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US – Deficits don't matter, until they do

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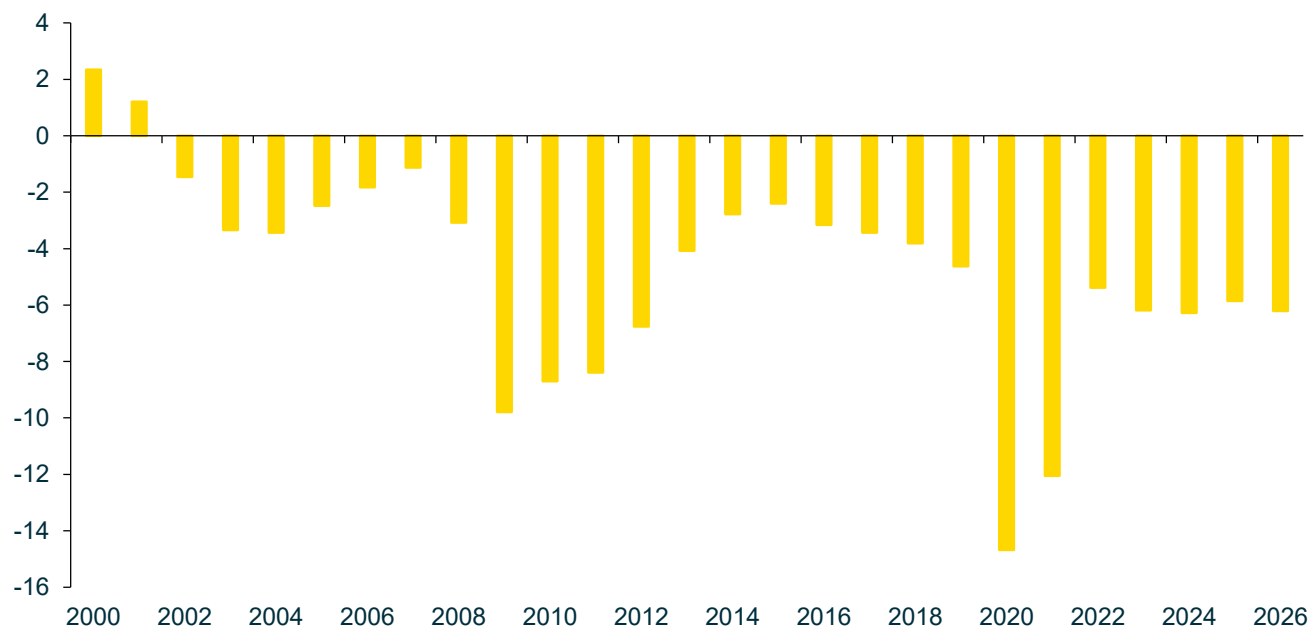
In fiscal year 2026, which just ended, the U.S. federal government's deficit rose to \$2 trillion, exceeding 6% of GDP. In addition to the continued increase in social spending, higher interest payments weighed on the budget. There is no relief in sight; the national debt will soon surpass the previous record high set at the end of World War II.

The Congressional Budget Office (CBO) has released preliminary figures: The U.S. federal budget deficit rose by nearly \$220 billion to just under \$2 trillion in fiscal year 2026, which ended in late September. This amounts to 6.2% of gross domestic product. Despite an economy close to full employment—which would normally reduce government budget deficits—there has been no progress whatsoever in fiscal consolidation over the past five years. Even after the end of the extraordinary circumstances caused by the COVID-19 pandemic in 2020 and 2021, the deficit remained in the range of about 6% of GDP (Chart 1).



Chart 1 - Enormous deficit as the normal state of affairs

Surplus (+) or deficit (-) of the US federal government budget, in % of GDP, fiscal years



Source: CBO,OMB, Commerzbank Research

Revenue increased by about 3% in 2026. Income tax remains the most important source of revenue, with a 7% increase. In contrast, corporate income tax revenue fell by 16% due to improved depreciation rules, while customs duties—a relatively minor item in any case—fell by 11%. The latter is primarily attributable to a Supreme Court ruling that declared portions of the collected customs duties unlawful, leading to refunds.

Expenditures rose by 6%, twice as much as revenue. The main drivers of spending were mandatory expenditures (Social security and the Medicare/Medicaid health insurance programs), which increased by 7%. These items account for nearly half of the budget. In addition, interest payments rose sharply by 11% (interest payments account for about 15% of total spending).

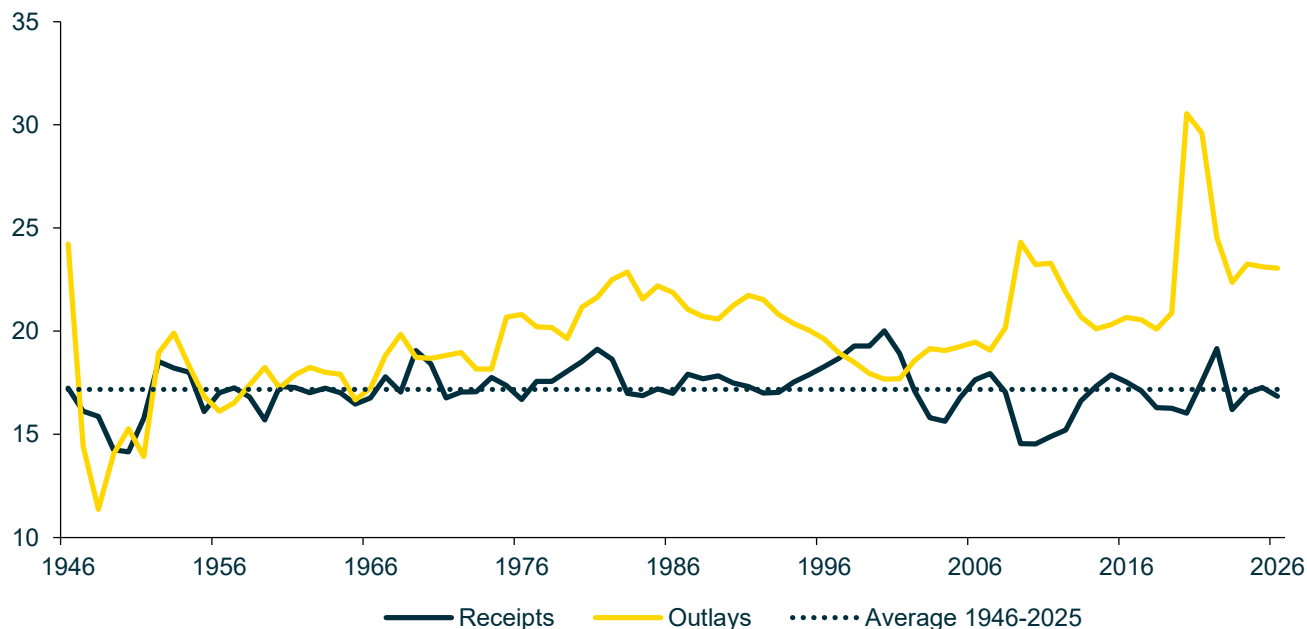
Looking at the long-term trend of the U.S. federal budget, it is striking that revenue in 2026, at just under 17% of GDP, is exactly in line with the long-term average (Chart 2). Expenditures, on the other hand, have been on a clear upward trend for about 20 years, even when excluding exceptional cases such as the temporarily higher spending during the 2008-09 global financial crisis and the 2020-21 COVID-19 crisis.

However, it would be too simplistic to conclude from this that the deficit in the federal budget is solely a spending problem. Congress has already significantly curbed the rise in its “discretionary” spending—that is, spending that Congress authorizes annually as part of the budget process. Even defense spending accounts for an increasingly smaller share of the budget. In contrast, social spending continues to rise, primarily due to the aging of the population. All attempts to curb this spending have only managed to slow the rate of increase. As a result, the size of the budget relative to economic output is now structurally higher than in previous decades. The political challenge is to structurally adjust the government’s revenue side as well—that is, to implement tax increases.



Chart 2 - What is the problem: Receipts or outlays?

Receipts and outlays of the US federal government in % of GDP, fiscal years. Dotted line: long-term average of receipts



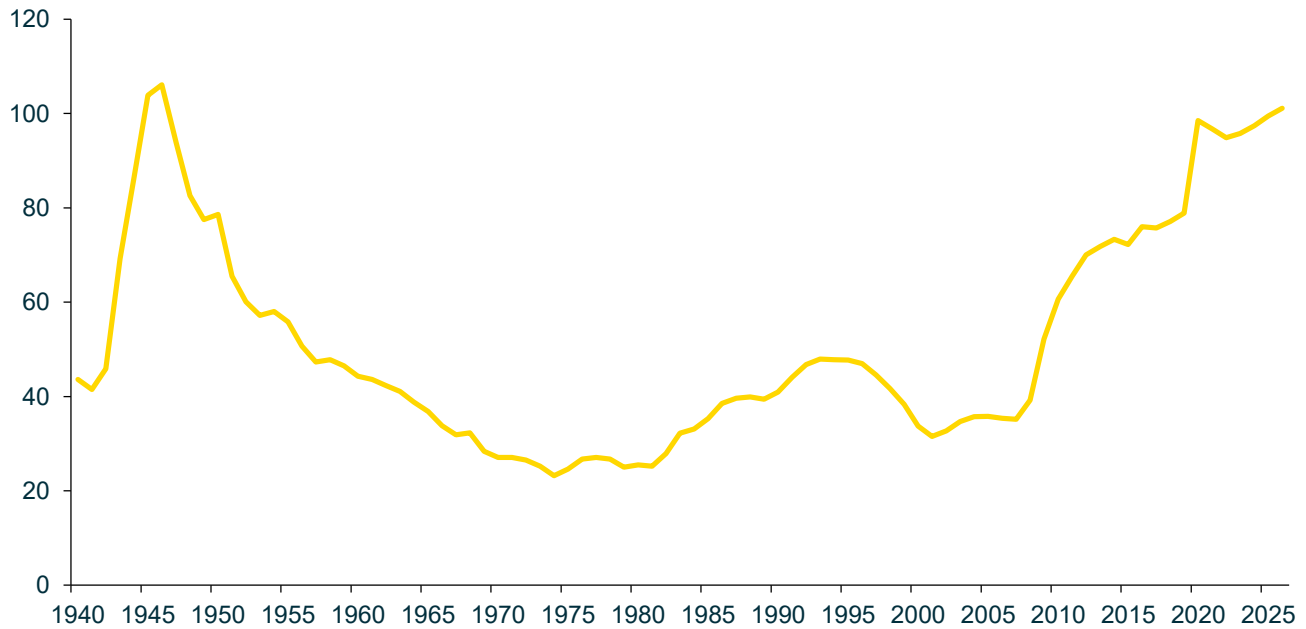
Source: CBO, OMB, Commerzbank Research

The high deficits have caused the U.S. federal government's debt to rise steadily. At the end of fiscal year 2026, the debt stood at \$32.4 trillion, equivalent to about 101% of GDP (Chart 3). The record high of 106%, reached at the end of World War II, will soon be surpassed.

Fiscal consolidation played no role in the Biden administration, and certainly not in the Trump administration. So far, all parties have adhered to the dictum "Deficits don't matter" [1]. This was possible for a long time because financing the debt posed no problems whatsoever. However, with the sharp rise in interest rates in recent years—which has pushed yields on 10-year U.S. Treasury notes to around $5\frac{1}{4}\%$ —that is no longer the case. Interest payments are rising sharply, leaving less room for other types of spending. Added to this is the fact that the U.S. government must not only finance the \$2 trillion deficit each year; \$10 trillion in Treasury bonds or money market instruments also come due annually. Given the budget trends, there is a risk that creditors will demand higher interest rates in order to continue purchasing these securities. In the coming years, the need for fiscal consolidation could make a comeback on the political stage.



Chart 3 - US federal debt on track to surpass WW-II peak
Federal government debt held by the public in % of GDP, fiscal years



Source: OMB, Treasury, Commerzbank Research

[1] Former U.S. Vice President Cheney is credited with saying that President Reagan (in office 1981-89) proved that deficits don't matter. ([back to text](#))



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