Testimony
of
Congressman John Linder (R-GA)
on
Fundamental Tax Reform
House Budget Committee Hearing
Wednesday, October 6, 2004

Mr. Chairman, thank you very much for giving me a chance to testify before the Budget Committee this morning on fundamental tax reform generally, and H.R. 25, the FairTax specifically. I appreciate having the chance to share with the Committee my thoughts on this pressing issue.

When debating any fundamental tax reform proposal, the Congress should judge any such bill by the following eight (8) key principles:

1. Fair: It must protect the poor and treat everyone else the same. No exemptions – no exclusions – no advantages.

2. Simple: It must be easy to understand for all Americans – no matter one's education, occupation, or station in life.

3. Voluntary: It must not be coercive or intrusive.

4. Transparent: We should all know what the government costs. There must be no "hidden" taxes.

5. Border-Neutral: Our exports must be unburdened by any tax component in the price system, while imports carry the same tax burden at retail as our domestic competition.

6. Industry-Neutral: It must be neutral between businesses and industries.

7. Strengthens Social Security & Medicare: Fundamental reform must address the long-term solvency of Social Security and Medicare.

8. Manageable Transition Costs: It must not be costly or difficult to implement.

The FairTax, which eliminates all Federal income and payroll taxes and replaces them with a national retail sales tax, meets these criteria. The FairTax is a compelling proposal that would benefit the U.S. economy, businesses across the nation, and all American taxpayers.

Allow me to briefly describe the problems associated with our current income tax code:

1. We spend 7 billion man-hours each year filling out IRS forms.
2. We spend at least that much calculating the tax implications of a business decision.
3. We lose 18% of our economy making "tax decisions" instead of "economic decisions".

Some economists believe that it currently costs us about $500 billion to comply with the income tax code in order to remit $2 trillion. Studies show that it costs the average small business $724 to collect, comply with the code and remit $100 to the federal government.

We have $5-6 trillion in overseas accounts because it is cheaper to borrow at 6% than repatriate dollars at 35%. Additionally, individuals shelter wealth in offshore accounts costing the U.S. an estimated $100 to $250 billion each year.

Just three activities – pornography, illicit drugs and illegal labor – constitute a $1 trillion economy that is untaxed.

The current dollar 75 year unfunded liability in Social Security and Medicare is $51 trillion. The total household wealth in America is less than $44 trillion. Taking every asset from every American and applying it to our retirement programs would cover only 80% of the shortfall.

The Alternative Minimum Tax (AMT) was passed in 1969 to ensure that those high income taxpayers, who have no tax liability due to their legal use of deductions and credits, would still be forced to pay some taxes. Within 6 years over 35 million Americans will be subject to the AMT.

We spend over $30 billion per year on the Earned Income Tax Credit (EITC) which is intended to refund the payroll tax burden of low income workers. It is estimated that nearly a third of that amount is fraud.

Upon close examination, it is crystal clear that the FairTax solves these problems: All of the above goes away if we stop taxing income and start taxing consumption.

HR 25 repeals all taxes on income and abolishes the IRS. Gone are personal and corporate income taxes, payroll and self employment taxes, capital gains, AMT, EITC, gift and estate taxes. They would be replaced by a single retail sales tax. Out of every dollar you spend on personal consumption - 23 cents goes to the federal government.

The FairTax is fair. It contains a rebate for every household, which would totally rebate the tax consequences of spending up to the poverty line. This rebate mechanism ensures that every household could buy necessities untaxed. It totally untaxes the poor. All Americans receive equal, fair treatment.

The FairTax is simple. The FairTax eliminates 55,000 pages of federal tax rules and replaces them with a 134 page law.

The FairTax is a voluntary tax system. Every citizen becomes a voluntary taxpayer, paying as much as they choose, when they choose, by how they choose to spend.

The FairTax creates transparency within the tax code. The FairTax eliminates the hidden tax component from the prices of goods.

According to a Harvard study, the current tax component in our price system averages 22 percent, meaning that those spending all they earn lose 22 percent of their purchasing power to the current system. The only mechanism businesses have to pay payroll taxes, income taxes, or compliance costs is price. Consumers pay those costs. By abolishing the IRS and abolishing the income paradigm in favor of a consumption paradigm we let the market drive the tax component out of the price system.

Knowing how much we pay in federal taxes on every purchase would make all Americans more aware of the cost of government. The next tax increase will not be able to be sold with the argument that it only applies to the top 2 percent of Americans. The reason for any future tax increase must necessarily be so compelling that all of America would be willing to pay it.

The FairTax is border-neutral. Under a national sales tax, imported goods and domestically produced goods would receive the same U.S. tax treatment at the checkout counter. Moreover, our exports would go abroad unburdened by any tax component in the price system.

The FairTax is industry-neutral. There is not a good reason that our neighbor who builds a bookstore, hires our kids, votes in our elections and supports our community should be placed at a 7 percent disadvantage against Amazon.com. Governors have a keen interest in this due to the loss of tens of billions of dollars in revenue to Internet and catalog sales. A national system would collect that.

Nor is there a good reason why I, as a dentist, didn't have to collect a sales tax in Georgia while my neighbor, the retailer, did. The first principle of government ought to be neutrality. Services would be taxed the same as goods.

The FairTax would solve our Social Security problem. All of the arguments about private accounts saving Social Security miss an important point – we will increase the number of retirees in the next 30 years by 100 percent and increase the number of workers supporting them by 15 percent. That system will only survive by dramatically reducing benefits, increasing taxes or increasing the number paying into it.

Under the FairTax, Social Security benefits will be paid out of the general sales tax revenues. The sales tax will be collected from 300 million Americans and 40 million visitors to our shores. Revenues to Social Security and Medicare will double, as we expect the size of the economy to double, in 15 years.

The FairTax has manageable transition costs. The only transition rule would allow retailers to use inventory on hand on December 31 as a credit against collecting taxes on sales in the New Year. This is based on the principle that things should be taxed only once and goods produced before the transition would already have the current tax embedded in them. U.S. businesses have about $1.4 trillion in inventory on hand at any given time. Not collecting taxes on that inventory would cost the Treasury about $350 billion. Compare that to any estimates of transition costs just trying to bring some private investment into Social Security alone.

The FairTax would efficiently tax the underground economy. This alone would increase revenues by over $200 billion.

Beyond the above arguments, what will the new paradigm do in our present economy? Passing the FairTax does several things that will directly affect the economy.

1. The monies saved on compliance costs will immediately be put to efficient and profitable use. We will create millions of new jobs.
2. Our GDP will grow by $180 billion per year because we would no longer make "tax decisions."
3. Eliminating the income tax will bring long-term interest rates down to municipal bond rates, ultimately reducing interest rates by 30 percent. That is good for corporate profits and the market.
4. If all the world's investors could invest in our markets with no tax consequences, values would rise. With no tax on capital or labor, foreign domiciled international firms would build their next plant in America. We would be the world's "tax haven" and the $6 trillion offshore would come home, increasing values in our markets and creating jobs.
5. Having no complicated depreciation schedules, AMT, credits and deductions to confuse investors, and no tax or compliance costs, would force a whole new look at corporate accounting. Only three numbers have meaning: earnings, expenses and dividends. Nothing to hide behind. It will be easier for shareholders to evaluate and monitor the companies they own.
6. Deficits spook the market. Instead of a 20 percent decline in collections over the last three years, we would have had increased revenues in 11 of the last 12 quarters.
7. Add to the above a 26% increase in exports in the first year, as well as a 78% increase in capital investment. Capital investment increases lead to increases in productivity and then increases in real wages. We also will have a 10.5% increase in economic growth in the first year.

How does the FairTax compare to other fundamental tax reform ideas? The FairTax is decidedly simpler and fairer than flat tax proposals. The U.S. instituted a flat tax in 1913. Since then, it has been amended over and over, resulting in the very plan we are working to correct today. In 1986, we eliminated most deductions and drastically lowered tax rates to only two levels. We have amended the code over 6,000 times since then. We have walked the flat tax path before, to no avail, and it simply does not make sense to implement the same mistake again. Also, by keeping the payroll tax and corporate tax in place, the flat tax proposals fail to remove the tax component from the price system.

Other sales tax proposals leave in place the payroll tax – the largest hidden tax component in the prices of our goods and services. The FairTax would completely eliminate these hidden taxes, allowing competition to bring prices down an average of 20-30 percent and increasing the transparency of the tax system.

In reviewing the FairTax, here are some important concepts to remember:

- Because of the tax component incorporated into prices under the current income tax code, we are already paying the equivalent of the FairTax!
- The FairTax eliminates payroll taxes, which are the most regressive of existing taxes.
- The FairTax is a tax on accumulated wealth. However, the holders of accumulated wealth are already paying it. It is just hidden. Their wealth will increase geometrically with all of the new investment expected.
- The FairTax saves Social Security and Medicare as federal entitlements.
- The FairTax efficiently taxes the underground economy.

A response to

"The Effects of Replacing Most Federal Taxes with a National Sales Tax: A State-by-State Distributional Analysis"

released in September 2004 by the
Institute on Taxation and Economic Policy

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Background: The Institute on Taxation and Economic Policy study
In early September 2004, the Institute on Taxation and Economic Policy (ITEP) released an unsigned paper entitled "The Effects of Replacing Most Federal Taxes with a National Sales Tax: A State-by-State Distributional Analysis" in response to President Bush's remarks indicating he thought a national sales tax was an idea worth exploring.

The ITEP study is being used heavily by certain political candidates to frustrate the urgently needed public debate over which tax reform alternative should replace the broken, unenforceable, unfair, and punitive income tax.

This paper discusses the points raised in the ITEP study and its origins so the context might be better understood.

Who is ITEP?
Analyzing the credibility of what is said by Washington pundits – how much stock to place in the veracity of what they say is said – is a function of knowing the political prism through which the pundits see the world. ITEP is a 501(c)(3) research organization (which allows their donors to receive charitable deductions) that is ostensibly dedicated to a non-partisan, non-lobbying, educational mission. Their 2002 Calendar Year Form 990 (the information form such organizations must file with the IRS) states ITEP "is a nonprofit policy research organization that focuses on the fields of economics and taxation."[1] However, ITEP is closely aligned if not a functioning arm of the Citizens for Tax Justice's think tank. Indeed, when you call the phone number listed on the study, the phone is answered "Citizens for Tax Justice." Their websites are similarly connected: http://www.ctj.org/itep/

Citizens for Tax Justice (CTJ), in turn, is perhaps the most left-liberal extremist policy organization involved in the tax policy debate. While technically non-partisan, it has opposed virtually every tax reduction/tax simplification/tax reform policy initiative since President Reagan was elected in 1980; the organization finds its warmest reception in the most liberal wing of the Democratic Party and its board includes many well-known, well-left-of-center Democrats such as Robert Reich and Robert Kuttner (see page 11). Many of its funding sources are similarly well left of center (see also page 11).

ITEP's director of tax policy is Richard G. Sims, who had earlier served as chief economist and director of economic policy for the Arkansas General Assembly. Sims is a proponent of tax increases and increases that are highly punitive of savings and investment. He has persistently argued that state sales taxes are regressive, "inadequate and inequitable" and his principal goal is to argue for "new broad-based taxes," the freezing or repealing of previously enacted tax cuts, rate hikes in sales, income, and excise taxes and temporary income "surtaxes."[2] Whether he has read the FairTax is uncertain, but the basis for his opposition to it by comparison to state sales taxes is entirely unfounded as the differences between state sales taxes and the FairTax are substantial.

[1] http://documents.guidestar.org/2002/042/688/2002-042688165-1-9.pdf
[2] See, http://auber.org/newsletters/April_2003/Highlights.cfm

Who supports the FairTax national retail sales tax?

The current tax system blights the American economy, and the debate concerning replacement systems – such as a national retail sales tax – will continue until the problem of income and Social Security taxes is resolved. Whether the national retail sales tax is the right plan is part of a national debate that will take leadership from the top, and President Bush has just recently thrown down the gauntlet to begin that public debate.

One way of gauging political interest is to look at the membership of the organizations that support a national retail sales tax. Americans For Fair Taxation (FairTax.org) – a nonpartisan organization dedicated solely to replacing the income tax with a national retail sales tax – is now the nation's largest taxpayer organization with more than 600,000 members. Also endorsing the FairTax is the National Taxpayers Union with 350,000 members. The American Farm Bureau Federation with 5.5 million members includes the FairTax in its policy book. And the list goes on.

What is wrong with the findings of the ITEP study?

The "study" is full of blatant errors of fact and misrepresentation. The most fundamental of these is when the study states specifically that it "looked at" HR 25/S 1493 and goes on to describe some features of the legislation with accuracy. However, it is immediately clear that ITEP modeled *its* version of the FairTax rather than the FairTax as written. Most obviously, ITEP substituted *its* rate, rather than the rate in the legislation. To add do this confusion, ITEP does not tell us exactly what rate it did use, while mentioning several possibilities. In short, ITEP did not model the FairTax at all, but a tax of its own design.

The rate: How anyone can calculate the FairTax national retail sales tax rate necessary to raise the same revenue as income and payroll taxes do today

Organizations and individuals opposing the national retail sales tax have often chosen exaggerate the revenue neutral rate. ITEP is no different.

What sales tax rate is necessary to replace the current system of income and payroll taxation? Let's do a simple common sense analysis.

The FairTax repeals personal, gift, estate, capital gains, alternative minimum, Social Security, Medicare, self-employment, and corporate taxes and replaces them with a tax on *all* new goods and services, without exception. In fiscal year 2003, the current tax system generated revenues of about $1.67 trillion.[3] In the same year, the economy produced goods and services valued at $11.0 trillion.[4]

Consumption in the U.S. economy was $9.5 trillion or 86.4 percent of total economic output in 2003. See Figure 4 on page 9.

Take the taxes replaced and divide by total U.S. consumption in the U.S., you get the percentage. $1.67 trillion (the taxes replaced) divided by $9.5 trillion (all consumption) equals 17.6 percent. This is the starting point for thinking about the sales tax rate.

Total taxes replaced	$ 1.67	trillion
Total consumption	$ 9.5	trillion
Taxes replaced as a percentage of total consumption	17.6	percent

A more detailed look

In 2001 (the latest year for which complete data is available), total adjusted gross income (i.e. income before personal and dependent exemptions, itemized deductions and the like) was $6.17 trillion.[5] Total consumption for the same year was $8.54 trillion or 38 percent larger.

Thus, the basic building block of the FairTax base – total consumption – is 38 percent larger than the current tax system's starting point – adjusted gross income. Taxable income under the current system was only $4.22 trillion in 2001, only 49 percent of total consumption. Or, stated differently, the FairTax base (total consumption) is more than twice the size of the income tax base (taxable income). See Figure 5 on page 10.

[3] As follows (fiscal years, billions of dollars):

Figure 1	2002	2003
Individual income tax	$858.3	$793.7
Corporate income tax	148	131.8
Payroll taxes	700.8	713
Estate and gift taxes	26	22
	$1,733.1	$1,660.5

See *Economic Report of the President*, Table B-81, p. 380 (available at http://www.whitehouse.gov/cea/pubs.html) or the Budget of the United States (available at http://www.whitehouse.gov/omb/budget/fy2005/).
[4] See, National Income and Product Accounts, Survey of Current Business, August, 2004 (available at http://www.bea.gov/bea/ARTICLES/2004/08August/0804NIPA_TABLES.pdf). The $9.5 trillion figure is the sum of personal consumption expenditures ($7.76 trillion) and government consumption ($1.72).
[5] See IRS Statistics of Income, Table A, Individual Income Tax Returns, Selected Income and Tax Items for Selected Years, 1997-2001, (available at http://www.irs.gov/taxstats/article/0,,id=96586,00.html).

Thus the FairTax can lower marginal tax rates because its tax base is broader than the current tax system. Its tax base is broader because the FairTax has no loopholes and no exclusions, whereas the current tax system is full of special-interest loopholes, exceptions, and exclusions.

Calculating an exact tax rate is a bit more complex because of three things.

- The federal fiscal year runs from October 1 to September 30 whereas the National Income Product Accounts are maintained on a calendar year basis, requiring adjustments.
- The National Income Product Accounts definition of consumption and the FairTax definition are somewhat different and adjustments (going both ways) have to be made.
- Lastly, and most significantly, the FairTax legislation (HR 25/S 1493) includes a rebate that allows each household tax-free spending up to the poverty level[6]. Primarily because of this last point, the FairTax rate must be higher than the 17.6 percent described above. Depending on the year, the tax level and the economy, the required sales tax rate to replace the repealed taxes *and* provide the rebate, has been about 10 to 13 percent higher than the rate required simply to replace the repealed taxes.

The FairTax rebate

The FairTax rebate is provided to households on a monthly basis in advance of spending. It is equal to the annual consumption allowance (spending at the poverty level) times the sales tax rate divided by 12. The rebate insures that no person spending at the poverty level or below would pay any tax at all.

Figure 2: The Fair Tax rebate schedule

Single head of household				:	Married couple			
Annual consumption allowance	Family size	Annual rebate	Monthly rate	:	Annual consumption allowance	Family size	Annual rebate	Monthly rebate
$9,310	1 person	$2,141	$178	:	$18,620	couple	$4,283	$357
$12,490	plus 1 child	$2,873	$239	:	$21,800	plus 1 child	$5,014	$418
$15,670	plus 2 children	$3,604	$300	:	$24,980	plus 2 children	$5,745	$479
$18,850	plus 3 children	$4,336	$361	:	$28,160	plus 3 children	$6,477	$540
$22,030	plus 4 children	$5,067	$422	:	$31,340	plus 4 children	$7,208	$601

Source: FairTax.org

Thus, a married family with two children could spend $24,980 before paying any tax and would have an effective tax rate of only 11.5 percent if they spent $50,000.

[6] The poverty level is determined annually by the Department of Health & Human Services.

A tax rate of $23 out of every $100 spent may sound high, but it simply replaces taxes paid today, plus the rebate. Additionally, it is important to remember that the FairTax (unlike *any* other reform plan) repeals regressive payroll taxes as well as all income taxes. Payroll taxes amount to 15.3 percent of most workers wages. Finally, only the wealthiest, biggest spenders pay the highest rate ($23 out of every $100) due to the progressive structure of the FairTax.

Alternatively, consider wage earners in the lowest income tax bracket. They pay 15 percent in income taxes (after personal and dependent exemptions and the standard deduction) and 7.65 percent in payroll tax - paid from the first dollar earned. That is 22.65 percent before considering the employer payroll tax (which most economists believe employees actually pay). The FairTax provides a direct rebate to each household in the amount of the sales taxes on spending up to the poverty level, instead of indirectly using personal exemptions and a standard deduction to reduce taxes.

Problems with the ITEP state-by-state analysis

The ITEP analysis presents tables purporting to show which states and income groups gain or lose. The study does not, however, choose to explain how these results were determined. Nor does the study show totals that sum to the total revenue raised. It is, therefore, impossible to analyze the methodology of the study or even assure that the amounts add up. We are simply asked to trust the “black box” of the ITEP model, which we assume to be a static, rather than dynamic, model.

Given the clear agenda of CTJ’s support network, there is considerable trust required here.

Despite these impediments, we did attempt to reverse engineer their calculations, assuming a simple static analysis. In doing so, if we use the revenue neutral rate from the FairTax legislation (23%), even the ITEP model appears to confirm the existing FairTax calculations.

Tax exclusive/tax inclusive: 30 percent or 23 percent

Because the FairTax is a replacement for the current tax system, logic dictates that FairTax rates be compared to the rates of the taxes it *replaces*. Such taxes are imposed on a tax base before payroll taxes and before federal income taxes are deducted. Economists describe this calculation as “tax inclusive.” To compare apples to apples the FairTax is, unlike most state sales taxes, quoted on a tax inclusive basis.

Should the FairTax be compared to state sales taxes, which are *applied* in a similar manner to the FairTax, the “tax exclusive” rate would be 29.9 percent. If current income and Social Security taxes were quoted on this basis, the rates on middle class taxpayers would be 55 percent and 76 percent if you take into account the hidden employer payroll tax that most economists believe is borne by workers.

Typically, state sales taxes are imposed on a tax exclusive basis.

Two examples clarify this point.

First example: Income tax rate viewpoint
Assume a worker earns $100. Under the income tax, a worker/consumer would have $20 dollars withheld from his paycheck, and have $80 left over to buy a CD player at Wal-Mart. The tax rate is $20 divided by $100 or 20 percent.

Now assume a worker walks into Wal-Mart with $100, pays $80 for the CD player and $20 in sales tax. The tax rate is $20 divided by $80 resulting in a rate of 25 percent.

Without proper examination, or through deceptive detractors, one might come to believe taxpayers are paying more via the sales tax computation *when the taxes are exactly the same in both cases*.

In its literature, FairTax.org has chosen to compare first to income taxes (tax inclusive) and then provides details on tax exclusive or sales tax calculations:
http://www.fairtaxvolunteer.org/smart/faq-main.html#47

Second example: Sales tax rate viewpoint
The way of looking at the income tax from a sales tax point of view is to ask how much a worker must earn in order to have $100 left to spend. Today, a worker in the 28 percent income tax bracket (who must also pay 7.65 percent in payroll taxes) must earn $155 to pay for $100 CD player.

Figure 3: Gross earnings vs. available spending

	Income tax bracket	
	28%	15%
Gross earnings	$155.40	$129.22
Income tax	43.51	19.35
Employee portion payroll tax (7.65%)	11.89	9.87
Available spending	$100.00	$100.00

If the employer share of the payroll tax is considered, this worker must earn $176 to spend $100.

A taxpayer in the 15 percent income tax bracket must earn $129 to spend $100. This figure would be $143 if the employer share of payroll taxes is taken into account.

Bottom line - whether that tax rate is described as tax-exclusive or tax-inclusive has no bearing on the ultimate tax paid – the same as whether the distance to the corner store is measured as 100 yards or 300 feet does not change the length of the walk.

Taxing government

Just like the FairTax, the current tax system taxes government consumption - a point that the ITEP study conveniently neglects to mention.

In 2003, total consumption was $9.5 trillion. Of this amount, $7.76 trillion were personal consumption expenditures and $1.72 trillion (or 18 percent of total consumption) was government consumption.[7] The $1.72 trillion of government spending is taxed today through the income taxes and payroll taxes paid by government workers. Local, state and federal governments pay employer taxes and those taxes are counted as tax revenue (and expenditures) in the federal budget. Government contractors also pay income and payroll taxes and those costs are reflected in the price of goods and service purchased by all levels of government.

The same amount of government consumption would remain subject to taxation under the FairTax. This is so for two reasons.

First, government spending is already subject to taxation. We could, in ITEP's analysis, simply not tax the salaries of government workers and pay them less, or in ITEP's judgment, pay them the same but not withhold or charge them taxes. Failing to tax government consumption would constitute a huge increase in effective government spending. Perhaps a hidden agenda?

Second, failing to tax goods and services consumed through government while taxing privately produced goods and services would provide a huge incentive to consume through government, thereby creating an unlevel playing field. Trash collection, transportation services, recreation services, printing, postal and delivery services, electricity production and so on are taxed under the FairTax whether they are provided by government or the private sector. To do otherwise is both unfair and economically inefficient.

Conclusion

The ITEP "study" is severely flawed and actually represents the efforts by an extremist organization to provide misleading and inaccurate information to the media and the public in an effort to derail a proposal that, according to many economists and legislators, would have very positive effects on the U.S. economy and most Americans.

The FairTax is the only plan that actually "untaxes" the poor. It repeals the existing regressive tax on jobs the Federal government calls payroll taxes; three quarters of Americans pay more in payroll taxes than in income taxes. And it makes spending up to the poverty level tax-free.

The FairTax gives individuals a choice whether to pay the tax (since basics needs are tax free). The decision to be made by the taxpayer is not whether to work or not, but whether to consume or not, and the rich consume a lot more than the poor.

[7] Supra, note 2.

Figure 4

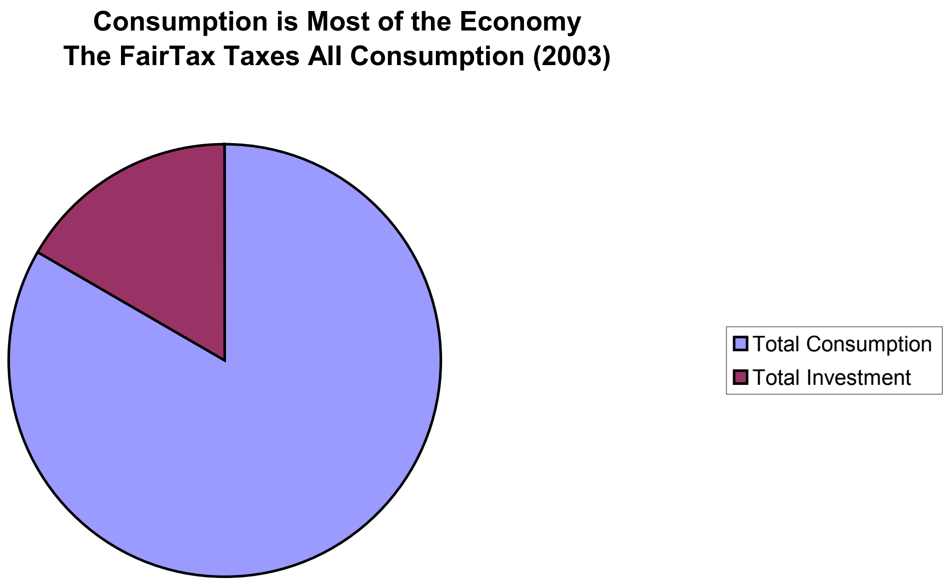
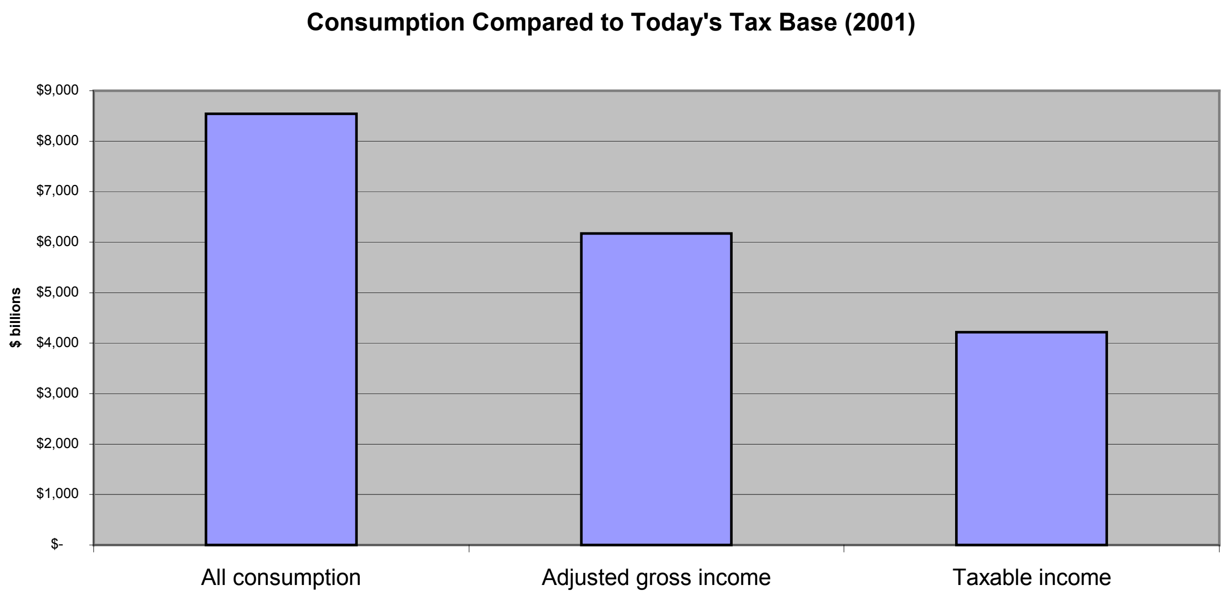

Consumption is Most of the Economy
The FairTax Taxes All Consumption (2003)
Total Consumption
Total Investment

Figure 5


Consumption Compared to Today's Tax Base (2001)
$ billions
$9,000
$8,000
$7,000
$6,000
$5,000
$4,000
$3,000
$2,000
$1,000
$-
All consumption
Adjusted gross income
Taxable income

ITEP funding

Source: http://www.ctj.org/itep/funding.htm

ITEP thanks all of its many individual contributors and the following philanthropic organizations for their financial support:

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Ford Foundation
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