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FY26 financial costs and primary deficit probably push public deficit to 100% GDP with limited political appetite for fiscal tightening

According to preliminary data released by the Congressional Budget Office (CBO), the Federal Government's financial deficit for FY26, ending in September, reached US\$2.0 trillion (tn). This represents a nominal increase of 12.2% in comparison to FY25 (US\$1.8tn), the largest movement since FY21 (US\$2.8tn), when the COVID-19-related support pressured spending. We estimate that the deficit reached 6.2% of LTM Gross Domestic Product (GDP through the third quarter. For its part, the public debt at US\$32.4tn represented 100.5% of GDP vs. 99.7% at the end of FY25. Total outlays of US\$7.4tn combined with US\$5.4tn in total revenue resulted in the US\$2.0tn deficit. The 6.2% deficit was larger than the 5.9% shortfall for FY25. HR Ratings' most recent sovereign debt rating anticipated a total deficit of 6.3% of GDP.

The deficit exceeded that of the previous year as a result of the convergence of numerous factors. The main one was the historic US\$1.1tn cost of paying interest on the national public debt, which going forward will be increasingly impacted by rising bond yields. We estimate that interest payments represented 3.5% of GDP, up from 3.4% in FY25 while the effective interest rate of the debt increased from 3.50% to 3.65%. By comparison, in FY19 interest accounted for 2.0% of GDP with an estimated effective cost of 2.60%.

Customs revenues were US\$172 billion, which is at risk due to the Supreme Court's decision deeming a substantial segment of the previously enacted emergency tariffs unconstitutional. An obligation was established for the Treasury to formally issue refunds of US\$130 billion in tariff refunds. Military operations in the Middle East contributed to a 5.5% nominal increase in national defense expenditure, which reached US\$916bn. Nevertheless, as a percentage of GDP defense spending declined slightly to 2.84% of GDP vs. 2.86% in FY25 and despite intensifying geopolitical tensions are increasingly outpaced by interest expense.

Public debt amounted to 100.5% of GDP in the third quarter, according to HR Ratings' estimate. This figure is lower than the 100.9% anticipated by HR Ratings in its U.S. Sovereign Rating Report, which was published in March 2026. Nevertheless, the trend of increasing public debt persists. This continues to be a substantial risk factor in light of the current high interest rate environment and the absence of political will to modify the debt trajectory. Figure 1 below shows the evolution of the public debt to GDP. The trajectory is steeper than it was in the years immediately preceding COVID, although not as steep as the spike after the 2008 financial crisis.



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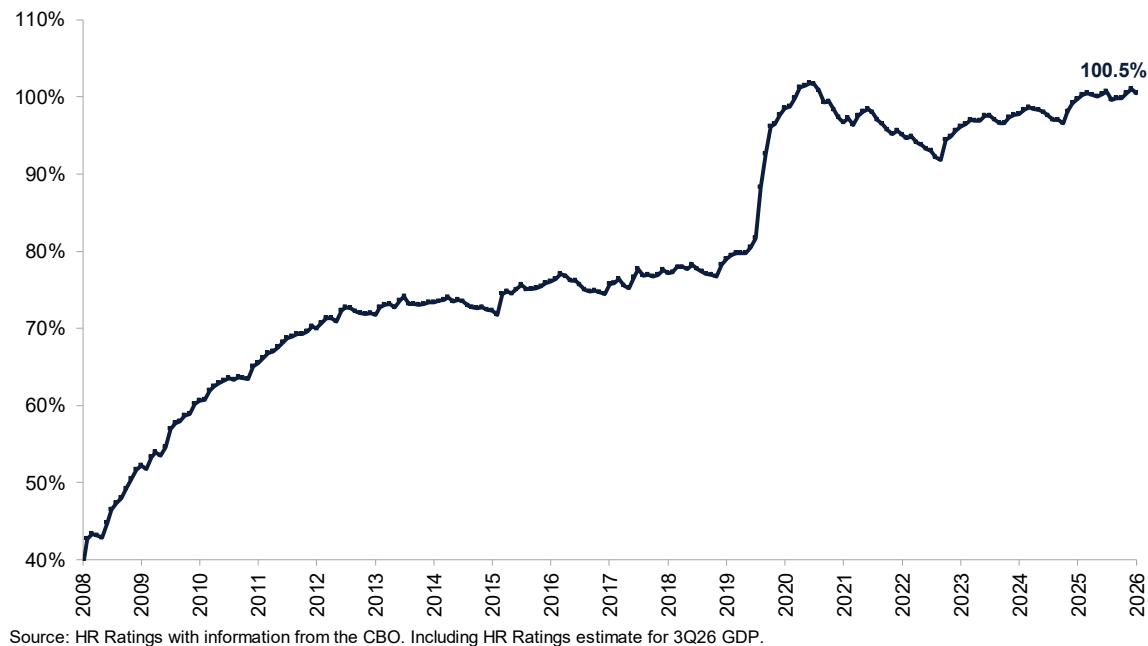


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Figure 1. Evolution of Public Debt as Percentage of GDP (LTM)



Total receipts constituted 16.7% of GDP at end of FY26, a decrease from 17.2% in FY25 and below HR Ratings anticipated 17.3%. The 37 basis points decline relative to GDP was primarily the result of relatively small 3.8% nominal increase in payroll (5.62% of GDP) and a 15.5% fall in corporate income taxes (from 1.5% to 1.2% of GDP). The latter was largely the result of the 2025 Reconciliation Act, which permitted increased deductions for specific investments. For their part individual income tax receipts, which accounted for over 52% of total revenue during FY26, increased by 7.0%. The decline in corporate tax revenue to a lower 1.2% vs. 1.8% in FY24 is likely to produce political pressure for a change, especially given the increase in payroll tax revenue. The counterargument is that the tax cuts helped produce economic growth.

While customs duties account for 3.2% of the total revenue, the public finances were also affected by refunds that were issued following the United States Supreme Court's invalidation of specific tariffs in February 2026. The CBO estimates that these refunds could amount to approximately US\$130bn in fiscal year 2026.

Outlays represented 22.9% of GDP, less than the 23.1% recorded at the end of FY25 and below HR Ratings' estimate of 23.7% from our last Sovereign Rating Report. In nominal terms, spending jumped by 5.5%. Looking at the main categories, defense and social security expenditures grew by 5.4%, while Medicaid and Medicare saw higher rises of 8.2% and 7.8%, respectively. Notably, defense spending as a percentage of GDP remains around 2.8%. For Fiscal Year 2027, the current administration has proposed increasing defense spending to US\$1.5tn, which according to HR Ratings would equal approximately 4.7% of GDP. However, US\$350 bn remains blocked in Congress, with an approval deadline of December 11, following the November midterm elections.

With interest expense rising significantly relative to GDP, defenses spending stuck at around 2.8% and mandatory spending (most notably Social Security and Medicare) rising inexorably (reaching a combined 8.4%) the remaining largely non-mandatory, non-defense spending has been cut back significantly, falling to 5.9% of GDP vs. 6.2% and 7.7% in FY25 and FY24, respectively. We expect a major shutdown battle this December, perhaps with the final result being large increases in both defense and non-defense non-mandatory spending and an even larger deficit for FY27.



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Primary expenses were equivalent to 19.4% of GDP, below the 19.7% recorded in FY25 and HR Ratings' expectation of 20.6%. Consequently, the primary deficit increased from 2.5% of GDP at the end of FY25 to 2.6% at the end of FY26. Nevertheless, net interest grew by 11.2% in nominal terms, pushing interest outlays from 3.4% to 3.5% of GDP over the same period. This rise drove the financial deficit from 5.9% to 6.2% of GDP, though it remained slightly below HR Ratings' expectation of 6.3%.

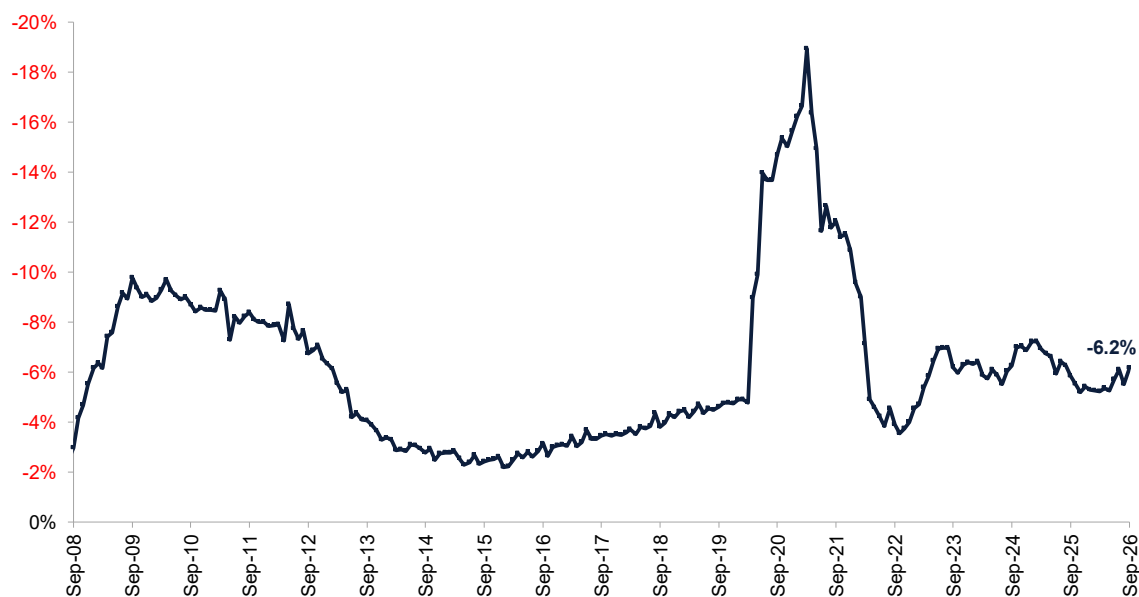
Figure 2. Annual Revenue, Expenditure and Debt

Calendar Year	In Billions of USD				As Percent of GDP				HR Ratings March projections for FY26	
	FY23	FY24	FY25	FY26	FY23	FY24	FY25	FY26	Bn USD	% GDP
Total Revenue	4,440	4,918	5,234	5,403	16.2%	17.0%	17.2%	16.7%	5,559	17.3%
Total Outlays	6,135	6,735	7,011	7,396	22.4%	23.3%	23.1%	22.9%	7,587	23.7%
Primary Outlays	5,425	5,786	5,983	6,253	19.8%	20.0%	19.7%	19.4%	6,603	20.6%
Defense	776	826	868	916	2.8%	2.9%	2.9%	2.8%	1,154	3.6%
Non Defense Primary	4,649	4,960	5,115	5,337	17.0%	17.1%	16.8%	16.5%	5,449	16.8%
Net Interest	710	949	1,029	1,143	2.6%	3.3%	3.4%	3.5%	984	3.1%
Deficit	-1,695	-1,817	-1,777	-1,993	-6.2%	-6.3%	-5.9%	-6.2%	-2,029	-6.3%
Public Debt	26,330	28,307	30,278	32,425	96.1%	97.8%	99.7%	100.5%	32,377	100.9%
GDP*	27,398	28,948	30,363	32,271	n.a.	n.a.	n.a.	n.a.	32,417	n.a.

Source HR Ratings with information from the CBO and Bureau of Economia Analysis for GDP
 *GDP figures for FY26 are an estimation made by HR Ratings.

The United States' current economic environment, which is characterized by resilient consumer spending, solid economic growth, and stabilization of unemployment, should serve as an incentive to strengthen fiscal discipline. The current deficit is extraordinarily large given the absence of war, plague or recession. Failure to establish this discipline at this time could potentially complicate the outlook in the event of a future decrease in government revenue or an increase in spending demands. Additionally, the recent significant spike at the long end of the nominal yield curve, which has seen 10-year and 30-year bonds reaching highs not seen since 2002, is expected to exert upward pressure on net interest. Although the pressures on sovereign yields come principally from the United States, other sovereigns such as the United Kingdom and France are also contributing, to which we need to add the huge demand for AI related investments.

Figure 3. Deficit as Percent of GDP (LTM)



Source: HR Ratings with information from the CBO. Including HR Ratings estimate for 3Q26 GDP.

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