

AMERICANS *for* TAX REFORM

No Automatic Tax Increase Trigger

By
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On March 31, the Brookings Heritage Fiscal Seminar, a joint project of the Heritage Foundation and the Brookings Institution, issued a paper entitled *Taking Back Our Fiscal Future*¹ at an event at the National Press Club. The paper included sixteen co-authors, including such prominent names as former CBO Directors Alive Rivlin, Robert Reischauer, and Rudolph Penner, Isabel Sawhill of the Brookings Institution, Progressive Policy Institute President Will Marshall, Eugene Steuerle of the Urban Institute, and Heritage Foundation Vice-President for Domestic Policy Stuart Butler.

The paper advocates fundamental budget process reforms to deal with projections of enormous long term Federal budget problems. It begins by defining the fundamental problem as “Unsustainable deficits in the federal budget threaten the health and vigor of the American economy.”² It also states upfront,

“The first step toward establishing budget responsibility is to reform the budget decision process so that the major drivers of *escalating deficits* – Social Security, Medicare, and Medicaid—are no longer on autopilot.”³ (emphasis added).

So the analysis begins by defining the problem as massive future budget deficits. But from a conservative and free market perspective, that is not the real problem. From this perspective, the real problem is runaway big government and massive federal spending growth. Current official U.S. government projections show that without fundamental reforms, federal spending will soar over the next 3 decades from 20% of GDP today, where it has been relatively stable for over 50 years now, to close to 40% of GDP, and quite possibly more. The major drivers of this spending explosion are precisely the major entitlement programs – Social Security, Medicare, and Medicaid.

¹ Joseph Antos et al., “Taking Back Our Fiscal Future,” The Brookings Heritage Fiscal Seminar, Washington, DC: April, 2008.

² Id.

³ Id.

If anything even close to that happens, conservatives in favor of limited government will have been completely routed. Add in state and local government spending, and total government spending in America will be over 50% of GDP. America's highly successful heritage of free market capitalism will then have been replaced by Swedish socialism (which even the Swedes don't believe in any more).

From a conservative, free market perspective, a budget with Federal spending at 15% of GDP, and a deficit of 3% of GDP, is far preferable to a balanced budget with Federal spending at 35% of GDP.

Whether the problem is defined as massive future Federal deficits, or massive, future runaway Federal spending, makes a huge, fundamental difference. If the problem is future deficits, then the solution is finding a politically feasible combination of tax increases and benefit cuts, which is the actual goal of the authors of the paper, as discussed below. But if the problem is runaway federal spending, then tax increases are not part of the solution. Tax increases would just support more federal spending, and so are part of the problem. The solution is finding politically feasible, fundamental entitlement reforms that would short-circuit the projected explosion of federal spending, or even reduce such spending as a percent of GDP.

Thinking outside of the box of current entitlement structures, we can develop fundamental entitlement reforms that would create new programs that would actually serve the public far better, while reducing the burden of Federal spending. Those reforms would consequently not only be politically feasible, but potentially quite popular. This is where conservatives and free market advocates should be focusing their energies.

The Automatic Tax Increase Trigger

The co-authors of Taking Back Our Fiscal Future agree that the first step in countering the looming deficit explosion that concerns them is budget process reform. They recommend that "Congress and the president enact explicit long term budgets for Medicare, Medicaid and Social Security..."⁴ These entitlement budgets would be reviewed every 5 years. But the key budget reform recommendation is as follows:

"The rules for the five-year review must include a trigger or action forcing device that requires explicit decisions when projected spending exceeds budgeted amounts. The trigger might involve automatic benefit cuts or revenue increases (including premium increases) that could only be overridden by an explicit vote or enactment of alternative policies that would achieve budget outcomes similar to the automatic adjustments. Alternatively, the trigger process could require that a commission make recommendations for closing the gap to the president and Congress on which an up or down vote must be held."⁵

⁴ Id.

⁵ Id., p. 6

The paper then goes on to discuss various tax increase options. These include raising the payroll tax rate, or increasing the earnings subject to the payroll tax (raising the cap on the annual income subject to the payroll tax).⁶ Another option mentioned is “replacing or supplementing the payroll tax with a broad-based energy levy or other earmarked tax that would raise revenues.”⁷ Still another option mentioned is to increase the taxation of Social Security benefits.

The paper discusses as well benefit cut options which may also be included in any overall solution. Among these are delaying the retirement age, changing the basic benefit formula to reduce future promised Social Security benefits, means testing entitlement benefits, and, under Medicare and Medicaid, reducing even more the fees paid to doctors and hospitals, increasing deductibles and co-payments, and raising premiums paid by retirees.

None of these benefit cut options would reduce future Federal spending by nearly as much as the structural reforms discussed below. Moreover, these benefit cut options are all deeply unpopular, as are the tax increases, making the political feasibility of this entire reform approach doubtful. Most importantly, the great political unpopularity of the benefit cut options means none of them will ever be adopted without compromising with Big Government liberals for a tax increase, a huge tax increase. Enacting any of these benefit cuts would require bringing almost everyone in Washington along for political cover in a Grand Compromise including stiff tax increases as well as the benefit cuts.

Indeed, at the event at the National Press Club where the paper was released, Rudolph Penner explained more clearly the thinking of the 16 co-authors. He said that he hoped that the proposed budget process reforms “would lead to the kind of outcome preferred by this committee [the 16 co-authors] – the 1990 budget deal.” That was the deal where President George H.W. broke his “Read my lips, no new taxes” pledge, which led to his defeat in 1992. That budget deal included a massive tax increase in return for spending reductions, which were soon erased in later budget years. The budget deficit, in fact, increased after that deal.

Even though another huge tax increase was enacted in 1993, the long string of budget deficits were actually not eliminated until Republican Congressional majorities were elected in 1994. President Clinton’s budget proposal in January, 1995 projected annual budget deficits continuing at about \$200 billion for the next 10 years. The Gingrich led Congress cut taxes on savings and capital investment, producing an economic boom. Then they held down the growth of Federal spending, which along with robust revenues produced by the growing economy, turned the \$200 billion annual deficits into \$200 billion annual surpluses.

⁶ Id., p. 7

⁷ Id.

Another co-author of the paper, Ron Haskins of the Brookings Institution, published a commentary in the Washington Times on April 7, along with former Congressman Bill Frenzel, that further explained the thinking of the 16 co-authors. Haskins and Frenzel explained the proposal of the 16 co-authors as follows:

“Specifically, they proposed that: (1) Congress and the President enact 30 year budgets for Social Security, Medicare, and Medicaid; (2) Congress review the budgets every five years; and (3) *automatic* program cuts or *revenue increases* be triggered if projected spending exceeds the budget.”⁸ (emphasis added).

Haskins and Frenzel described the expected effect of this proposal as follows:

“The second effect of the trigger proposal will then kick in. Congress and the President will realize they cannot achieve a 30 year sustainable budget for Social Security, Medicare and Medicaid by simply reducing benefits. Rather, the solution will require a combination of benefit cuts and revenue increases.”⁹

We want to be on the public record now as saying that if these budget process reform proposals ever do amount to anything, they will lead to a very large, probably record setting tax increase.

Panic and Confusion

Another paper by Stuart Butler, co-authored with Maya McGuineas of the New Century Foundation, actually called for cutting Social Security benefits for current retirees. Butler and MacGuineas write,

“As quickly as possible, we should phase in a means test for premiums and benefits for Medicare and Social Security....We support including current and near retirees in this change since these demographic groups have fared disproportionately well under our social insurance programs and because the more widely the benefit reductions are spread, the smaller they will have to be....”¹⁰

Butler’s co-author MacGuineas has, in fact, argued for such cuts for current retirees for several years.

This same policy prescription is reflected in another Heritage publication, which complains,

“[M]any believe that anyone over age 55 should be exempt from entitlement reforms. Yet every year, 4 million more baby boomers turn 55, effectively locking

⁸ Bill Frenzel and Ron Haskins, “What, Me Worry? Ignoring the Entitlement Tsunami,” Washington Times, April 7, 2008, p. A17.

⁹ Id.

¹⁰ Stuart M. Butler and Maya MacGuineas, “Rethinking Social Insurance”, The Heritage Foundation, New America Foundation Fiscal Policy Program, February 19, 2008, p. 13.

in their future benefits (and taxpayer costs) by this standard. By 2019, all 77 million baby boomers will have turned 55....”¹¹

The Heritage Backgrounder goes on to state, “Personal accounts by themselves do not reduce the tax liabilities to current seniors.”¹² That is quite true. The only changes that would reduce tax liabilities to current seniors are benefit cuts for current seniors. Personal accounts do not involve any such benefit cuts. **But personal accounts of sufficient size would eventually phase out all tax liabilities to future seniors.** That is because personal accounts shift the payment of Social Security benefits from the public sector to the private sector, where they are financed by savings, investment, and investment returns, rather than taxes.

Advocating Social Security benefit cuts for current seniors does not advance the cause of entitlement reform. Rather, it stifles such reform. Such extreme positions scare away potential political leaders from even becoming associated with entitlement reform. They also short-circuit potential grassroots support. Moreover, the more reformers focus on benefit cuts the higher price they will have to pay in compromising with tax increases.

Politically successful entitlement reform requires reformers to think outside the box of current entitlement programs. Instead of focusing on packages of tax increases and benefit cuts, reformers need to focus on restructuring and modernizing these programs from the bottom up. Through such reforms, we can provide new entitlement frameworks that actually maintain the social safety net and, indeed, actually achieve the social goals of these programs far better than the current, outdated, 19th century entitlement structures. At the same time, these fundamental, structural reforms would leave the programs costing far less in terms of government spending. Indeed, far more can be achieved in reducing Big Government and government spending through these positive structural reforms than through benefit cuts. This approach provides the prospect of actually making entitlement reform appealing to voters, and, indeed, even popular. We will discuss these positive structural reforms below.

In other words, entitlement reformers would achieve far more for America if they would agree to not even use the words tax increases or benefit cuts, and thereby force themselves to think anew of possible structural alternatives.

The Heritage Backgrounder goes on to endorse so-called “progressive price indexing.” Under the current Social Security benefit formula, during working years, the future retirement benefits to be paid to workers increase each year at the rate of growth of wages in the economy. Progressive price indexing would change that for higher income workers, so that their future benefits would grow only at the rate of growth of prices, which is consistently lower than the rate of growth of wages, reflecting real wage growth. Low income workers making less than \$25,000 per year would be exempt from

¹¹ Brian M. Riedl, A Guide to Fixing Social Security, Medicare, and Medicaid, Heritage Foundation Backgrounder no. 2114, March 11, 2008, p. 3.

¹² Id., p. 7.

this change. The price indexing would be phased in for those making over \$25,000 per year, with more price indexing and less wage indexing the higher income goes, until full price indexing is reached.

Advocates of this change argue that future Social Security benefits would still grow, but just not as fast. But full price indexing would be a huge cut in future promised benefits, close to 40% compared to what is promised to workers under current law, and, eventually more. Under progressive price indexing, that same result would still be achieved for everyone making over \$25,000 per year, just more slowly for middle income workers.

The fundamental problem with price indexing is that Social Security benefits are not the only thing changing over time. Because of economic growth, everything else is moving as well. In particular, with the payroll tax, Social Security taxes also grow at the rate of growth of wages over time. With taxes growing each year at the rate of growth of wages, and benefits growing at the slower rate of growth of prices, the effective rate of return paid by Social Security on its taxes would decline each and every year, *in perpetuity!*

As a result, the effective, actuarial, real rate of return paid by Social Security would fall to zero, and then below into the negative range, for more and more workers over time. Eventually, the real rate of return under Social Security for everyone earning more than \$25,000 per year would fall into the negative range.

Conservatives and other free market advocates have argued for years that Social Security now promises workers a very low, below market, real rate of return. That low return is what is paid by the very wage indexed benefits that advocates of progressive price indexing want to cut further.

Another thing that is moving in the real world is wage incomes, which also grow at the rate of growth of wages each year. With wage incomes growing at the rate of growth of wages, but future promised Social Security benefits growing at the slower rate of growth of prices, the replacement rate, or percent of pre-retirement income replaced by Social Security benefits, would also decline each and every year *in perpetuity!*

Social Security now replaces close to 40% of pre-retirement income for average income workers. With wage indexed benefits, those benefits would grow with wages over time along with wage incomes, and this replacement rate would be stable. But under price indexing, this 40% would decline over time to 30%, then 20%, then 10%, and lower and lower. Under progressive price indexing, this result would again be reached for everyone earning over \$25,000 per year, just more slowly for middle income workers than for higher income workers.

In the mid-1970s, Congress debated how to index Social Security for the long run, and both parties joined in choosing wage indexing over price indexing for precisely the above reasons. These points, in fact, show why shifting to price indexing now, even progressive price indexing, would be draconian and ultimately politically indefensible. Moreover, any effort to make such a change now would entail a heavy price in terms of a

compromising tax increase, as shown precisely by the above discussion of the proposed automatic tax increase trigger.

Personal accounts for Social Security would phase out completely the current wage indexed benefits that price indexing advocates quite rightly argue are too expensive under the current Social Security framework. With personal accounts, instead of tax financed wage-indexed benefits, workers would receive benefits financed through private capital markets and private savings, investment and insurance. Moreover, because of the much higher investment returns of modern capital markets, the market based benefits would actually be much higher than the wage indexed Social Security benefits they would replace. Surely, this is a much more politically sensitive and feasible means of reducing taxpayer obligations for Social Security benefits than simply trying to cut those benefits. And surely so much more is achieved by replacing those benefits entirely with better market based benefits than, again, simply trying to cut those benefits.

The Heritage Backgrounder argues for a Social Security reform package including progressive price indexing, delaying the retirement age, and personal accounts. But, as demonstrated in a forthcoming paper from the Institute for Policy Innovation, this was precisely the approach taken by President Bush in trying to advance personal accounts during his term in office. That approach failed completely precisely because the positives of personal accounts were buried by the negatives of the benefit cuts, and so no grassroots support for reform ever developed. By the end of 2005, polls showed over half the public still supported the idea of personal accounts. But support for “the President’s plan” was less than half that. Why would we go back to this tried and failed approach?

Moreover, the Backgrounder completely fails to account for the criticism and analysis discussed above.

Entitlement reformers lament that no one in this election year seems to be campaigning on entitlement reform. Indeed, the Democrat candidates for President, and the Democrat party in general, are campaigning on adding massive new entitlements, such as national health insurance. This is because the reformers have not sufficiently projected interesting and appealing reform proposals that would compel real world candidates to address them. As long as reformers remain focused on combinations of tax increases and benefit cuts as the solution, they will continue to be ignored.

Entitlement Reform Without Tax Increases

As discussed above, to achieve successful, positive, entitlement reform, we must think outside the box of our current entitlement programs, and promote reforms that thoroughly restructure and modernize these programs, rather than packages of tax increases and benefit cuts. To begin, we must recognize that our entitlement programs are based on old-fashioned, late 19th century models of simple tax and spend redistribution. Social Security, for example, does not involve any saving and investment at all. Close to 90% of the money that comes in is paid out within 30 days in current benefits. Any surplus is lent to the Federal government and immediately spent as well.

Such old fashioned systems retard economic growth with perverse incentives on both the tax and spending sides. High taxes to finance these programs discourage savings, investment, entrepreneurship and work. Welfare discourages work, and government retirement benefits discourage private retirement savings, as workers do not have to save for the benefits the government will pay.

To modernize and restructure these programs with positive, pro-growth reforms, the key is to bring in much greater roles for highly productive modern capital and labor markets to serve the goals of these programs. Reformers have to recognize that voters are going to insist upon sturdy safety nets remaining in place. But with positive, pro-growth, structural reforms and the broad benefits of capital and labor markets, we could maintain such safety nets and actually provide a far better deal for beneficiaries, with far less in government spending.

Personal Accounts. One key concept for positive, structural entitlement reform is personal accounts for Social Security, where workers would be free to choose to substitute savings and investment accounts for at least part of the current system. These accounts involve expanding the overall Social Security framework to bring in a central role for modern capital markets in serving the goals of the program.

These accounts are especially powerful in reducing government spending because they don't just trim the growth of such spending. They would shift huge chunks of it from the public to the private sector, dramatically reducing Federal spending over the long run.

The accounts can start at any size, and then can be expanded over time until workers can choose to substitute the accounts for all of their Social Security retirement benefits. The accounts could be expanded further, eventually substituting private life insurance for Social Security survivors benefits, and private disability insurance for Social Security disability benefits. Eventually, the accounts could be expanded to cover the payroll taxes for Medicare, with the saved funds financing annual annuity benefits that would be used to purchase private health insurance in retirement. Such accounts would reduce Federal spending by about 9% of GDP, as the personal accounts replace this spending with market financed benefits. Such spending reductions would involve an unprecedented, historic achievement.

In the process, the payroll tax would ultimately be phased out completely, and replaced with an engine of personal family wealth in the personal accounts. Workers would get much better benefits through these accounts because market investment returns are so much higher than what the non-invested, purely redistributive, Social Security system can even promise, let alone what it can pay. Workers across the board would accumulate several hundred thousand dollars in real terms by retirement, directly owned by each worker, which can be left to the family at death. This would do far more to reduce inequality than anything else, yet do so in a way that reinforces rather than undermines the economy. Indeed, done right, such reform would produce an historic breakthrough in the personal prosperity of working people.

The bill introduced in the last Congress by Rep. Paul Ryan (R-WI) and Senator John Sununu (R-NH) serves as a comprehensive model of how to structure such accounts, with substantial input from the Social Security Administration itself and from experienced Wall Street fund administrators on how to make the concept workable. That bill also maintained the current social safety net in full, by including a federal guarantee that if any retiree's account cannot pay at least what Social Security would under current law, the federal government would pay the difference. That works because capital market returns are so much higher than even what Social Security promises, let alone what it can pay. As a result, it is extremely unlikely that the fully invested personal accounts would not be able to pay at least what Social Security promises, especially when workers are investing through a structured framework where they are choosing among highly diversified, professionally managed, investment funds approved and regulated by the government for safety and soundness. These features follow exactly the model personal account reform adopted in the South American nation of Chile over 25 years ago, which has worked spectacularly well.

The transition to personal accounts can be financed by reducing the growth of other government spending and by the increased revenues resulting from higher economic growth. Indeed, the other structural entitlement reforms discussed below can help greatly in financing this transition. Brian Riedl and the Heritage Foundation have advocated a limit on the growth of total Federal spending that would be more than sufficient to finance the transition. He has also published on behalf of Heritage lists of wasteful Federal spending that should be cut, as has the Cato Institute and others, which would be more than sufficient to finance the transition as well. The popularity of personal accounts and the need to finance the transition would draw in the public to more actively support reducing such wasteful and even counterproductive spending.

Indeed, the growing literature on the optimal size of government indicates that our government is so overgrown and wasteful that for every dollar of government spending and taxes reduced the economy actually enjoys a net gain of \$2.75. Financing the transition by reducing such spending growth would consequently produce another net gain, not a cost. Such reduced government spending would, in any event, be seen as another benefit of the reform by conservatives and other free market advocates. This would mean that the personal account reform overall would reduce total Federal spending by even more than the amounts discussed above resulting directly from the personal accounts alone. This is the most economically positive and most politically appealing way to finance the transition.

We know such personal account reforms would be politically quite popular, as many candidates won elections campaigning on such accounts from 1998 through 2004, including President Bush. Indeed, voluminous polling conducted last summer by Newt Gingrich's organization American Solutions found that two-thirds of Americans still support a personal account option for Social Security. This is the most popular reform alternative for Social Security by far.

But instead of fighting for what he campaigned on so successfully, President Bush got lost in the swamps of Washington putting every bad, unpopular idea on the table as well, such as cutting the basic benefit formula, increasing taxes, delaying the retirement age, etc. As was predicted, this buried the positive, populist features of the personal accounts, confused the grassroots, and lost the appeal to the general public necessary to succeed in enacting the reform.

Block Grant Welfare to the States. A second key concept for positive, structural entitlement reform is block grants back to the states for the remaining Federal welfare programs. Legislation enacted in 1996 block granted the old Aid to Families with Dependent Children (AFDC) program back to the states. The share of Federal spending on this program was returned to each state in a block grant to be used in a new program designed by the state based on mandatory work for the able bodied. The key is that the block grant is finite, not matching, so it does not vary with the amount the state spends. If the state spends more, it must pay for the extra costs itself. If the state spends less, it can keep the savings.

The reform was shockingly successful, with the old AFDC rolls reduced by close to 60% nationwide, close to 80% in states that pushed work most aggressively. Requiring able bodied recipients to work for their benefits eliminates the old welfare work disincentives. But probably even more important are the reversed incentives for state administrators. Previously, the Feds matched increased state spending, so each new welfare dependent signed up brought more federal funds to the state. But with the state now paying all added costs, the focus has changed to getting recipients out to work.

These reforms bring in modern labor markets to take over more of the role of providing for the poor, through wages earned in real private sector jobs. This again sharply reduces government spending over the long run.

These same reforms should now be extended to the other Federal welfare programs, particularly budget busting Medicaid. Even if the reform allowed each state to keep all of its savings from greater flexibility, positive incentives, and reduced rolls, and Federal spending on the block grants was just not increased, the reform would save the Federal government a trillion dollars over the first 10 years. This would help greatly in financing the transition to personal accounts. If Federal spending growth on the block grants was limited to grow no faster after that than the rate of growth of GDP, then Medicaid would no longer contribute to increasing Federal spending as a percent of GDP.

Large personal accounts would contribute to reducing Medicaid spending over the long run, by providing a source of funding for nursing home care insurance for older retirees. If families reach retirement age with half a million to a million dollars in their accounts, they could use some of that money to buy such insurance to protect the rest of the family nest egg. Personal accounts and block grants for Medicaid consequently are quite complementary reforms.

Such block grant reforms should be expanded to Food Stamps, Federal housing assistance programs, and other, smaller Federal welfare programs as well. The new state programs created with these block grant funds can be focused on getting beneficiaries into real, private sector jobs, market health insurance, and ultimately even home ownership. The result would be a much better overall safety net system for the poor. We would be changing our “welfare system” into a “Prosperity System”. This would provide a new, historic opportunity to end poverty, and greatly expand again the prosperity of working people.

Such welfare reform has long been popular, which is why it passed in 1996 despite opposition from many liberals and President Clinton. Now that it has been proven a huge success, it should be even more popular.

Conclusion

Positive, structural entitlement reforms offer a tremendously exciting opportunity for conservatives, free market advocates, and taxpayer activists. Such reforms are the truly popular alternatives to deal with the long term fiscal crisis. At the same time, they would dramatically reduce government spending over the long run. Pursued to the maximum, these policies may not only avoid the enormous increase in Federal spending as a percent of GDP now projected. They may actually reduce it substantially from the current level.

These structural reforms include replacing the payroll tax steadily over the years with personal accounts. These accounts would ultimately take over responsibility for all of the benefits now financed by the payroll tax. In the process, the payroll tax would be transformed from the most oppressive tax burden now suffered by working people into an engine of personal family wealth, expanding the long term prosperity of every family in America. With such full size accounts, American families at all income levels would accumulate hundreds of thousands of dollars over their lifetimes, perhaps approaching a million dollars for average income families. These accounts would pay workers and their families much more than Social Security even promises, let alone what it can pay. At the same time, the current social safety net would be maintained. This would amount to an historic breakthrough in the personal prosperity of working people.

The structural reforms also include block granting the remaining Federal welfare programs back to the states. These reforms would follow the model of the enormously successful 1996 reform of the old AFDC program. Such reforms would be extended to Medicaid, Food Stamps, Federal housing programs, and dozens of smaller, means tested, Federal welfare programs. The states could then use the new broad freedom of these block grants to build an entirely new safety net system focused on achieving middle class prosperity through real private sector jobs, real private health insurance, and even ultimately home ownership. This would provide a new, historic opportunity to end poverty and greatly expand again the prosperity of working people.

Other desirable, fundamental reforms include a limit on the growth of Federal discretionary spending that would squeeze out wasteful, unnecessary spending,

particularly for corporate welfare and runaway Federal farm aid. Pro-growth tax reform would further reduce Federal spending as a percent of GDP by increasing GDP more rapidly.

Conservative leaders and organizations should focus more aggressively on this agenda as the heart of free market, domestic policy reforms. We can and should appeal to liberals and Democrats to join in support of these structural entitlement reforms. Indeed, the reforms have been carefully designed to win such support.

But negotiating with liberals and Democrats for packages of tax increases and benefit cuts is unnecessary and counterproductive. That is just going to lead to an enormous tax increase, and distract focus from the real free market, conservative agenda discussed above, which provides the opportunity for massive reductions in Big Government. In particular, budget process reforms including an automatic trigger for tax increases are highly counterproductive and should be opposed by conservatives, free market advocates, and taxpayer activists.

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