ECONOMIC VIEWPOINT

The Devil's in the Details:

What the Fiscal Monitor Tells Us about the State of Federal Finances

By Randall Bartlett, Senior Director of Canadian Economics

Highlights

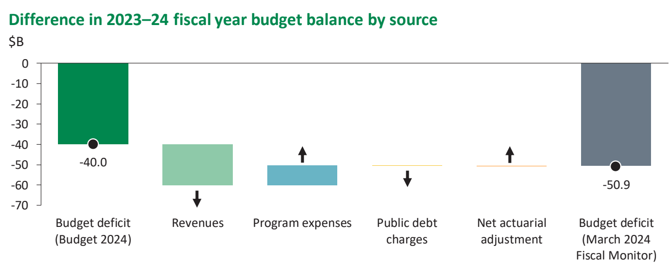
- Once again, the federal Fiscal Monitor for March implied the Government of Canada ran a much bigger deficit last year than was published in the budget, at $50.9B versus $40B respectively. Federal debt is estimated to have been similarly higher, seemingly corroborating this estimate. As such, it's no surprise that some fiscal analysts may be tempted to accept this as fiscal fact.
- However, the March Fiscal Monitor often misses the mark for a few reasons. First, personal income tax (PIT) revenues almost always come in higher than estimated in the Fiscal Monitor. Second, other transfer payments are also often higher, providing an offset to greater PIT. While these adjustments aren't always a wash, we think they largely will be in the 2023–24 fiscal year. Finally, the Fiscal Monitor doesn't correct for the final audited numbers in the prior fiscal year.
- Taken together, we think this points to a deficit between $40B and $45B last year—slightly larger than estimated in Budget 2024 but smaller than suggested in the March 2024 Fiscal Monitor.
- But regardless of the size of the deficit, all measures of federal debt came in modestly higher than expected in both Budget 2024 and the prior fiscal year—in absolute terms and relative to GDP. This is a cautionary sign for a government hoping to demonstrate fiscal prudence.

Overshadowed as it so often is by the release of real GDP for the first quarter of the year, the federal Fiscal Monitor for March 2024 was published at the end of May. This is the final piece of information Canadians will receive on the state of federal finances for the 2023–24 fiscal year until the release of the audited Public Accounts of Canada sometime in the fall. But while some analysts are more than happy to publish these numbers as fiscal fact, how useful is the Fiscal Monitor as an indicator?

What Does the March 2024 Fiscal Monitor Tell Us?

The federal government's March 2024 Fiscal Monitor showed a deficit of $50.9B for the 2023–24 fiscal year. That's much larger than the $40B deficit published in Budget 2024 (graph 1). The difference can largely be explained by a lower tax tally

Graph 1
The Fiscal Monitor Points to a Higher Deficit Last Year than in the Budget



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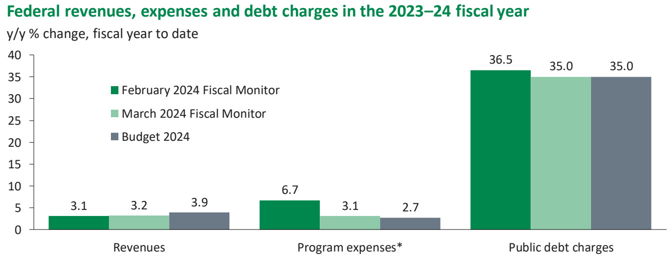
in the Fiscal Monitor than in the budget (-$20.3B). However, nearly half of this hit to the budget balance was offset by less program spending in the Fiscal Monitor than projected in the budget ($9.7B).

Revenues increased by 3.2% last fiscal year according to the March 2024 Fiscal Monitor, roughly in line with earlier months' tracking but short of the 3.9% revenue growth forecast in Budget 2024 (graph 2). But where end-of-year adjustments really made an impact was in program expenses, where year-to-date, year-over-year growth fell to half the pace in March that it clocked in at in February. Program expense growth for the 2023–24 fiscal year is now just slightly above the outlook in the spring budget. Meanwhile, the increase in public debt charges is exactly as Budget 2024 predicted.

Graph 2
Federal Program Expense Growth Slowed Sharply in March 2024

Federal revenues, expenses and debt charges in the 2023–24 fiscal year



*Excluding net actuarial losses
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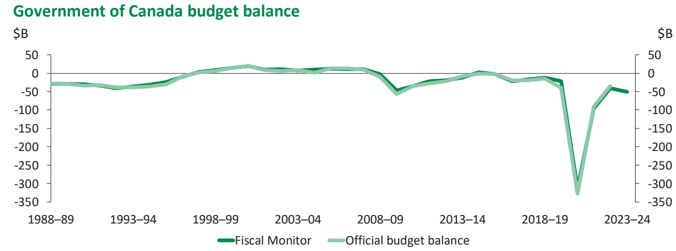
Looking under the hood of program expenses, it's no surprise that the big driver of the lower spending profile between the February and March 2024 Fiscal Monitors was lower Direct Program Expenses (DPE). In fact, with just one extra month of data, DPE went from tracking a 3.5% year-to-date increase over the prior year in February to a 3.7% reduction after the March 2024 data were out (graph 3). That's a big swing, even for a spending category that has been subject to substantial end-of-year changes historically. According to the Fiscal Monitor, DPE are now expected to have contracted in the 2023–24 fiscal year by a similar magnitude as that forecast in Budget 2024. But the underlying composition is very different between the two fiscal documents. Operating expenses are estimated to have declined by 4.0% versus a 1.0% increase in Budget 2024. Meanwhile, other transfer payments are estimated to have contracted by much less than forecast in the budget. Unfortunately, no explanation is provided in the March 2024 Fiscal Monitor for the change in fortunes of operating expenses and other transfer payments in the final month of the 2023–24 fiscal year.

The Fiscal Monitor Is a Good Fiscal Guide …

With the deficit coming in well above the 2023–24 fiscal year estimate, it's important to look at the past performance of the federal Fiscal Monitor to gauge its accuracy. And historically, the budget deficit published in the March Fiscal Monitor for any given fiscal year has done a reasonably good job of estimating the magnitude of the federal budget balance (graph 4).

Graph 4
The Fiscal Monitor Does a Good Job of Estimating the Budget Balance

Government of Canada budget balance



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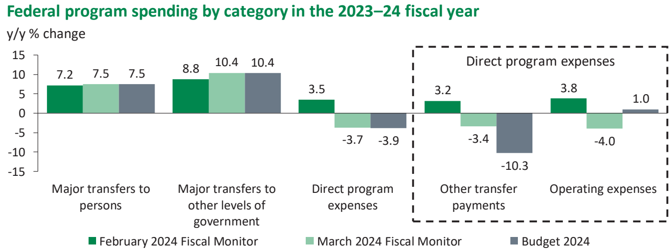
However, more often than not the Fiscal Monitor tends to be overly optimistic. Nearly two thirds of the time, the budget deficit has been larger or the surplus smaller in the final audited Public Accounts of Canada than in the March Fiscal Monitor (graph 5). Prior to the surge in spending during the COVID-19

Graph 3
A Sharp Drop in DPE Is to Thank for Lower Program Spending Growth

Federal program spending by category in the 2023–24 fiscal year



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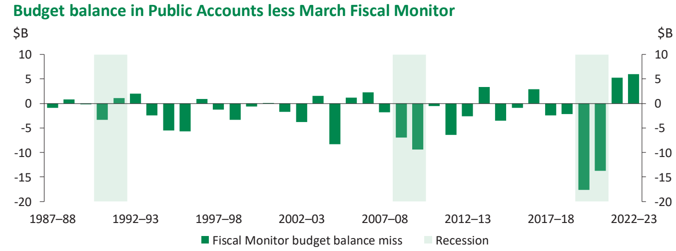
Graph 5
The Fiscal Monitor Is Generally Too Positive on Fiscal Performance

Budget balance in Public Accounts less March Fiscal Monitor



Government of Canada and Desjardins Economic Studies pandemic, the final budget balance came in worse than the Fiscal Monitor by about $1.6B on average annually. Not surprisingly, the biggest discrepancies tended to occur in recessions. Indeed, during the big deficit fiscal years of 2019–20 and 2020–21, the Fiscal Monitor miss increased to an average of $15.7B each year. However, since emerging from the pandemic, the federal government has been able to keep the official budget deficit to less than the Fiscal Monitor would suggest, by as much as $6B in the 2022–23 fiscal year. In fact, the last two fiscal years have seen the largest positive surprises in the budget balance between the Fiscal Monitor and audited Public Accounts on record. This begs the question: did the federal government manage to pull this off again last year?

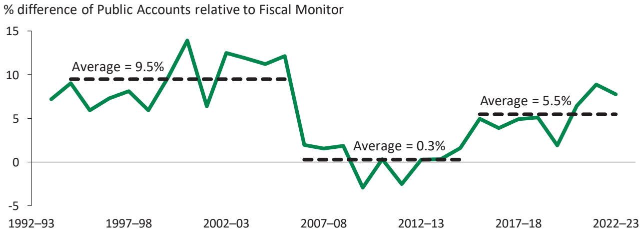
… but the Devil's in the Deficit Details

While the Fiscal Monitor has shown a trend toward being close to but overly optimistic on the federal budget balance historically, not all revenue and spending categories contribute equally to this bias.

Looking first to revenues, taxes have come in higher than estimated by the Fiscal Monitor more than 90% of the time over the past nearly 40 years. This partly reflects the accounting conventions used in the Fiscal Monitor, which are closer to cash than accrual principles. But personal income tax (PIT) revenue is where the difference has been most substantive, both in absolute and percent terms. Given that PIT accounts for nearly half of revenues, this is an important consideration. And as we highlighted in our pre-Budget 2024 analysis, under the current government, PIT revenues have come in about 5.5% higher on average annually than estimated in the Fiscal Monitor (graph 6). It's been even higher in the two most recent fiscal years, topping 7%. In contrast, the difference was miniscule under the previous administration.

Graph 6
PIT Revenues Are Typically Underestimated in the Fiscal Monitor

Degree of PIT underestimate in the federal Fiscal Monitor
% difference of Public Accounts relative to Fiscal Monitor



PIT: Personal Income Tax
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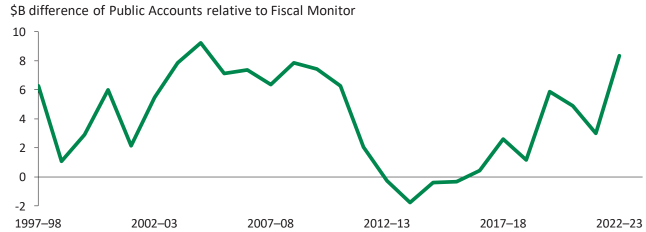
So, the optimism bias in the Fiscal Monitor is obviously not on the revenue side. Instead, it's a spending issue. But looking to program expenses, both major transfers to persons and major transfers to other levels of government tend to come in close to estimates in the March Fiscal Montior. This is particularly true outside of recessions. That's because many of the biggest line items either have broadly fixed escalators, like the Canada Health Transfer and the Canada Social Transfer, or are relatively predictable, such as elderly benefits and the Canada Child Benefit.

Instead, the optimism bias in Fiscal Monitor program spending tends to come from direct program expenses. And within DPE, other transfer payments have been the primary contributor, having exceeded estimates in the Fiscal Monitor in all fiscal years except those from 2012–13 to 2015–16 (graph 7). Other transfer payments include transfers to Indigenous peoples related to reconciliation, payments for housing initiatives and international assistance. More recently, they have also come to include Canadian Dental Care Plan benefits, support for electric vehicle battery manufacturing and refundable clean economy investment tax credits. Operating expenses (excluding short-lived COVID measures) have a mixed but much more modest record, surprising to the upside under the current administration and coming in below the Fiscal Monitor estimate under the previous government. Increased employee compensation and defense spending should largely push this spending category higher in the coming years.

Graph 7
The Fiscal Monitor Has Underestimated Other Transfer Payments Recently

Degree of other transfer payment underestimate in the federal Fiscal Monitor
$B difference of Public Accounts relative to Fiscal Monitor



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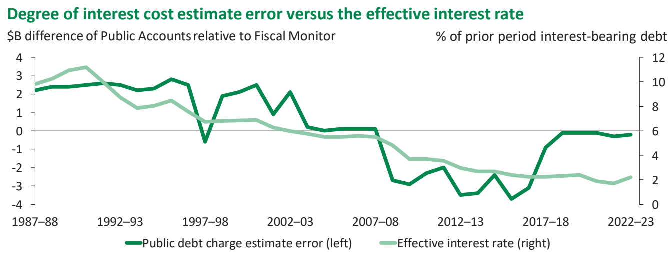
Finally, public debt charges have come in lower in the Public Accounts of Canada than in the Fiscal Monitor every year since the onset of the Global Financial Crisis in 2008. Lower borrowing rates on marketable debt leading to a falling effective interest rate (the interest a government pays relative to its outstanding debt in the prior period) may help to explain this (graph 8 on page 4). However, the March Fiscal Monitor has been very close to estimating the final public debt charges published in the Public Accounts of Canada since the 2018–19 fiscal year. As such, there's no reason to think it won't be close again this year.

Graph 8
Until Recently, Lower Rates Explained Borrowing Cost Estimate Errors



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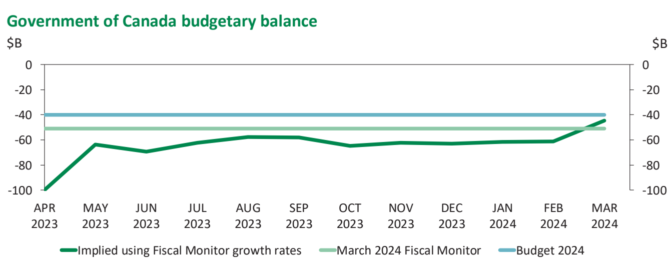
What Does This Mean for Last Year's Budget Balance?

The decline in the spending estimate in the March 2024 Fiscal Monitor was substantial. It was largely responsible for reducing the Fiscal Monitor implied budget deficit from over $61.3B in February 2024 (graph 9). And applying the growth rates of revenues and spending from the March 2024 Fiscal Monitor to the final audited levels for the 2022–23 fiscal year, the deficit improves further still—to $44.6B from $50.9B in the most recent Fiscal Monitor. This largely reflects the $6B improvement in the actual 2022–23 budget balance in the Public Accounts of Canada relative to that in the March 2023 Fiscal Monitor.

Graph 9
The 2023–24 Fiscal Year Deficit Came in Close to That in Budget 2024



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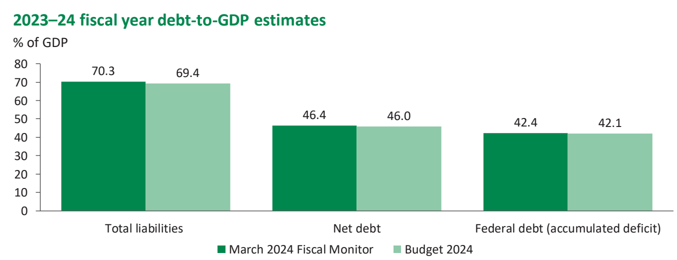
But as has already been discussed, higher PIT revenues and other transfer payments should also be expected. Applying adjustments based on the historical underestimate of these series suggest that PIT revenues could be about $17.5B higher than estimated in the March 2024 Fiscal Monitor, while other transfer payments could be higher by a similar dollar amount. As such, we expect the changes to these revenue and expenditure categories to be broadly offsetting, keeping the estimated deficit at nearly $45B in the 2023–24 fiscal year.

Don't Forget the Debt

Digging into the debt data at the back of the March 2024 Fiscal Monitor, it quickly becomes apparent that the federal government issued more debt than expected in Budget 2024. First, at $2.03T, total liabilities ended March 2024 $30B higher than planned in the spring budget. Notably, most of this increase appears to be in non-market debt, such as pension and other liabilities, as marketable debt was almost exactly in line with the Budget 2024 estimate. As a result of greater total liabilities, and despite both higher financial and non-financial asset values than anticipated, net debt and federal debt (accumulated deficit) ended the fiscal year $15B and $10B above plan, respectively. And despite higher nominal GDP in 2023 than estimated at the time of the budget, this pushed up the ratio of these debt measures to GDP by an average of 0.5 percentage points in the 2023–24 fiscal year (graph 10).

Graph 10
Federal Debt-to-GDP Was Modestly Higher than in Budget 2024



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Conclusion

Analysis based on the March 2024 Fiscal Monitor suggests the Government of Canada's budget deficit for the 2023–24 fiscal year could have come in modestly larger than expected in Budget 2024, at between $40B and $45B. Certainly, the higher debt-to-GDP ratios in the Fiscal Monitor than in the budget seem to support this assertion. However, upside surprises to the deficit estimates in the last two fiscal years relative to the Fiscal Monitor tip the balance of risks in the federal government's favour. We'll need to wait until the Public Accounts of Canada are released in the fall to know for sure.