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ISSUE BRIEF



WHY DEFICITS STILL MATTER

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Introduction

For decades, a consensus of economic policy experts warned that escalating national debt brings about higher interest rates, larger government interest costs, and slower economic growth. For the most part, politicians and voters at least gave lip service to these concerns. Today, the return of trillion-dollar annual budget deficits—projected for this year and heading toward \$2 trillion within a decade—is being greeted with a collective shrug.¹ Indeed, a variety of spending proposals over the past several months exhibit a political momentum for increasing deficits even further. If enacted, such proposals risk a financial crisis, even if interest rates remain relatively low.

The public's general indifference toward rising deficits may reflect the experience of the recent past. The Great Recession—plus the resulting stimulus laws and financial bailouts—caused the annual deficit to rise from \$161 billion to more than \$1.4 trillion in just two years (2007–09). This sparked Tea Party rallies and helped the Republicans win control of the House of Representatives in the wave election of 2010. Yet the end of the recession, expiration of stimulus spending, and repayment of most financial bailout funds (plus some modest spending caps and upper-income tax hikes) reduced the deficit to \$439 billion by 2015. This fairly rapid decline may have convinced many Americans that earlier deficit concerns had been overblown. The problem with this inference: budget deficits driven by temporary factors such as wars or recessions are different in kind and effect from relentlessly increasing deficits driven by entitlement spending, especially Social Security and Medicare. Today the economy is growing, wages are rising, and interest rates are low; Americans do not yet feel the economic effects of rising debt. They will.

Nevertheless, some economists and commentators have grown accepting of large budget deficits. Jason Furman and Lawrence Summers, for example, have asserted that low interest rates make the national debt more affordable.² MIT's Olivier Blanchard asserts that, as long as the economic growth rate exceeds the interest rate paid on government debt ($r < g$), the debt's share of the economy will fall.³ Commentators Chris Hayes of MSNBC and Matthew Yglesias of Vox argue that even larger deficits than the country did experience would have softened the Great Recession and stimulated a strong economy.⁴

Among others, Furman and Summers also argue that rising government debt no longer crowds out business investment, adding that “no one seriously argues that the cost of capital is holding back businesses from investing.”⁵ Yglesias asserts that new debt can be used on pro-growth projects that offset whatever economic drag results from the borrowing.⁶ Advocates of Modern Monetary Theory regard any concern about deficits and debt as unnecessary—and holding the economy back from a new era of prosperity.

By contrast, this paper argues that ever-rising deficits and debt, even in a low interest-rate environment, do pose a significant risk to the economy—that is, to Americans' prosperity and living standards. Deficits still matter, and the standard economic assumptions about government debt remain in force. Trillions of dollars in *new* government deficit spending will not produce significant new economic growth. Instead, the rising deficits and debt that are *already* baked in to current entitlement spending will consign future generations to exorbitant interest payments to fund consumption by senior citizens. Here are the problems with the view that there is little to worry about:

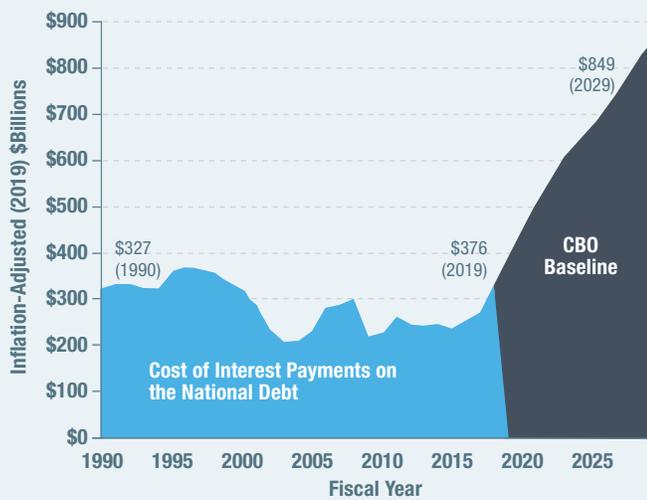
Interest Rates and Interest Payments

Consider Blanchard’s claim that, as long as the economic growth rate exceeds the interest rate paid on government debt ($r < g$), the debt’s share of the economy will fall even if the interest payments are funded entirely by borrowing.⁷ This formula, however, assumes that the debt is growing only from the borrowing cost of those interest payments—and that the rest of the budget (excluding interest spending) is balanced. Otherwise, increased borrowing to pay for the rest of government will further increase the debt.⁸ In other words, the debt’s share of the economy will continue to rise, not fall.

And that is exactly what is happening. The U.S. Treasury borrowed \$984 billion in 2019—far exceeding that year’s \$376 billion interest payments (**Figure 1**). More broadly, the current-policy budget baseline, using Congressional Budget Office (CBO) data, shows that government debt—39% of GDP in 2008—has already doubled, to 78%. The debt-to-GDP ratio is projected to reach 105% within a decade, and 194% after three decades (**Figure 2**).

FIGURE 1.

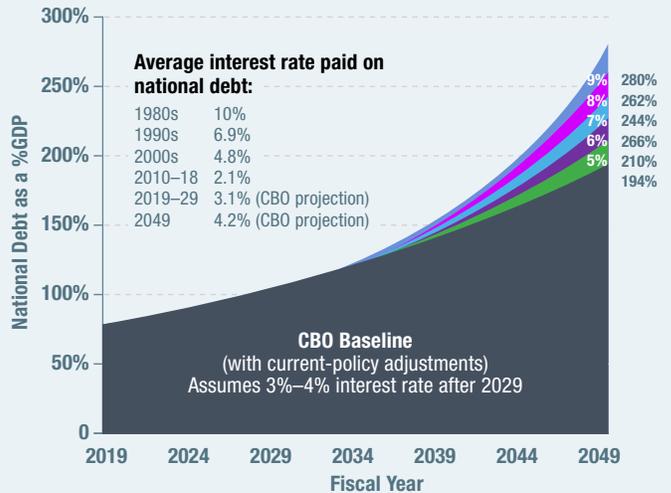
Interest Payments on the Federal Debt Are Set to Rise Dramatically



Source: OMB Historical Table 3.2 and CBO’s January 2019 Baseline (current policy), table 1.1, adjusted for inflation into 2019 dollars by the author

FIGURE 2.

The U.S. Debt–GDP Ratio Will Approach 200% in 30 Years



Source: Author’s calculations using CBO, “The 2019 Long-Term Budget Outlook,” June 25, 2019; alternative scenarios assume that higher interest rates phase in during 2030–49

CBO’s projection assumes no wars, no major recessions, and no expensive new federal initiatives.⁹ Accordingly, the government’s interest payments on this debt—which have risen from 1.2% to 1.8% of GDP since 2015—are projected to reach 3.4% within a decade and 7.6% (and steeply rising) by 2049 (**Figure 3**).

By that point, the interest payments on the national debt would be the federal government’s largest annual expenditure, consuming 42% of all projected tax revenues. In fact, just the *increase* of 6.4% of GDP in interest costs between 2015 and 2049 would exceed the cost of the entire Social Security system, Medicare system, or full discretionary spending budget over that period. So what? Funding this expenditure within existing spending

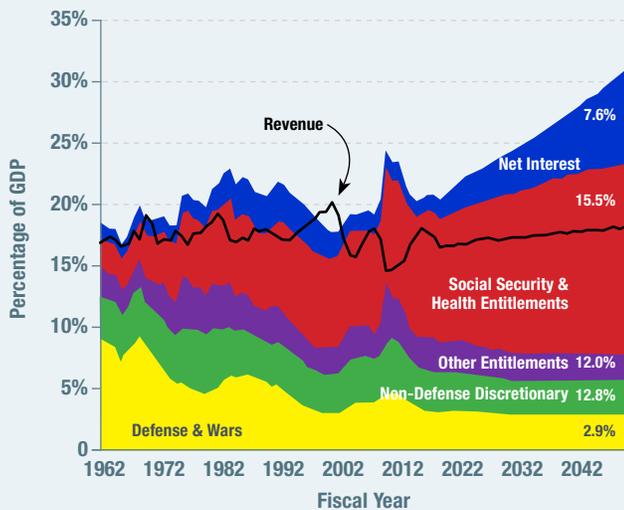
levels would require eliminating more than one-quarter of all federal program spending. Or, on the tax side, it would require choosing between options such as an across-the-board income-tax hike of 19 percentage points or establishing a 38% value-added tax.¹⁰

Calculations based on CBO data show that these interest costs will drive the annual budget deficit to 7% of GDP within a decade and nearly 13% after three decades (13% of today's GDP would be the equivalent of running a \$3 trillion annual deficit—dramatically higher than the actual deficit of just under \$1 trillion in 2019). And these projections for growing deficits assume peace, prosperity, and low interest rates.

While it is tempting to dismiss long-term budget projections as unreliable, the ones presented here are actually optimistic. CBO's projected primary deficits are driven by 74 million baby boomers retiring into Social Security and Medicare, which will drive these systems into a \$72 trillion cash deficit (plus \$31 trillion in resulting interest costs) over 30 years (Figure 4).¹¹ This is not a guess; it is demography. The baby boomers exist, and their program payment formulas are set in law. Moreover—and apart from Social Security and Medicare—CBO's projections optimistically assume no major recessions or expensive new spending programs. The CBO baseline

FIGURE 3.

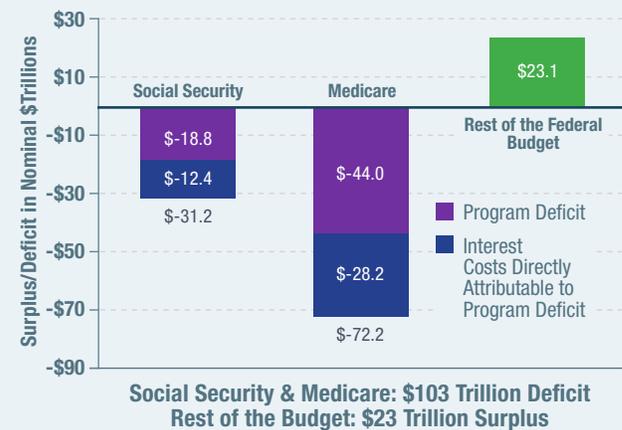
Federal Budget, 1960–2049 (Projected) if Current Policies Continue



Source: CBO, "The 2019 Long-Term Budget Outlook," converted into a current-policy baseline

FIGURE 4.

Drivers of the \$80 Trillion in Projected Budget Deficits: 2019–49 (\$Nominal)



Source: Author's calculations from CBO, "2019 Long-Term Budget Outlook," reflecting a current-law baseline; to adjust for inflation, trim amounts by one-third

Note: Social Security and Medicare deficits are the benefits that must be paid from general revenues because payroll taxes, premiums, and other noninterest trust-fund revenues are insufficient. CBO assumes that full benefits will continue even after trust-fund insolvency.

assumes that defense spending as a share of the economy falls to 1930s levels, and the rest of the non-health-care budget also falls as a share of the economy.¹² If any of these optimistic assumptions proves wrong, deficits and interest payments on the debt will rise even higher.

To put this another way: even if Blanchard, Furman, Summers, and others are correct that interest rates will likely remain well below the averages of the past 50 years, the rising debt principal will still push the debt to nearly 200% of GDP under the most optimistic assumptions. A government debt that permanently grows significantly faster than the economy itself is not sustainable.

What Happens if Interest Rates Begin to Spiral?

The federal government currently pays an average interest rate of 2.3% on its debt. This is far below the previous average rates of 10.5% (1980s), 6.9% (1990s), and 4.8% (2000s).¹³ CBO assumes that interest rates paid on the debt will remain historically low—rising to 3.4% over the next decade and 4.2% over 30 years.¹⁴

What if interest rates rise higher? Each 1-percentage-point increase in the interest rate that the federal government must pay on the national debt means an additional \$1.8 trillion in interest payments over the decade and \$11 trillion over 30 years.¹⁵ To put that in perspective:

- A 1% interest-rate increase would add nearly as much government debt—\$11 trillion—as the 2017 tax cuts, extended over 30 years.¹⁶
- A 2% interest-rate increase would impose a 30-year cost of \$22 trillion, which is greater than the entire Social Security shortfall.¹⁷
- A 3% interest-rate increase would cost \$33 trillion, or nearly as much as the entire defense budget over the next 30 years.¹⁸
- A return to 1990s interest rates would add \$1 trillion to the projected deficit a decade from now, pushing it to \$3 trillion per year.¹⁹

The debt-to-GDP ratio is projected to reach 194% of GDP in 30 years under current policy. If interest rates were to rise to 6.9%—the average rate paid by the federal government on its debt in the 1990s—the U.S. debt-to-GDP ratio would move closer to 250%.

Why Interest Rates Might Rise

In recent years, interest rates have faced downward pressure from the slow growth of the labor force and productivity, a soft-money Federal Reserve, and investor preference for safer assets—factors that may continue to persist. On the flip side, there are reasons rates could rise. Over time, total private savings may become constrained by baby boomers drawing down their savings or emerging markets attracting an increasing share of global investment. An increase in nominal economic growth rates—whether from productivity, inflation, or even a reversal of the labor-force slowdown—could also nudge rates back up. A recent study shows that in countries with high private debt—such as the U.S.—rising government debt puts added pressure on interest rates.²⁰

A recent analysis by former Treasury economist Ernie Tedeschi shows that each percentage-point increase in federal debt as a share of GDP raises the interest rate on the 10-year bond by four basis points—even if other economic factors are currently pushing rates back down.²¹ These figures line up with several other academic studies of the past two decades, which estimate that each percentage-point rise in the debt-to-GDP ratio pushes up interest rates by 2 to 4 basis points.²²

If the interest rates paid by the government remained at 3% forever, the debt-to-GDP ratio would still reach approximately 175% of GDP over three decades, rather than 194% under baseline interest rates.²³ However, the conservative consensus assumption—that each 1-percentage-point increase in the debt-to-GDP ratio raises interest rates by three basis points—suggests that the coming 116-percentage-point increase in the debt-to-GDP ratio should raise interest rates by approximately 3.5 percentage points. It is highly unlikely that offsetting factors holding interest rates down—slower growth of productivity and the labor force, low inflation, a soft-money Federal Reserve, a global flight to safe investments—could counter the debt-to-GDP ratio effect.

Finally, market psychology is always a factor. A sudden, Greece-like debt spike—resulting from the normal budget baseline growth combined with a deep recession—could cause investors to see U.S. debt as a less stable asset, leading to a sell-off and an interest-rate spike. Additionally, rising interest rates would cause the national debt to further increase (due to higher interest costs), which could, in turn, push rates even higher.

Gambling on Low Interest Rates

Economists such as Furman, Summers, and Blanchard assert that interest rates will remain permanently below the rates of the past several decades because of factors such as low inflation and slow productivity growth. Yet past economists have more than once prematurely declared a permanent victory over long-term economic challenges. Throughout the 1960s and early 1970s, Keynesian economists declared that they had fully tamed the business cycle—right before eight brutal years of rising inflation and interest rates, as well as economic stagnation. Then, in the late 1990s, some journalists and economists explained that the Federal Reserve (with help from the U.S. Treasury) had finally eliminated the risk of serious recessions through smart monetary policy and targeted market interventions. Within a decade, low interest rates and an unforeseen housing bubble brought on the worst economic downturn since the Great Depression.

This should bring some humility to claims that we no longer need to worry about interest rates. Building the largest government debt in history on the gamble that interest rates will remain low forever is imprudent in the extreme. Instead, the U.S. should gradually stabilize the national debt as a share of the economy.

Economic Growth and a Rising National Debt

The dangers of mounting government debt reach far beyond the rising federal budget interest costs and their resulting fiscal squeeze. While the U.S. may be awash in capital today, a federal debt headed toward 200% of GDP will reduce the savings available for business investment, ultimately reducing productivity and growth. These effects would be exacerbated by falling private savings rates, as retired baby boomers will continue to draw down their IRAs and 401(k)s to finance their retirement. Some of these savings may be replenished by global investors, although the returns would accrue outside the U.S., limiting domestic income. As savings rates decline and more of those savings are borrowed by the government, fewer savings are available within the private economy to finance the business and capital investments that ultimately drive much of economic growth. A recent study published by the Mercatus Center suggests that swelling debt levels have already reduced U.S. economic growth rates by up to 1 percentage point annually.²⁴ CBO estimates that the current debt trajectory will reduce annual incomes by \$7,000 (adjusted for inflation) within three decades, relative to a scenario where the debt remains at 78% of GDP.²⁵

Apart from interest rates and payments, economists such as Paul Krugman and Stephanie Kelton say that U.S. deficits are economically harmless because they are financed in domestic currency.²⁶ It is true that controlling the currency certainly makes *default* unlikely and presents an option for the government to inflate the debt away. Relying on inflation, however, would substantially harm the economy and raise the cost of future borrowing. Yet, default or no default, a financial crisis can still occur, as investors lose faith in the nation's ability to handle a rapidly growing debt burden—and stop buying U.S. debt or demand much higher interest rates to do so.

Moreover, America's status as the world's largest economy may lower the debt-to-GDP ratio at which a financial crisis could occur. In 2010, Greece warned the European Union that it might default. At the time, the country's national debt had reached 175% of its GDP. Greece's \$350 billion debt, however, represented a small share of the global economy and global savings pool, leaving it relatively easy for other governments and markets to bail out

the country. A U.S. debt equal to 200% of its GDP—\$100 trillion in total debt by that point—would represent a much larger share of the global economy and global savings pool. Other governments and markets would have much less capacity to rescue the U.S. Instead, an uncontrollable U.S. debt could destabilize the entire global financial system. While this may seem far-fetched, the projection of a debt approaching 200% of GDP by 2049 is based on optimistic predictions: that interest rates remain moderately low by historical standards and that the country does not experience additional deep recessions or get embroiled in additional wars. The last decade has shown how deep recessions, in particular, can accelerate debt crises in governments (such as Greece) whose finances had already been fragile.

What About the Benefits of Government Debt?

There are also advocates of more aggressive borrowing, the argument being that a narrow focus on the economic drag of debt fails to account for the economic benefits of government investments that this debt makes possible.²⁷ And modest levels of debt can be pro-growth if they finance productive long-term investments. Unfortunately, that outcome is not relevant to the current increase in deficit spending and debt. Virtually the entire projected expansion of the national debt over the next 30 years—116% of GDP in additional borrowing—will be necessary to cover the \$103 trillion cash shortfall of the Social Security and Medicare systems (including the interest costs). Essentially, the federal government will borrow from the financial markets not to finance new investments but rather to subsidize the current consumption of senior citizens.

In any event, many current spending proposals that would incur *new* debt are not necessarily pro-growth. Medicare-for-All would mainly finance current consumption. A broad climate agenda of new regulations, taxes, and expenditures, whatever their environmental merits, would likely harm the economy in the short- and medium-term. Any long-term economic benefits would depend on the development and distribution of new technologies that truly reduce global warming without imposing large new economic costs. Forgiving past student loans would represent a transfer payment, not an investment, and “free” public college would aid economic growth only to the extent that college enrollment and completion rates grow significantly enough that the economic benefits of educational attainment exceed the costs of subsidies to all college students—many of whom would have attended college either way. Bernie Sanders’s proposed guarantee of a \$15-per-hour government job for anyone who wants it would reduce productivity growth by moving workers from the private sector into government “make work” projects.²⁸ Regardless of their popularity or any other justifications for these proposals, the mammoth leap in economic growth that would be necessary to offset the effects of new debt is highly unlikely to materialize.

In fact, the sorts of public investments that are complementary to economic growth—such as improving or enhancing necessary infrastructure—would likely be squeezed out by the rising costs of Social Security, Medicare, Medicaid, and new initiatives such as Medicare-for-All and free public college. States are already feeling the squeeze on their educational and other spending to pay for their unfunded public pensions.²⁹ Overall, pro-growth investment spending is likely to be a casualty—rather than a driver—of rising government debt.

Generational Fairness

Going deeply into debt to fight World War II, or even for major investments that will benefit current and future generations, can be justified for their long-term benefits. Borrowing \$103 trillion over the next three decades to finance current consumption for seniors defies generational fairness. Even low interest-rate assumptions show annual interest payments rising to 7.6% of GDP (Figure 3) annually within a few decades. That represents the current equivalent of \$1.7 trillion in annual federal spending that will not be available for future generations to

safeguard national security, build infrastructure, educate children, or provide more targeted assistance to the poor. These large deficits and debt will leave little budgetary room to respond to deep recessions, national security crises, or other emergencies.

Generational equity tells us that anything worth doing is worth paying for. If Washington wants to provide a full range of expensive services and benefits, it should be willing to set priorities, cut lower-priority spending, and raise the required tax revenue. Only for legitimate long-term investments—and short-term crises—is there a strong ethical or economic case for adding to future generations' debt burdens. Lawmakers should aim to minimize budget deficits over the course of the business cycle.

Conclusion: Delay Only Worsens the Inevitable Reforms

Current federal debt trends are unsustainable. Simply continuing current policies with modest interest rates would produce a debt of nearly 200% (and growing) of the economy within three decades—at which point, interest payments would consume 42% of all federal tax revenues. And this projection assumes no major wars, recessions, expensive new policies, or significant interest-rate increases. Overall, CBO assumes lost income, less economic growth, and less policy flexibility for future generations.

In light of these factors, the most dangerous policy is to keep building debt and then wait and see if a recession or financial crisis occurs. If it does, lawmakers will be forced to implement drastic fiscal consolidations at a time when the economy is least equipped to handle them—and after the rest of the baby boomers have retired and locked in their Social Security and Medicare benefits.

It would be far more prudent for lawmakers to begin reining in the \$103 trillion Social Security and Medicare shortfall with gradual reforms.³⁰ Additionally, any new savings from spending restraint or tax increases should be applied to deficit reduction, rather than expensive new initiatives. This responsible fiscal stewardship would ensure a soft landing on deficits and strengthen the economy for future challenges.



Endnotes

- ¹ Congressional Budget Office (CBO), “The Budget and Economic Outlook: 2020 to 2030,” Jan. 28, 2020, table 1-1. The deficit would exceed \$2 trillion within a decade if the 2017 tax cuts are extended, which is not assumed in CBO’s current-law baseline.
- ² Jason Furman and Lawrence H. Summers, “Who’s Afraid of Budget Deficits?” *Foreign Affairs*, March/April 2019.
- ³ Olivier Blanchard, “Public Debt and Low Interest Rates,” Peterson Institute for International Economics, working paper 19-4, February 2019.
- ⁴ See Twitter thread from Chris Hayes posted on May 3, 2019; Matthew Yglesias, “Democrats Need to Get a Grip About the Budget Deficit,” *Vox*, Dec. 5, 2017.
- ⁵ Furman and Summers, “Who’s Afraid of Budget Deficits?”
- ⁶ Matthew Yglesias, “The Best Way to Pay for an Infrastructure Surge Is to Not Pay for It at All,” *Vox*, Apr. 1, 2016.
- ⁷ Blanchard, “Public Debt and Low Interest Rates.”
- ⁸ This critique of Blanchard also appears in the Committee for a Responsible Federal Budget, “Why Should We Worry About the National Debt: Questions and Answers,” Apr. 16, 2019: “Economist Olivier Blanchard and others have pointed out that governments can shrink their debt-to-GDP ratio while still borrowing to finance their interest payments when $r < g$. However, this only leads to a sustainable outcome if a government is running a primary balance (revenue equals non-interest spending) or a sufficiently modest primary deficit. The United States today is running a large and growing primary deficit. As a result, both debt and interest payments will continue to rise faster than the economy despite low interest rates.”
- ⁹ Author’s calculation using data from CBO, “The 2019 Long-Term Budget Outlook,” June 25, 2019; CBO figures are converted from a current-law to a current-policy baseline by assuming that all expiring tax cuts are instead made permanent and that discretionary spending follows the CBO alternative scenario through 2029, and then grows 4% annually thereafter.
- ¹⁰ The interest payments, projected tax revenues, and tax increases in this paragraph are based on the author’s calculations using CBO, “Options for Reducing the Deficit: 2019 to 2028,” Dec. 13, 2018. Each 1-percentage-point increase in the income-tax rate raises revenues by 0.33 percentage of GDP by year 10. Each 1-percentage-point rate of a value-added tax rate (using a European-style narrow tax base) raises revenues by just under 0.17 percentage of GDP by year 10. These static estimates do not incorporate any lost revenues due to the macroeconomic effects of large tax increases.
- ¹¹ Medicare and Social Security shortfalls are defined as the annual program benefits that must be paid from general revenues because payroll taxes, Medicare premiums, and other dedicated revenues are insufficient. They include the interest cost of expanding the national debt. Shortfalls are calculated using CBO, “2019 Long-Term Budget Outlook,” summary tables 1 and 6.
- ¹² This outcome is likely because the overall economy is projected to grow faster than programs that expand only by inflation and population growth rates. As such, spending on programs (such as national defense or education) growing at these rates would see their share of the economy gradually decline. By contrast, Social Security and health-care entitlements are projected to grow much faster than inflation plus population growth.
- ¹³ Interest rates from 1990 through 2049 (projected) are in CBO, “2019 Long-Term Budget Outlook,” summary table 3. For earlier interest rates, see Council of Economic Advisers, “Economic Report of the President,” March 2019, table B-42.
- ¹⁴ CBO, “2019 Long-Term Budget Outlook.”
- ¹⁵ Ten-year figures come from CBO, “The Budget and Economic Outlook: 2019 to 2029,” Jan. 28, 2019, table B-3. Long-term estimates are calculated by the author using data from CBO, “2019 Long-Term Budget Outlook.”
- ¹⁶ The 2017 tax cuts were originally scored by CBO as costing \$1.85 trillion over the decade, including both macroeconomic effects and interest costs, and are projected to cost \$7 trillion over 30 years (plus \$5.6 trillion in interest costs). A 1-percentage-point increase in interest rates would not only add \$11 trillion to the debt over 30 years, but the cost would be rising much faster than the cost of the 2017 tax cuts.
- ¹⁷ The projected 30-year cash shortfall for Social Security is \$18.9 trillion (not including \$12.4 trillion in resulting interest costs of the new debt to finance this shortfall).
- ¹⁸ A current-policy baseline projects defense spending totaling \$35 trillion over the next 30 years.
- ¹⁹ This figure assumes a 6.9% interest rate and is calculated using CBO, “The Budget and Economic Outlook: 2019 to 2029,” Jan. 28, 2019, table B-3.
- ²⁰ Thomas Grennes, Qingliang Fan, and Mehmet Caner, “New Evidence on Debt as an Obstacle to US Economic Growth,” Mercatus Center, working paper, Apr. 8, 2019.
- ²¹ Ernie Tedeschi, “Deficits Are Raising Interest Rates. But Other Factors Are Lowering Them,” *medium.com*, Feb. 19, 2019.
- ²² For similar studies, see Eric M. Engen and R. Glenn Hubbard, “Federal Government Debt and Interest Rates,” NBER, April 2005; Thomas Laubach, “New Evidence on the Interest Rate Effects of Budget Deficits and Debt,” *Journal of the European Economic Association* 7, no. 4 (June 2009): 858–85; Edward Gamber and John Seliski, “The Effect of Government Debt on Interest Rates,” CBO, working paper, Mar. 14, 2019.
- ²³ Calculated by the author using data from “2019 Long-Term Budget Outlook.”
- ²⁴ Grennes, Fan, and Caner, “New Evidence on Debt.”
- ²⁵ CBO, “The Impact of Various Levels of Federal Debt on GNP and GNP per Capita,” letter to Honorable Steve Womack, Aug. 12, 2019. The \$7,000 figure reflects the income gap between a 2049 debt of 78% of GDP, versus the extended alternative fiscal scenario of 219% of GDP (\$194% is this author’s 30-year estimate of the current-policy baseline; \$219% is a figure that CBO published as an alternative scenario that was not fully spelled out).
- ²⁶ See William Gale, “Five Myths About Federal Debt,” *Washington Post*, Apr. 26, 2019.
- ²⁷ Yglesias, “The Best Way to Pay for an Infrastructure Surge.”
- ²⁸ Brian Riedl, “Fantasyland Economics,” *City Journal*, May 1, 2018.
- ²⁹ Josh B. McGee, “Feeling the Squeeze: Pension Costs Are Crowding Out Education Spending,” Manhattan Institute, Oct. 18, 2016.
- ³⁰ For a 30-year deficit-reduction proposal, see Brian Riedl, “A Comprehensive Federal Budget Plan to Avert a Debt Crisis,” Manhattan Institute, Oct. 10, 2018.

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