.

Another aspect of the 1996 Act that may already be affecting the amount of revenue that is collected from the State's telecommunication tax is the cable industries new freedom to set their own rates. After the Act took effect, it was expected that cable rates would increase in the short term until competition from other industries began to form. Again, an increase in rates equates to an increase in State tax revenues. However, in the long term, the rates in the cable industry are expected to decline, as competition becomes more fierce. Although an increase in cable subscribers would cause the amount of revenue collected to rise, a lower rate base would partially or fully offset it.

Property tax revenues, which are an important source of local revenue, may also be affected by telecommunications deregulation. Several states have reported in their deregulation bill's fiscal impact analyses that the property values of telecommunications providers would be affected by the changes taking place in the industry. For example, if the legislative changes cause property values to go up, local governments would experience higher revenues from increased property tax collection. However, if the changes diminish the value of the real property owned by the telecommunications industry, a loss in property tax receipts would occur.

Other State revenue sources could see indirect effects due to the 1996 Act. Revenue sources, such as the corporate income tax could experience an increase in State revenue, if new telecommunications businesses are created. Also, state sales tax receipts, could increase in situations where competitors are building new facilities to expand their business. However, there is current legislation that would exempt sales tax on some telecommunication service goods, which would allow companies to expand at a cheaper price. For example, one proposal would exempt sales taxes on tangible personal property and its component parts purchased by a telecommunications carrier if the property and parts are used directly and primarily in transmitting, receiving, switching, or recording any interactive, two-way electromagnetic communications, including voice, image, data, and information, through the use of any medium, including, but not limited to, poles, wires, cables, switching equipment, computers, and record storage devices and media.

CONCLUSION

In conclusion, various analyses discussed earlier in this report indicate that the 1996 Act was successful in increasing competition in the telecommunications industry. The 1996 Act achieved this goal by opening up local telephone service, allowing the Regional Bell Operating Companies to provide long-distance telephone service, and allowing local telephone companies to compete in cable television markets. Prior to the passage of the 1996 Act, proponents argued that increasing competition would simultaneously reduce consumer prices. To this point, consumers have not witnessed the lower prices. Therefore, consumers have benefited from the addition of available choices, but have yet to witness the reduced prices that generally accompany a competitive marketplace.

Examples of this competition can be seen in the previously-mentioned sectors of the telecommunications industry. In local telephone service, CLECs increased their percentage of local telephone lines served. In long-distance telephone service, the FCC approved three applications allowing RBOCs to enter long-distance telephone markets. In cable service, numerous cable television rivals emerged following the elimination of the ban that prohibited telephone companies from providing video service. The 1996 Act was also followed by a number of telecommunications mergers.

The 1996 Act increased the State's regulatory authority over the telecommunications industry. The federal government made this change, because it felt that the states would be more capable of addressing the specific needs associated with their own state. However, since the Illinois Telecommunications Act does not sunset until July 1, 2001, the State delayed its response. As this date approaches, state legislators need to decide whether or not to update the Illinois Act or simply extend the sunset to a later date. Currently, legislators are working with members of the telecommunications industry, the ICC, and the Citizens Utility Board to address this problem. At this time, several bills have been introduced that seek to improve the current legislation.

From a fiscal perspective, the actual impact that telecommunications deregulation would have on State revenue receipts depends on the provisions contained within the final bill. Revenues from the telecommunications tax have steadily increased over the last decade. However, if increased competition results in lower prices, the revenue generated via the telecommunications tax and other related taxes will be adversely affected. On the other hand, this increased competition is expected to increase usage thereby possibly offsetting the loss of tax revenues. Regardless of the effects that deregulation has on State revenue, Illinois citizens will be the direct recipients of an increase in choices for telecommunications services at lower rates if deregulation works as intended.

APPENDIX I

The Radio Act of 1927

The U.S. Congress passed the Radio Act in response to the case of the *United States v. Zenith Radio Corporation, et al.* In that case, a federal district court ruled that the U.S. Commerce Department did not have the authority to regulate radio communication. In response, Congress passed the Radio Act of 1927. This act created the Federal Radio Commission, and authorized it to regulate the communications industry so as to prevent chaotic interference over the airwaves. Although the Act was Congress's first attempt at specifically regulating broadcast activities, federal regulation of communications remained divided between the Department of Commerce and the Interstate Commerce Commission.

The Communications Act of 1934

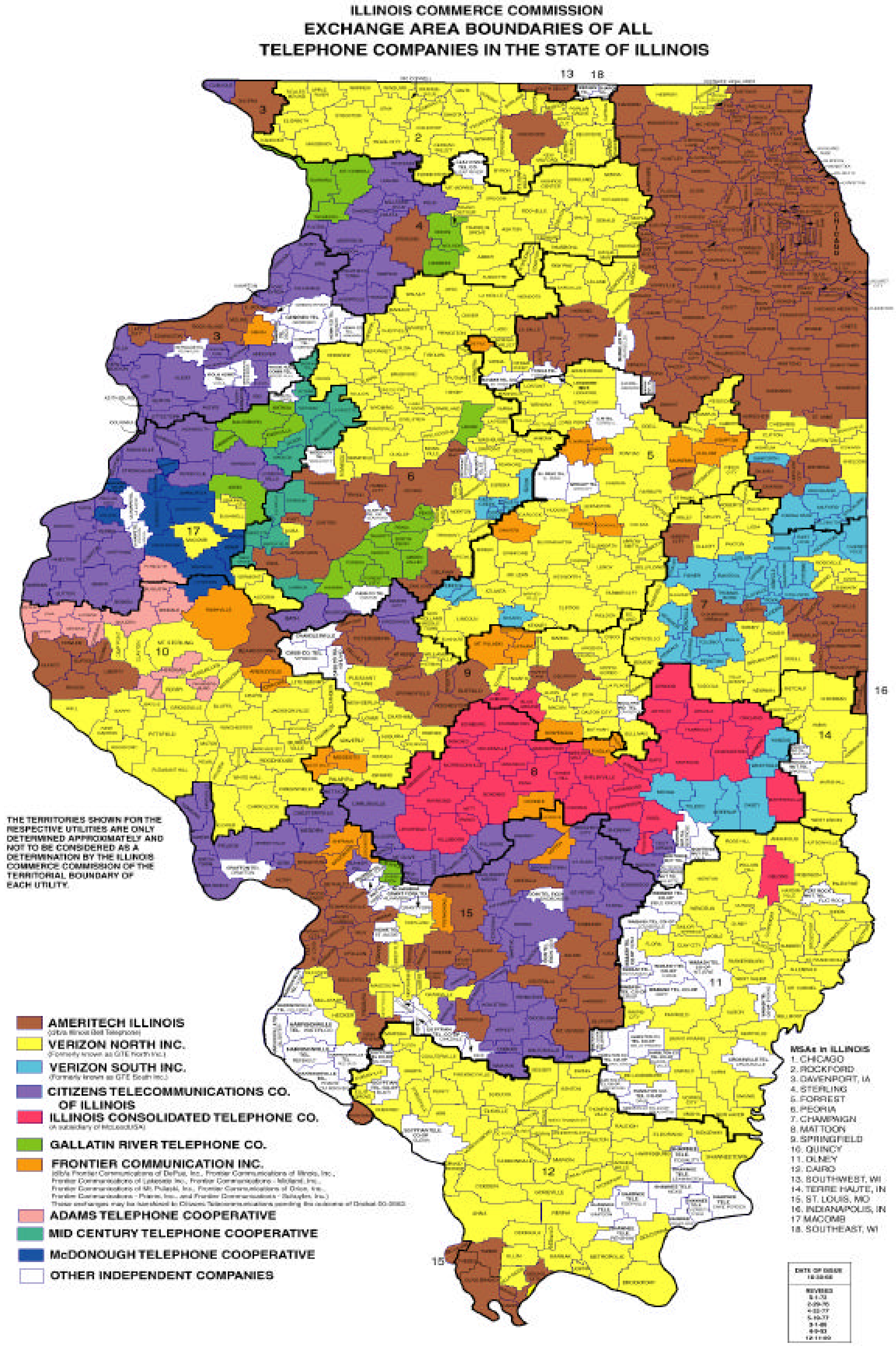
In 1934, President Franklin Roosevelt sought the consolidation of telecommunications regulation for both wired and wireless services. This effort prompted the passage of the Communications Act of 1934, which created the FCC. This reorganization shifted interstate telephone regulation from the Interstate Commerce Commission to the FCC, and moved the spectrum allocation regulation from the Federal Radio Commission to the FCC.

The Cable Communications Policy Act of 1984

The Cable Communications Policy Act of 1984 amended the Communications Act of 1934, and gave the FCC jurisdiction over cable television and preempted local regulation of cable television rates. This Act effectively deregulated television and noncommercial broadcasters and, therefore, allowed prices charged by cable operators to rise without constraint. The Act also established policies in the areas of ownership, channel usage, franchise provisions and renewals, subscriber rates and privacy, obscenity and lock-boxes, unauthorized reception of services, equal employment opportunity, and pole attachments. The new law also defined jurisdictional boundaries among federal, state and local authorities for regulating cable television systems.

The 1992 Cable Television Consumer Protection and Competition Act

Following the 1984 Cable Act, the number of households subscribing to cable television systems increased, as did the channel capacity of many cable systems. These increases were accompanied by a lack of competition among cable service providers and a subsequent increase in cable service rates. In response to these problems, Congress enacted the Cable Television Consumer Protection and Competition Act of 1992. Although it modestly enhanced the opportunities for competitive entrants in cable TV markets with rules allowing upstart rivals better access to video programming, the measure's primary thrust was rate regulation.



SOURCE: Illinois Commerce Commission

BACKGROUND

The Illinois Economic and Fiscal Commission, a bipartisan, joint legislative commission, provides the General Assembly with information relevant to the Illinois economy, taxes and other sources of revenue and debt obligations of the State. The Commission's specific responsibilities include:

1) Preparation of annual revenue estimates with periodic updates;

2) Analysis of the fiscal impact of revenue bills;

3) Preparation of "State Debt Impact Notes" on legislation which would appropriate bond funds or increase bond authorization;

4) Periodic assessment of capital facility plans; and

5) Annual estimates of the liabilities of the State's group health insurance program and approval of contract renewals promulgated by the Department of Central Management Services.

The Commission also has a mandate to report to the General Assembly ". . . on economic trends in relation to long-range planning and budgeting; and to study and make such recommendations as it deems appropriate on local and regional economic and fiscal policies and on federal fiscal policy as it may affect Illinois. . . ." This results in several reports on various economic issues throughout the year.

The Commission publishes two primary reports. The "Revenue Estimate and Economic Outlook" describes and projects economic conditions and their impact on State revenues. "The Illinois Bond Watcher" examines the State's debt position as well as other issues directly related to conditions in the financial markets. The Commission also periodically publishes special topic reports that have or could have an impact on the economic well being of Illinois.

These reports are available from:

Illinois Economic and Fiscal Commission
703 Stratton Office Building
Springfield, Illinois 62706
(217) 782-5320
(217) 782-3513 (FAX)

Reports can also be accessed from our Webpage:

http://www.legis.state.il.us/commission/ecfisc/ecfisc_home.html