1st Meeting of the Advisory Panel

Minutes
October 4, 2013

Council for Budget Responsibility
Imricha Karvaša 1
Bratislava 1, 813 25

Advisory Panel Meeting

4th, October 2013

Venue: National Bank of Slovakia, Imricha Karvasa 1, 30th floor, Bank Board Meeting Room

Advisory Panel Members Present: George Kopits, Philip Lane, Daniele Franco, Kevin Page,
CBR Members Present: Ivan Šramko, Ľudovít Ódor, Michal Horváth
Secretariat of the CBR: Viktor Novysedlák (Executive Director)

Apologies: Simon Wren –Lewis (comments sent before the meeting)

Session: CBR's Fiscal Framework

Presented by: Ivan Šramko

Mr. Šramko presented an overview of the main features of the new fiscal framework set by the Fiscal Responsibility Act adopted in 2011. He focused mainly on the basic responsibilities of the CBR in the context of the new fiscal framework. Major outputs of the Council in the first year of its existence were also presented.

Panel members appreciated the strength and clarity of the legislation supported by the constitutional majority in the parliament. The CBR may become a good example for other countries regarding fiscal surveillance at the national level. Specific questions were raised regarding the mandate of the CBR. The Panel asked mainly about procedures how the macroeconomic and fiscal (tax) forecasts are produced and to what extent are consistent with each other. Questions were raised also about the potential role the CBR might play in endorsing macroeconomic forecasts of the government (under the "2-Pack" regulation recently enacted by the European Parliament). In this regard the CBR briefly explained the mandate of the independent macroeconomic and tax revenue forecasting committees attached to the Ministry of Finance. Although the CBR does not present forecasts officially at this stage, it can actively participate in the discussions. However, CBR's participation in these committees was seen as a possible conflict of interest insofar as it may inhibit or compromise the Council's independent monitoring role.

Session: Overview of the CBR´s Toolkit

Presented by: Ľudovít Ódor

In order to understand the role of the individual components in context, the whole toolkit of the CBR was presented to panel members. Mr. Ódor emphasized the basic objective when designing the toolkit, namely, filtering out populism and creative accounting with given resources and capacity constraints. Moreover an additional limitation is the mandate defined in the legislation. The toolkit contains models and methods in three important areas: macroeconomic analysis, budget evaluation and long-term sustainability. As far as macro modeling is concerned, the CBR is working on several models including a standard ECM-type econometric model for forecasting purposes and a DSGE model tailored to small and open economies able to simulate the consequences of different policy proposals. When analyzing long-term impacts, simple supply-side models and possible overlapping generations models are on the agenda. An important part of the toolkit is the framework for output gap estimation. In the area of budgetary analysis detailed tax models, behavioral microsimulation model and simple approaches to risk assessment are in the forefront. In addition, balance sheet analysis and structural budget balance estimates are key for evaluating fiscal performance. The toolkit for long-term sustainability analysis is centered around standard demographic and labour market predictions. Three sectoral models stand out when analyzing the most important consequences of ageing: SLOPEM (universal pension model), PESO (pensions of armed forces) and LTHM (long-term healthcare model). Generational accounting and standard fiscal gap indicators are also included in the toolkit.

Members of the Panel considered the envisaged toolkit as overly ambitious with given resources and recommended clear prioritization of future work.

Session: Output Gap and Structural Budget Balance

Presented by: Ľudovít Ódor
Lead discussant: Philip Lane
Staff: Judita Jurašeková, Mária Marčanová, Marián Šaling

Mr. Ódor presented the draft of the basic methodology to calculate the structural budget balance and the underlying output gap. According to the Fiscal Compact, independent fiscal institutions should assess the deviation of the structural balance from the MTO (or the path toward it) every year. Moreover, these institutions are expected to play an important role in triggering correction mechanisms if the deviation is significant. While structural budget balances represent a theoretically sound concept, their estimation in small open economies is more an art than a science. The CBR defines potential output as a maximum level of output sustainable in the medium- to long run i.e. without presence of imbalances of any sort (internal, external or financial).The basic approach presented was "estimate combination" of different output gap measures from different models based on different information sets. The CAB is then calculated based on the disaggregated approach of ECB with some modifications. Finally, 10 basic principles for identifying one-off and temporary measures were presented to arrive at an estimate of the structural budget balance.

Philip Lane considered the paper as an interesting starting point to estimate structural budget balances in Slovakia. He also sees the current production function methods as problematic for small and open economies. Moreover the inflation-unemployment disconnect at low inflation rates makes the Phillips curve related approaches implausible in many cases. He clearly sees value in multiple estimation approaches, but according to him the preferred methodology should be model-based. Substantial revisions in output gap estimates reflect policy uncertainty and should not be viewed as a problem (even if it leads to credibility losses in the short-term and to false triggers of correction mechanisms). He agrees with the focus on financial cycles and current account imbalances as a potentially fruitful avenue for research. On the other hand he would simply discard estimates based on the HP filter and the multivariate Kalman filter. In relation to the financial cycle, he would also consider some other alternatives to the BIS methodology and encourages more work on current account norms. Finally, he sees important value added of fiscal councils in identifying country specific one-offs.

Other members of the Panel were divided as far as the importance of the stability of estimates for policy making is concerned. Doubts were expressed about the usefulness of averaging estimates from a wide range of methods; instead, along with the lead discussant, it was felt that CBR should select the approach best suited for Slovakia. On the other hand, calculating one-offs by independent fiscal institutions was unanimously viewed as a step in the right direction. All in all, the result of the discussion was that while stability might be important, more weight should be attached to complex model-based estimates incorporating financial cycles and external imbalances.

Session: CBR vis-à-vis the OECD Principles

Presented by: Ľudovít Ódor
Lead discussant: George Kopits
Staff: Jana Valachyová, Mária Marčanová, Marek Porubský, Michal Lehuta

The main question of the session was: what can the CBR learn from international good practices? The benchmark for comparison was the set of 22 principles identified by the OECD. Mr. Ódor presented these principles under 9 broad headings and evaluated the set up of the CBR compared to them.

Mr. Kopits started with praising the CBR, saying it ranks among the best of such institutions in Europe. He stressed the importance for such institution to gain name recognition both at home and abroad early on, with the understanding that ultimately it should serve the general public. The lead discussant also dwelled on the importance of preparing its own macroeconomic and fiscal projections in order to conduct meaningful evaluation of fiscal policy. In any event, this would be a logical extension of the remit, especially since the basic tools to produce these projections are already under construction. Within the projections, the baseline (no policy change) scenario is very important, especially when costing the effects of new policy measures. In fact, parliament should be provided projections and estimates beforehand, as a key input in the legislative debate and decisionmaking. Tricks in government forecasts take place often in baseline projections (e.g., what CBO uncovered in the USA). Mr. Kopits valued that the CBR works in a very strong legislative framework, which is a big plus in his opinion. On the other hand, a staff of 15 employees is insufficient, especially when costing the effects of new measures; equally, an annual budget of 1.5 million euros does not seem commensurate with the tasks at hand. Within the realm of access to information, timing is crucial – that is, to have the data in real-time when the statistics become available (e.g., CBR should have the data at the same time as the Ministry of Finance). Communication by CBR should be pro-active, not only via occasional press conferences. However, the CBR should make its reports and opinions publicly available simultaneously to all, without displaying preference toward anybody (e.g., to rating agencies).

Other panel members also highlighted the importnace of strong legislation behind the CBR. According to them it is also very important to build a community around CBR, for example from the people in the academia. Also the transparency of fiscal council could be enhanced by placing the minutes of all meetings online, as it is done for example in Ireland and Portugal. Relationships with the European Commission with regard to the Fiscal Compact will have to become clear in the future. Members of the Panel expressed the opinion that the CBR should not be an agent of the Commission in Slovakia, but should rather be a national institution operating above all at the service of Slovak citizens.

Session: Aspects of long-term sustainability

Presented by: Ľudovít Ódor
Lead discussant: Kevin Page
Staff: Jana Marek Porubský, Michal Lehuta, Matúš Kubík, Marián Šaling

Mr. Ódor presented four principles for assessing the long term sustainability of public finances in Slovakia – solvency, stability, growth and fairness based on Schick (2005). Solvency includes the analysis of both stock and flow variables to determine the value of the intertemporal net worth of the public sector. The stability principle refers to two distinct approaches. The first is the standard tax-smoothing argument from the literature, while the second is more about highlighting the uncertainty around central estimates by presenting sensitivity tests. The growth principle explores the various links between macroeconomic and fiscal scenarios. The main channels include investment, taxes and risk premium. The fourth principle, fairness, is mainly about intergenerational accounting and cohort-level analysis, but strictly without normative elements.

According to Kevin Page if the CBR completes this ambitious plan, it can be a leader regarding long-term analysis of public finances. On the other hand he warned that moving too quickly too far may confuse the public. Presenting too many new concepts to the general public in a short period of time might result in problems with understanding them. Mr. Page prefers more gradual educative approach, which was selected also in Canada. He highlighted also the importance of professional networks to base the methodology on international best practices. From a transparency point of view it is important to update the basic set of sustainability indicators at each major legislative change, since it strengthens evidence based policy making. Mr. Page also stressed the importance of generational accounting especially since the basic methodology has been well known for years.

Other members of the Panel welcomed the Council's commitment to conduct fiscal sustainability analysis, including on the basis of quantitative long-term scenarios. In particular, regularly updated baseline scenarios (possibly calibrated to medium-term macro-fiscal projections) should be useful for alerting the authorities about the future need for structural adjustment to ensure sustainability. They also discussed potential problems arising from generational accounting and the main channels between growth and fiscal forecasts.

Session: Slovak Tax & Transfer System: A Microsimulation Approach

Presented by: Michal Horváth
Lead discussant: Daniele Franco
Staff: Jana Valachyová, Zuzana Siebertová, Zuzana Múčka, Norbert Švarda

Mr. Horváth presented the basic features of the CBR´s microsimulation model linked to a simple neoclassical (long-term) macro model. The micro part is a behavioral model taking into account labor supply decisions both at the intensive and extensive margin. Changes in the tax-benefit system are translated into changes in financial gains to work. The model then computes pre-and post-reform probability of being economically active and effective hours worked for different groups of the population. The results are aggregated into an economy-wide labor supply shock which feeds into the simple macro model. In the macro framework, the general equilibrium effects on wage rates are calculated which then feed back into the micro-part of the model.

Daniele Franco started his comments with a note on the general purpose of the microsimulation model. He pointed out that this approach can be useful to answer important policy questions. In particular, it can serve to better understand reform effects and tradeoffs and it can be helpful in the design of tax and benefit schemes. In the next step, Mr. Franco presented his comments on the technical aspects of the model. He highlighted that a comparison of long-run steady states need not to be necessarily informative about changes in the short and medium run, which is of primary interest to policy makers. He also suggested that more heterogeneity in the model would be desirable, namely in the production function, as well as an extensive examination of dissimilarities across different socio-demographic groups and different groups of workers. Mr. Franco also advised to consider a two sector version of the model and to analyze the dependence of the effects of changes in the tax-benefit system on labor market institutions such as wage-setting mechanisms and minimum wages. Finally, he recommends to include examples of specific reforms both on the tax and benefit side.

In a lively discussion with other members of the Advisory Panel, the discussants acknowledged the need for a reliable (preferably administrative) data source as a necessary condition for a good analysis of this kind, and encouraged the Council to get involved in the discussions concerning data collection in Slovakia. Members of Panel agreed that a microsimulation model is a necessary tool to evaluate the macro and budgetary effects of changes in tax and benefit policies and suggested to share this kind of model with the government (if it does not have one).

Session: The new DSGE for Slovakia (Fiscal Policy Matters)

Presented by: Michal Horváth
Lead discussant:
Staff: Zuzana Múčka, Marián Šaling, Miroslav Kľúčik

Mr. Horváth made a short presentation of the new DSGE model tailored to the main features of the Slovak economy. He highlighted the key differences compared to standard modeling practices in the literature. Among them the most important are: extensive reliance of the production side on foreign inputs, strong export orientation and the rather limited domestic capital ownership. The fiscal block in the model also reflects country-specific procedures as well as the need to be detailed enough for realistic policy experiments.

Concerning the new DSGE model for Slovakia, the evaluator Professor Simon Wren-Lewis emphasized the role of DSGE models in theoretically sound policy analysis. It has been pointed out that carefully crafted DSGE models may offer poor fit to data. In addition, the complexity of the model may be an obstacle to understanding its properties.

Nevertheless, the draft model prepared by the CBR follows the current 'state of the art' in modelling, and is well-designed to match important characteristics of the Slovak economy (e.g. limited wealth of households, or existence of capital owned by foreign investors, etc.). It was suggested that foreign capital is treated in the same way in both the public and private sector production. Referring to the Great Recession and the households' apparent over–borrowing (especially in the housing sector), also it was advised to consider precautionary savings and introduce various financial frictions or changes in the availability of credit.

During the discussion with the advisory panel it was recommended that the exogeneity of capital inflow be dropped, and consider endogenous capital that is tied to the economy's competitiveness. It was recommended that endogenous potential output growth be introduced into the framework. The inclusion of financial frictions and of an explicit housing sector was deemed less of a concern in the context of Slovakia. It was advised that a careful look is taken on the current account structure. The introduction of a private non-tradable sector could help accounting for the real appreciation experienced over the past decade.

In sum, the panel commended the efforts to incorporate specific attributes of the Slovak economy and strongly encouraged to use the model not only to conduct theoretical exercises to evaluate the effects of changes in fiscal policy, but also to use it as an instrument for medium-term macro-fiscal projections.

Session: Closing remarks and work plan for 2014

Presented by: Michal Horváth

At the end of the meeting, Mr. Horváth very briefly outlined the work plan for the year 2014. In general panel members expressed their support for the work plan although they felt it is very ambitious. They asked for more details on the fiscal space/limit, Early Warning Indicator and Fiscal Multipliers projects. After the discussion, some Members of the Panel concluded that Early Warning Indicator should be an important part of the CBR work in order to identify the potential risks in the budget execution. They expressed some doubts about the usefulness of a meta-analysis on fiscal multipliers, as the academic literature provides extensive coverage of this topic.

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