ORGANISATION DE COOPÉRATION ET DE DÉVELOPPEMENT ÉCONOMIQUES
OECD OCDE
ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

DIRECTION DES AFFAIRES FINANCIERES, FISCALES ET DES ENTREPRISES
DIRECTORATE FOR FINANCIAL, FISCAL, AND ENTERPRISE AFFAIRS

BANQUE INTERAMERICAINE DE DEVELOPPEMENT
INTER-AMERICAN DEVELOPMENT BANK

CARIBBEAN RIM INVESTMENT INITIATIVE

BUSINESS ENVIRONMENT REPORT

COSTA RICA

29 April, 2003

CARIBBEAN RIM INVESTMENT INITIATIVE (CRII)
BUSINESS ENVIRONMENT REPORT (BER)
COSTA RICA

Executive Summary

Costa Rica is a small developing economy located in Central America, with a GDP per capita of U.S.$ 4.083 in 2001 and a population of 4 million. Traditionally open to foreign investment, during the last decade, Costa Rican economic policies have been oriented towards fostering an optimal penetration of the country into international markets, mainly by expanding and diversifying its export base.

Within this process, foreign direct investment (FDI) has played a key role. Despite facing important challenges ahead, Costa Rica represents an outstanding success story of a small economy being able to increase and diversify its exports and attracting significant FDI inflows into its economy.

At the beginning of the 1980s, when the debt crisis revealed the limitations of the import substitution industrialization (ISI) model, Costa Rica opted for an export-led development strategy, based on the increase and diversification of its exports. As a result of this policy paradigm Costa Rica has become more effective in penetrating international markets. This has been reflected not only in the magnitude and composition of its trade of goods and services with the rest of the world, but also in the way the country has financed the excess expenditures over domestic savings. Costa Rican economic policy has entailed the adoption of fiscal incentives and the application of an exchange rate policy fully committed to maintaining the competitiveness of Costa Rican exports abroad. These elements, among others, have led to a more favorable environment for the exporting sector and foreign investment.

During the 1990s, Costa Rican exports experienced a significant change in structure, which has been mainly reflected in the considerable share manufacturing exports and trade in services have gained within total exports, gradually decreasing the dependence of Costa Rica's economy on traditional export commodities, such as coffee and bananas. During the last decade the balance of payments showed an quantitative and qualitative improvement, and the current account deficit became to be financed mainly by FDI flows towards the private sector. Indeed, during 1997-2001 FDI flows have financed on average 81.6% of the current account deficit in Costa Rica.[1]

Costa Rica has adopted a proactive policy towards attracting increasing FDI flows, by improving its human resources, reducing red-tape and favoring an economic policy which improves the country's business climate. Contrary to other countries in Latin America, FDI inflows in Costa Rica have not been associated with significant privatization programs. In fact, the pace of domestic economic reform since 1990 has been slower than in most other countries in Latin America -- in particular in the field of privatization of state-owned monopolies in key services sectors of the economy such as

[1] Source: Central Bank of Costa Rica

telecommunications, distribution of electricity and insurance. This factor is gradually becoming a serious bottleneck in Costa Rica's long term development, and casts some shadow over an overall economic performance assessment which otherwise has been extremely positive during this period.

Despite the slower pace of economic reform, in particular in the services sector, since the mid 1980s Costa Rica has been able to maintain the internal stability during the reform process. The average rate of the GDP in real terms during the 1990s was 5.4% and the GDP per capita, 20.1%, while the average rate of inflation was 16.9%, after registering a median of 27.1% during the previous decade. At the end of 1996-1999, the inflation average decreased to 11.9% and the rates of growth of the real GDP and GDP per capita were 5.7 percent and 18.1 percent respectively. An old and chronic public debt (now reaching more than U.S.$ 4 billion) has not only impeded the move to lower inflation rates to single-digit figures, but represents another major challenge that Costa Rica will have to face in the near future in order to provide the macroeconomic environment needed to regain the rates of growth experienced during the last decade.

Mirroring the situation in most parts of the world, in 2000, the pace of growth of the Costa Rican economy has slowed down, mainly as a consequence of a weak external demand for goods and services and a deterioration of the international terms of exchange. In that year, the growth of the GDP in real terms was 2.23 percent, well below the 8.2 percent registered in 1999, the GDP per-capita growth rate reduced to 6.5 percent. Nevertheless, the inflation rate was just above the previous year at 10.2 percent. In 2001 there were no signs of recovery. The sum of several factors (mostly current economic variables) meant that GDP grew only by 0.9 percent, the rate of unemployment increased to 6.1 percent and GPD growth declined even more, to 5.8 percent while inflation prevailed at 11 percent.

Among the economic factors explaining this decline after 2000 are the following. First, the effects of the recession of the U.S. economy, by far the main destination of Costa Rican exports. Second, the fall in the prices of numerous exports in the agricultural sector. Third, a high cost in oil imports, and fourth a considerable reduction in exports of high tech products, motivated by individual decisions of major MTNs located in Costa Rica. The national currency, the "colon", has avoided major depreciations as the exchange rate has been subject to a policy of regular "mini-devaluations" aimed at reflecting domestic inflation.

Several variables indicate that Costa Rican exports and GDP growth will regain their momentum in the near future. The reactivation of growth in the U.S. economy will lead to increased demand for Costa Rican exports, a trend which will likely be strengthened by the launching of negotiations for a United States-Central American Free Trade Agreement (CAFTA)—the conclusion of which is expected by December 2003. The CAFTA negotiations will certainly represent a very strong and positive signal for international investors. CAFTA will secure the access that most Costa Rican exports have enjoyed into the U.S. market as a result of the Caribbean Basin Initiative (CBI). By establishing a legal framework regulating its trade and investment relations with the

United States, Costa Rica is likely to become an even more attractive place for export-oriented FDI in the near future.

The success that Costa Rica has experienced during the last decade in attracting increasing FDI inflows into the high tech and services sectors represents a strong signal of the path the country could follow in the future. Indeed, with its high human development level and strong educational base, combined with its geographic location and proximity to the U.S. market, Costa Rica is gradually experiencing a qualitative leap in its development. Thus, the need to undertake the domestic reforms and to continue strengthening one of the country's most valuable asset: its human capital.

Within this context, this report intends to provide an overview not only of the features of FDI in Costa Rica and the main factors behind FDI trends, but also an analysis of the multiple variables which affect its business climate.

PART I

FDI Trends

1.1. Flows and Stocks of FDI

From 1990 to 2000, FDI inflows into Costa Rica increased at an impressive average annual rate of 18 percent (see Table 1).

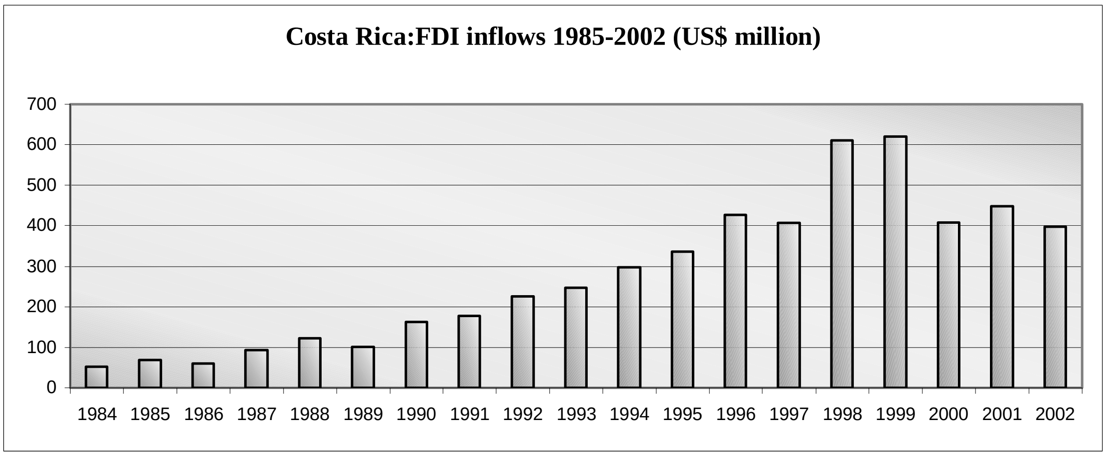
Table 1
FDI Inflows, 1990-2000
(Millions of U.S. Dollars)

Year	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002*
Total	162.4	178.4	226.0	246.7	297.6	336.9	426.9	406.9	611.7	619.5	408.6	447.9	642.0

Sources: BCCR, CINDE, PROCOMER, COMEX

In 1990 total FDI flows into Costa Rica were U.S.$162.4 million, and as figure 1 shows, up to 1999, they experienced a constantly growing trend. By 1995 FDI flowing into the country reached U.S.$ 336.9 million, representing more than double the figure of five years earlier. During this period, FDI inflows to Costa Rica peaked in 1998 and 1999 at U.S.$611.7 and U.S$619.5 respectively, as the constant growth in FDI inflows was supplemented by significant new investments in the high technology sector. In 2000, FDI inflows decreased by 19.5% compared to the previous year, reaching U.S.$ 408.6 million. Although FDI inflows increased again in 2001 to U.S.$447.9 million, due to the persistence of the slowdown of the U.S. economy it is expected that FDI inflows in 2002 will reach only U.S.$ 397.5 million.

Figure 1



As will be explained below, given that most of the FDI in the manufacturing sector is export-oriented – and mainly to the U.S market— such decrease in FDI inflows can be explained in terms of the impact that the slowdown in the U.S. economy has had over numerous export-oriented industries based in Costa Rica. It is worth noting, however, that despite the decrease in FDI referred to above, by 2002 FDI inflows to Costa Rica will still represent more than double the figure at the beginning of the decade.

Multiple factors explain the trend of increasing FDI inflows to Costa Rica during the last decade. One of them is the continuous implementation of an export-oriented development strategy that commenced in the 1980s. Among other objectives, this strategy aimed to diversify Costa Rica's export supply away from its traditional export commodities, i.e. coffee, bananas and beef. For that purpose, several programs including tariff and other fiscal concessions lured business towards non-traditional export activities such as manufacturing. Indeed, as will be explained in section 1.3. below, the bulk of FDI inflows into Costa Rica has concentrated in that sector, in particular in manufacturing located in Free Trade Zones (FTZs). However, significant amount of FDI flows have also been attracted by the tourism industry as well as in the financial services sector -- especially after State monopoly in current accounts was dismantled in 1995. In contrast, FDI inflows into traditional agriculture have tended to diminish during the decade.

Although in Costa Rica there is not accurate information to allow a clear distinction between green-field investment and reinvestments, CINDE—the Costa Rican Investment Board—has developed records covering key investments in certain sectors that provide some indication of the composition of the total FDI flowing into the country. On the basis of that approximate data, which should be taken only as indicative, Table 2 suggests that out of the total FDI flowing into Costa Rica during the 1997-2000 period, the most part was new, green-field investment. According to the partial data available, new investment represented almost 60 percent of the total, while reinvestments represented 43 percent.

Table 2
FDI Inflows, 1995-2000
(Millions of U.S. Dollars)

Year	**New Investment**		**Reinvestment**		**Total**
	% of Total		% of Total		
1997	72%	294.63	28%	112.27	406.9
1998	49%	300.72	51%	310.98	611.7
1999	61%	378.88	39%	240.62	619.5
2000	47%	191.12	53%	217.48	408.6
Total		1,165.35		881.35	2,046.70

Source: BCCR, CINDE, PROCOMER

Another indicator evidencing the significant growth of FDI inflows into Costa Rica during the 1990s is the total FDI inward stock, which, as table 3 below shows, in 2000 was nearly four times higher than in 1990.

Table 3
FDI Inward Stock, 1990, 1995, 2000
(Millions of U.S. Dollars)

Year	**1990**	**1995**	**2000**
Total	1447	2733	5198

Source: UNCTAD, World Investment Report 2001

1.2. Country of Origin and Destination

A quick overview of the origin of FDI inflows into Costa Rica is enough to discover the overwhelming importance that U.S. investment has in the country. Between 1990 and 2000, more than two thirds of the total FDI flowing into Costa Rica originated in the United States. U.S. predominance as a source of FDI is undisputed, as the second main FDI supplier, Mexico, represents a figure well below the U.S. share. The pattern is complemented by several other sources of FDI, however, none of them representing a share of more than 4 percent of the total.

Table 4 shows the top ten sources of FDI for Costa Rica in absolute and relative terms between 1995 and 2000. The table confirms the trends described above, placing the United States as the predominant source of FDI, with approximately 65 percent of total inflows, far above the second main supplier, Mexico provided 10 percent of the total FDI inflows during this period. The rest of Costa Rica's main sources of FDI represent significantly lower figures. Despite being the third FDI source for Costa Rica, Panama only represented 3.5 percent of the total during the period, followed by Canada, Spain[2], Germany, El Salvador and Italy.

Table 4
FDI Inflows by Country of Origin, 1995-2000
(Millions of U.S. Dollars and Percentage)

[2] The relative weight of Spain among Costa Rica's main sources of FDI is underestimated in this table. In fact, Spain's share of FDI inflows in Costa Rica is very likely to be much higher than the 0.8 percent indicated by the table. This misrepresentation stems from the fact that the data corresponding to 1995 and 1996 FDI inflows does not include the tourism sector, which was measured separately. For 1995 FDI in tourism reached U.S.$66.9 million and for 1996 U.S.$ 53.6 million. As most Spanish investments in Costa Rica are concentrated in this sector, Spain may in fact represent the third or fourth source of FDI in the country.

Country	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**Total**	**Percent**
USA	119.6	291.4	304.6	486	345.5	279.5	1826.6	64.99 %
Mexico	80.4	36.6	21.7	21.2	92.5	29.3	281.7	10.02 %
Panama	5.9	-4.3	0.2	1.9	69.2	26.2	99.1	3.52%
Canada	-	8.6	8.2	34.2	35.7	-2.7	84	2.98%
Germany	19.3	4.4	5.4	10.9	7.5	10.3	57.8	2.05%
El Salvador	0.7	11.6	13.9	0.6	15.0	15.1	56.9	2.02%
Italy	-	1.5	10.3	0.4	8.2	6.6	27	0.96%
Guatemala	5.2	0.7	2.1	1.9	13.7	2.4	26	0.92%
Spain	-	0.8	1.5	-	0.1	21.8	24.2	0.86%
Taiwan	-	-	3.8	6.9	3.9	2.9	17.5	0.62%
Others	105.8[3]	75.6	35.2	47.7	28.2	17.2	309.7	11.01 %
Total	336.9	426.9	406.9	611.7	619.5	408.6	2810.5	100

Source: Central Bank of Costa Rica, CINDE, PROCOMER, COMEX and ICT

The significant weight of United States among Costa Rica's main suppliers of FDI is no coincidence. The pattern demonstrates the new synergy between trade and investment as two complementing modes to service a particular market. The bulk of U.S. FDI investment in Costa Rica is export-oriented, mainly to the U.S. market. It is efficiency-seeking FDI that has found, in the internationalization of production, the best strategy to service its own domestic market. U.S. enterprises have then implemented an international production system to which Costa Rica is gradually becoming integrated, thanks to the market-access concessions the country enjoys under the U.S. Caribbean Basin Initiative. This phenomenon also explains the sectoral distribution of U.S. FDI and the significant impact it is having in transforming Costa Rica's export supply, traditionally centered on export commodities, towards manufactures of higher and rising levels of technology. This point is developed in section 1.3 below.

FDI originating in countries other than the United States have also increased their participation in Costa Rica during the last decade. That is the case of FDI from Mexico, Spain, and other Central American countries. However, it should be noted that contrary to the case of U.S. FDI, investment from these countries has tended to be market-seeking, and particularly concentrated in the services sector.

[3] Data for 1995 and 1996 FDI in the tourism sector was aggregated under the category of "others". A significant share of FDI under this category should be attributed to Spain.

In the case of Mexico, the negotiation of the Free Trade Agreement with Costa Rica in 1994 enhanced the interest of Mexican investors in penetrating the financial services market as well as manufacturing of some consumption goods. Likewise, in 1999 Central American and Panamanian investors also began to invest in the financial sector and retail services. Spanish investment in turn has been mainly focused on the tourist sector.

Costa Rica does not keep any official record on FDI outflows from the country. However, through empirical evidence and FDI statistics in other countries, it is possible to obtain an indication of the approximate magnitude of Costa Rican investments abroad. As shown in table 5 below, UNCTAD has estimated that between 1995 and 2000 FDI outflows from Costa Rica amounted approximately U.S.$ 29 million.

Table 5
FDI Outflows, 1995-2000
(Millions of U.S. Dollars)

Year	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**
Total	6	6	4	5	5	3

Source: UNCTAD, World Investment Report 2001

Information on the geographic and sectoral distribution of Costa Rican investments abroad is scant. Empirical evidence shows also the existence of Costa Rican investment in the other Central American countries – in particular in Nicaragua -- as well as in Dominican Republic and Panama. However, no detailed statistical evidence is available. The situation is different for Costa Rican FDI in Mexico. According to data from the Secretariat of Economy (SECOFI), between 1994 and 2000 a significant share of Costa Rican FDI outflows were geared towards the Mexican market. Indeed, according to SECOFI data, Costa Rican investments in Mexico reached U.S.$9.1 million during that period, although empirical evidence suggests this figure is conservative. Mexican statistics suggest that Mexico captured approximately one third of the total Costa Rican FDI outflows during the second half of the last decade.

Information on the behavior of FDI outflows from smaller developing countries such as Costa Rica is extremely limited. Thus, the experience of Costa Rican FDI flows in Mexico is a case worth exploring in more detail. This experience provides evidence of two key trends. First, Costa Rican FDI abroad has focused on sectors that until the 1990s were not geared towards the international market. As shown in table 6, out of the 47 companies with Costa Rican capital that are registered in Mexico, 38% are in commercial activities, 19.1% in services and the same percentage in manufacturing activities. Within the services sector, most of the companies are providers of professional, technical and specialized services, while those in commerce are dedicated to the wholesale of foodstuffs. As regards the industrial sector, the greatest concentration has focused on the production of plastics. This data suggests the gradual development of an increasingly aggressive and competitive business sector that is penetrating foreign markets not only via trade, but also via FDI.

Table 6
Sectoral distribution of Costa Rican FDI in Mexico: 1994-2000

Sector	# of companies	Participation (%)
Commerce	18	38.3
Other services	9	19.1
Manufacture	9	19.1
Financial Services	5	10.6
Construction	3	6.4
Restaurants	2	4.3
Farming & Livestock	1	2.1
Total	**47**	**100**

Source: SECOFI – Data up to September 9, 2000

The second trend that can be observed in Costa Rica's FDI experience in Mexico is that most flows took place during the second half of the last decade, that is, after 1995. It was precisely in 1995 when the Costa Rica-Mexico Free Trade Agreement entered into force. Thus, the behavior of Costa Rican FDI in Mexico is also indicative of the positive effect that international agreements can generate in increasing the level of certainty required to do international business.

1.3. Distribution by Economic Activity

Three major trends can be observed in the evolution of the distribution of FDI inflows by economic activity in Costa Rica during the last decade. First, the agricultural sector has suffered a dramatic decline in absolute FDI inflows, especially after 1992 when FDI peaked at U.S.$113.8 million. In fact, as table 7 shows, during 2000 FDI this sector registered a disinvestment equivalent to U.S.$ 11.2 million. The decline of FDI flowing towards the primary sector is also evident in relative terms. From being the main magnet of FDI in 1990, when it attracted 54.8% of the total FDI flowing into Costa Rica, in 2000 agriculture became the sector attracting less FDI. This fall is associated with the extremely low price commodities experienced in the international market during this period. This is particularly true for the banana sector, which traditionally used to concentrate significant shares of FDI inflows in Costa Rica and during the last decade has suffered a significant decrease in profits.

Table 7
FDI Inflows by Sector
1990-2000
(Millions of U.S. Dollars and Percentage)

Sectors	**Agriculture**		**Industry**		**Commerce**		**Others**		**Total**
	$million	% share	$million	% share	$million	% share	$million	% share	$million
1990	89.9	54.8%	48.8	30.0%	-0.5	-0.3%	25.1	15.5%	163.3
1991	108.4	60.8%	32.0	17.9%	9.6	5.4%	28.4	15.9%	178.4

1992	113.8	50.4%	51.9	23.0%	5.8	2.6%	54.5	24.1%	226.0
1993	81.9	33.2%	98.3	39.8%	12.4	5.0%	54.1	21.9%	246.7
1994	42.7	14.4%	167.9	56.4%	48.5	16.3%	38.5	12.9%	297.6
1995	48.4	14.4%	186.3	55.3%	21.2	6.3%	81.0	24.1%	336.9
1996	34.6	8.1%	257.4	60.3%	35.5	8.3%	99.4	23.3%	426.9
1997	38.1	9.4%	270.6	66.5%	17.6	4.3%	80.6	19.8%	406.9
1998	41.9	6.9%	423.5	69.2%	39.3	6.4%	106.9	17.5%	611.7
1999	49.9	8.1%	355.9	57.4%	9.2	1.5%	204.5	33.0%	619.5
2000	-11.2	-2.8%	296.2	72.5%	17.4	4.3%	106.2	26.0%	408.6
Total	638.4	16.27%	2188.8	55.8%	216	5.50%	879.2	22.41%	3922.5

Source: Central Bank of Costa Rica, CINDE, PROCOMER, COMEX, ICT

A second trend worth noting is in the industrial sector where FDI inflows have registered an astronomic increase during the period. Indeed, from attracting only U.S.$ 48.8 million in 1990, by 1998 FDI in this sector was almost ten times higher, reaching U.S.$ 423.5 million. Although decreasing after that year, by 2000 the sector still attracted U.S.$296.2 million in FDI flows, more than six times the figure at the beginning of the decade. Further, during the 1990s, the relative share of industry in total FDI inflows increased from 30% to 72%.

The concentration of FDI inflows into the manufacturing sector in Costa Rica stem from two main variables. First, as mentioned in section 1.2 above, Costa Rica is gradually becoming part of a scheme of international production – mainly from U.S. multinational corporations. It is in the manufacturing sector where global production has been concentrated. Thus, efficiency-seeking investors, who represent a significant share of the investors investing in Costa Rica, tend to be concentrated in this sector. A second variable explaining the concentration of FDI inflows in the industrial sector is the harvest Costa Rica is enjoying as a result of investing in education for more than five decades. Nowadays Costa Rica's workforce ranks among the most educated in Latin America. This has provided the country with a comparative advantage in highly-qualified labor, a key factor explaining not only the establishment of manufacturing industries requiring a sophisticated workforce – such as hairdryers and fine apparel -- but also the gradual conformation of a high-tech manufacturing cluster in Costa Rica.

Table 7 above also evidences a third trend in the evolution of the sectoral distribution of FDI in Costa Rica, that is, the significantly less dramatic growth of FDI in the commerce sector, a limited growth which also has occurred on a more erratic basis. Although registering overall growth, FDI in this sector has oscillated almost constantly during the decade. A tentative explanation for this trend might be associated with the limited dimensions of the Costa Rican consumption market, which does not make it attractive for market-seeking FDI in this particular sector.

A totally different situation can be observed in the category of "others" in table 7 above. This category comprises FDI in tourism, a sector that definitively has shown a dramatic development and has lured significant FDI inflows into Costa Rica during the last decade. Indeed, in 2000 FDI in this item almost quadrupled the level reached in 1990. The positioning of Costa Rica as an attractive destination, politically stable and with a significant flora and fauna diversity has served the tourist industry well. In this sector, FDI is concentrated in European consortia, mostly from Spain. The peak in FDI experienced in this category in 1999, can also be explained in terms of the significant FDI inflows geared towards the financial sector, in particular in banking services. FDI flowing into the financial sector, mostly from other Central American countries, explains to a certain extent the final amount of FDI attracted in 1999.

1.4. Main Foreign Investors

The United States is home to seven out of the ten largest investors in Costa Rica, including the top 3 of them (see Table 8). It is worth noting that with the just one exception, all of the U.S. largest investors participating in the top ten are concentrated in the export-oriented manufacturing sector, producing articles such as microprocessors, medical devices, textiles and hairdryers. The other three main investors among the top ten are from Spain and El Salvador, both of which are concentrated in the tourism services industry, and one from Panama, who has investment in financial services.[4]

Out of the top 50 foreign investors in Costa Rica, 28 of them (56 percent) are concentrated in manufacturing industries, 6 (12 percent) in commercial activities, 5 (10 percent) in agro-industry or agriculture and another 5 in various services. Further, the number of investors in some activities representing significant amounts of FDI, such as tourism and financial services, is surprisingly low. Thus, for instance, out of the top 50 foreign investors in Costa Rica there are only 4 investors in the tourism sector and only 2 in the financial services industry.

Table 8
Costa Rica's Top Ten Largest Foreign Investors

Company	Country of Origin	Sector	FDI US.$ million	% Participation
1	USA	Manufacturing	91.23	22.3%
2	USA	Manufacturing	39.43	9.7%
3	USA	Manufacturing	30.24	7.4%
4	Spain	Tourism	21.58	5.3%
5	USA	Manufacturing	20.53	5.0%
6	USA	Commerce	18.00	4.4%
7	USA	Manufacturing	18.00	4.4%
8	Panama	Financial ss	17.57	4.3%
9	USA	Manufacturing	16.00	3.9%
10	El Salvador	Tourism	15.00	3.7%
TOTAL			287.58	70.4%

Source: BCCR,CINDE, PROCOMER, COMEX, ICT

[4] These firms are: AES, Enron, Coastal, Seaboard, and Union Fenosa. TRICOM, in which Motorola has a stake, ranks 15th. It is the second largest provider of long distance and cellular phone services in the country.

1.5 Main Explanatory Factors for FDI

In many ways Costa Rica has always been the exception to various political, social or economic paradigms in Latin America. The explanation of the significant surge of FDI inflows during the last decade into this small Central American country is, in many ways, another example of this trend. In many Latin American countries, during the 1990s FDI inflows grew at impressive rates after sweeping economic nationalist policies which discriminated against foreign investment were discarded, deep market-oriented reforms implemented and for the first time in decades, FDI was allowed to participate in different sectors of the economy. Furthermore, in many Latin American countries economic reform entailed the privatization of various key sectors that attracted important amounts of foreign capital into these economies.

Costa Rica deviates from this paradigm in two ways. First, although not totally exempt from the economic nationalistic trend, in Costa Rica neither economic policy, nor the legal system traditionally discriminated against foreign investment in favor of the domestic private sector. As a matter of fact and in general, Costa Rica has been a country open to FDI.[5] However, at the same time, and contrary to other Latin American countries, the surge of FDI inflows into Costa Rica cannot be explained in terms of sweeping privatization programs. The reason is simple: they have not happened. In fact most of the State monopolies in Costa Rica have not been yet dismantled. This does not mean that market-oriented reforms have not been implemented in the country, nor that they have not played a key role in fostering increasing flows of FDI. However, economic reform has mainly been geared towards the external sector.

Thus, the surge of FDI inflows in Costa Rica during the 1990s can be explained in terms of a clearly defined export promotion and diversification strategy, the success of which has gradually lead to the development of an investment policy based on a clear understanding of the comparative advantages of the country.

Although FDI has taken place in various sectors of the Costa Rican economy, as mentioned in section 1.3 above the most dynamic sectors attracting FDI flows have been the industrial and tourist sectors.

1.5.1 Market-Seeking FDI in Costa Rica

Market-seeking investment in Costa Rica basically comprises three categories: FDI in certain manufacturing activities aimed at the domestic market, such as foodstuffs and cement, FDI in certain services oriented to the domestic market, such as retail and financial services, and FDI in tourism.

[5] As a matter of fact, contrary to most Latin American countries, Costa Rica has never enacted foreign investment law, nor established any screening mechanism or even FDI registry.

The first category of market-seeking FDI has been attracted essentially from Mexico. Mexican FDI has concentrated in foodstuffs, and construction materials, in particular, cement. In fact in 1999 Mexican investors acquired one of the largest cement factories in Costa Rica. Mexican investment in this country has mirrored the trend in other Central American countries. Due to cultural affinity and geographic vicinity Central America is a natural market for certain Mexican enterprises. Furthermore, the negotiation of the Mexico-Costa Rica Free Trade Agreement that entered into force in 1995 also seems to have been instrumental in fostering these flows. This kind of FDI has been motivated by the need of obtaining distribution channels into the domestic market. Mexican companies have acquired local enterprises and used them to penetrate the market with their own brands.

The second category of market-seeking FDI in Costa Rica comprises services industries oriented to the domestic market. Central American investment in sectors such as retail and financial services have dominated this category. In fact, just between 2000 and 2002, FDI in the financial services sector has reached U.S.$ 80.6 million. These resources have mainly come from Panama and Nicaragua. The opening of the financial sector in 1995, and in particular the dismantlement of the State monopoly in banking current accounts definitively has had an impact in enabling this FDI flow into the Costa Rican economy.

FDI in tourism is the third, and most important, kind of market-seeking FDI. Although not reaching the same magnitude as FDI in the export-oriented manufacturing sector, FDI in tourism experienced a substantial increase after 2000. In 2001 FDI in this sector reached U.S.121.8 million, more than double the figure for the previous year. The estimates for 2002 are still very impressive, reaching U.S.$101.4 million. During the last two years, tourism has become the most dynamic sector in FDI attraction in Costa Rica. Thus, the tourist industry in Costa Rica has not been affected by the terrorist events in the United States. Although FDI in this sector is basically originated in Spain and to a lesser degree in Canada, most of the tourism flowing into Costa Rica is from the United States.

In brief, Costa Rica has been able to exploit its natural endowments and fill a niche market as an ecological destination.

1.5.2 Natural Resources-Seeking FDI in Costa Rica

Natural resource-seeking FDI in Costa Rica has been the less dynamic of all FDI categories during the last decade. Although increasingly active in the production of non-traditional tropical products such as pineapples and other tropical fruits, in Costa Rica natural resource-seeking FDI has been traditionally concentrated in the banana sector. Thus, the dramatic decline of this kind of FDI seems to be associated with the deterioration of the terms of exchange in most agricultural products during the last three years. Indeed, FDI in the agricultural sector dropped from U.S.$ 49.9 million to a dis-investment equivalent of U.S.$11.2 million in 2000. Although FDI to the sector resumed in 2001, reaching U.S.$ 17.9 million, it is estimated that it will decline again in 2002 to only U.S.$11.8 million, a figure that is almost ten times lower than FDI inflows into this sector in 1991 and 1992 (see table 6 above).

1.5.3 Efficiency-Seeking FDI in Costa Rica

A fundamental element in the impressive performance that Costa Rica has demonstrated during the last decade in terms of its export expansion[6] and diversification has been the role played by efficiency-seeking FDI, which has become a key component of the country's development strategy. Since the beginning of the last decade, efficiency-seeking FDI has represented the bulk of foreign investment flowing into Costa Rica.

As in other countries of the Central America and the Caribbean, most efficiency-seeking FDI in Costa Rica is concentrated in the free trade zones ("*zonas francas*" as they are known in Spanish, hereinafter "FTZs"). The FTZ system began to be implemented during the 1980s, and currently approximately 300 enterprises operate in Costa Rica under this regime, generating around of 34.000 direct jobs. Although most enterprises operating under FTZ are located in one of the thirteen industrial parks in the country, a small number of enterprises of significant dimension operate outside those parks in their own premises. These enterprises are in fact the main exporters, comprising approximately 65 percent of the total exports under the FTZ regime.

Without doubt, efficiency-seeking FDI in FTZs increased significantly during the 1990s. However, during the last two years there has been an important decrease in FDI in this sector, dropping from U.S.$226.7 million in 2000 to U.S.$131.1 million in 2002, (see table 9 below). This trend seems to mirror the decrease in world-wide FDI flows during the period as a result of the de-acceleration of the world economy. Another important variable was the uncertainty generated by the obligation all developing countries had to comply under the WTO Subsidies Agreement, according to which, these countries had to dismantle all export subsidies – a category under which some benefits of the FTZs fall— by 2003. As a result of negotiations at that multilateral forum, WTO Members opted to extend the original grace period for five additional years. This is an issue that will likely be brought to the current round of multilateral trade negotiations, so the grace period may be extended longer than 2008.

Table 9
Costa Rica: FDI for Type of Enterprises
U.S. $ Million

	1997	1998	1999	2000	2001*	2002*
Regular Enterprises	137.1	153.1	206.9	108.1	119.4	140.4
Tourist Sector	79.3	61.4	84.7	52.1	121.8	101.4
Financial Sector	-0.2	22.1	93.4	27.1	29.8	23.7
Free Trade Zones	184.7	370.5	225.5	226.7	117.0	131.1
Draw Back System	6.0	4.5	8.9	-5.3	0.0	0.9
Total	**406.9**	**611.7**	**619.5**	**408.6**	**447.9**	**397.5**

[6] . Indeed, during the 1990s, Costa Rican exports multiplied by a factor of five, passing from U.S$ 1.676 million in 1990 to U.S.$ 6,719 million in 1999. This point is further developed in section 2.3 below.

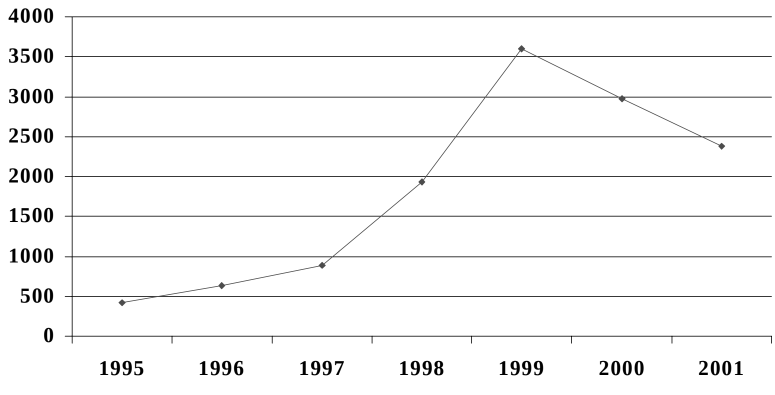
Percentages						
Regular Enterprises	33.7%	25.0%	33.4%	26.5%	26.6%	35.3%
Tourist Sector	9.5%	10.0%	13.7%	12.7%	27.2%	25.5%
Financial Sector	0.0%	3.6%	15.1%	6.6%	6.6%	5.9%
Free Trade Zones	45.4%	60.6%	36.4%	55.5%	39.5%	33.0%
Draw Back System	1.5%	0.7%	1.4%	-1.3%	0.0%	0.2%
Total	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**

***** Estimated Figures

Source: CINDE, PROCOMER, ICT, COMEX & BCCR

The decrease in absolute amounts of FDI in FTZs, and in its lesser relative importance during the last two years, may be misleading. In fact, the impact of efficiency-seeking FDI within the Costa Rican economy has been overwhelming. It can be better appreciated once its quantitative and qualitative impact over Costa Rica's export performance is observed. From a quantitative perspective, during the second half of the last decade, exports under the FTZ regime rose exponentially in Costa Rica. While in 1995 those exports accounted for U.S.$417.3 million (representing a 12.3 percent of total Costa Rican exports) in 1999 they increased by a factor of eight, reaching U.S.$ 3591.9 million (representing 47.2 percent of the total). Figure 2 below illustrates this trend. From a qualitative perspective, FDI in FTZs has been a key instrument in modifying the composition of Costa Rica's export supply. Nowadays, Costa Rica's main export products are no longer agricultural commodities, but microchips, medical devices and to a lesser degree textiles.[7]

Figure 2
Costa Rica: Exports under Free Trade Zone Regimes: 1995-2001



[7] This point is developed in section 2.3. below.

As figure 2 above shows, despite the decline in FDI flowing into FTZs after 1999 which, as explained before is owed more to current economic trends than structural factors-- by 2001 FDI flows were still four times higher than in 1995. These numbers allow the assertion to be made that the Costa Rican strategy aimed at attracting export-oriented FDI has been a success.

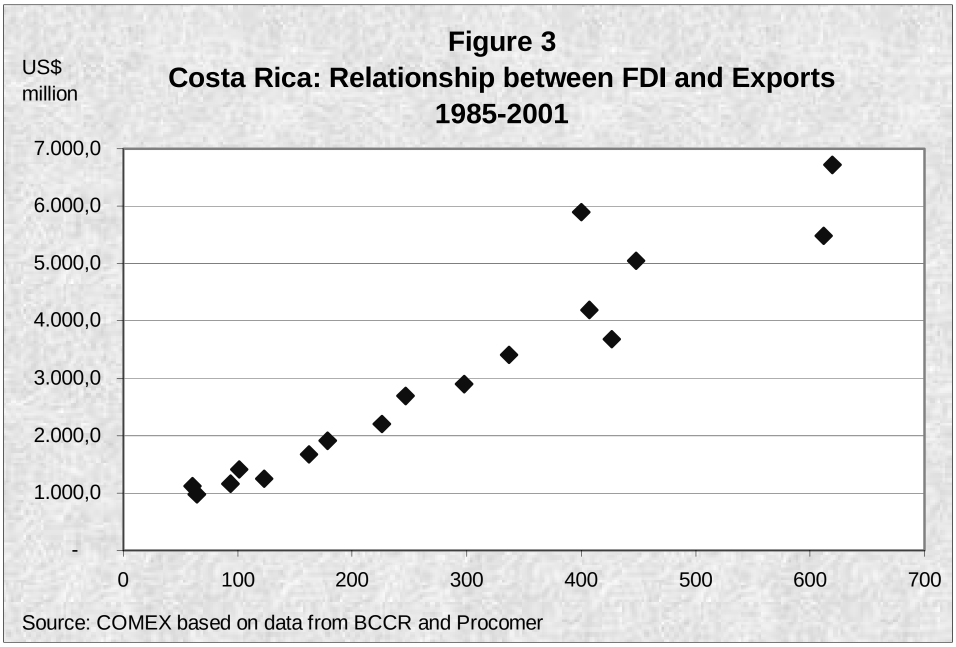
Three key factors, which are clearly understood by Costa Rican policy makers, explain the country's success in attracting increasing inflows of efficiency-seeking FDI. First, as efficiency-seeking FDI is export-oriented, securing preferential access to main export markets becomes pivotal. In this regard, Costa Rica has benefited from the Caribbean Basin Trade Partnership Act (CBTPA), which became effective in 1984 and was renovated in 2000. Under this law, with some key exceptions, most of the products exported from the Central American and Caribbean Countries receive duty-free treatment in the U.S.. Thus, multinational enterprises based in Costa Rica can place the country within an integrated international production strategy aiming at the U.S. market.

Second, providing a favorable environment for business has also been a crucial element of the strategy. Numerous variables interplay in providing international business with an adequate environment. Sections 2 and 3 of this report focus on them. Nevertheless, the traditional political and economic stability prevailing in the country, the strength of the rule of law, legal institutions and the low level of corruption have definitively played a key role in attracting FDI into the country, just as the tariff and fiscal concessions granted through the FTZ regimes seem to have played an important – although not always crucial role in this regard.

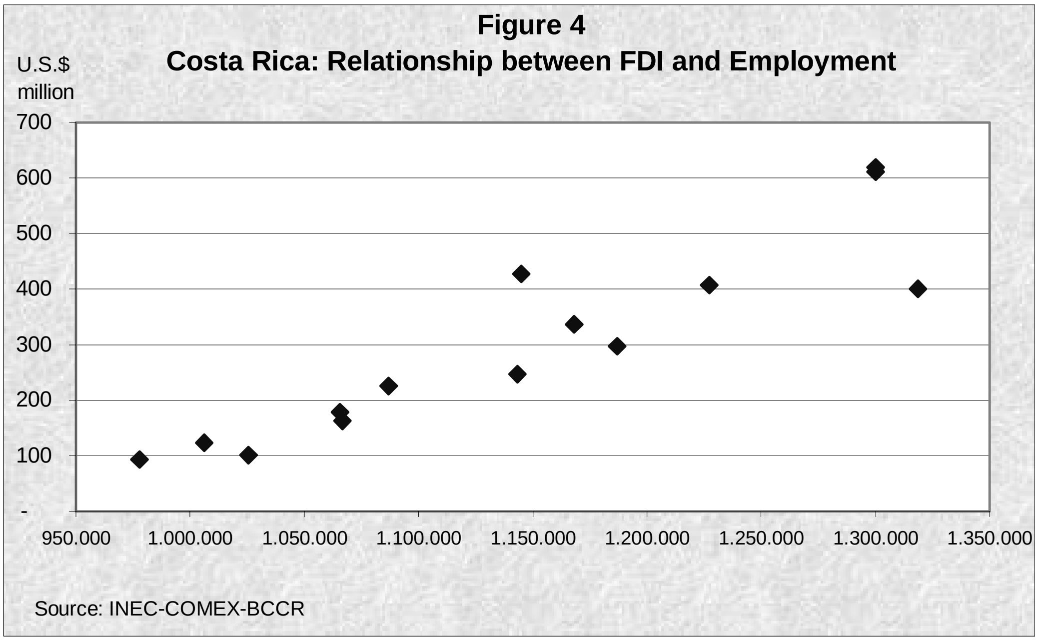
A third key factor of the Costa Rican success is its endowment of qualified labor at different levels of the skill spectrum. Indeed, even low skill labor is usually literate and able not only to perform more sophisticated tasks, but also able to easily learn other operational processes. This point is developed in section 2.11. below.

1.6 Economic Impact of FDI and Linkages with the Local Economy

As initially suggested in section 1.5 above, among the main positive impacts FDI inflows have had over the Costa Rican economy is its key role in fostering exports. Figure 3 shows a clear positive co-relation between the increase in FDI inflows and total Costa Rican exports.

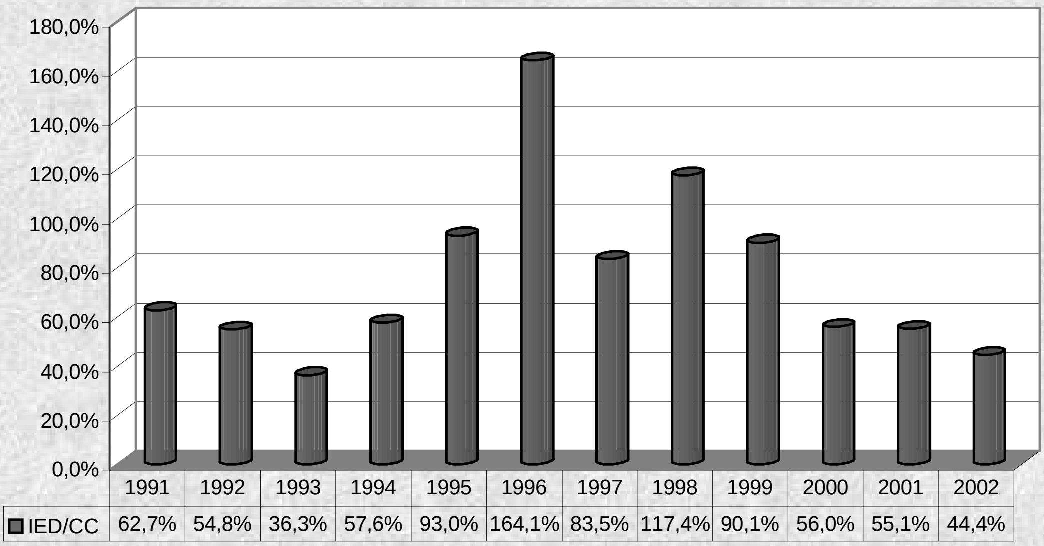


Another significant positive effect FDI inflows have had over the Costa Rican economy can be assessed in terms of generation of employment. In Costa Rica there are no specific statistics indicating the direct and indirect jobs generated by FDI. Data available only allows a comparison between the growth of FDI inflows into the country and the number of jobs created during the same period of time. Although such comparisons only infer indicative trends and not any causal relationship, data available suggest the existence of a positive co-relation between FDI inflows and employment generation. Figure 4 below illustrates that positive trend, showing how the number of total jobs in the country has risen substantially as FDI flows have also increased.



FDI has also played a key role in the overall macroeconomic stability of the Costa Rican economy. Indeed, during the last decade, FDI has become one of the major sources of cash to finance current account deficits. As shown in figure 4, FDI has become one of the main instruments to offset the trade deficit in the balance of payments of Costa Rica. During the last 12 years, FDI inflows have represented in average 76.25 percent of the current account deficit. In two years, 1996 and 1998, FDI inflows in fact were higher than the current account deficit, representing a significant source of fresh resources, and less volatile than other financing means, to the Costa Rican economy.

Figure 5: FDI as percentage of current account deficit 1991-2002



Fuente: BCCR

Despite efforts to generate linkages between export-oriented activities and the rest of the domestic industry, spillovers have so far been limited. Although, strictly speaking, numerous local companies are already supplying TNC's, the truth is that most of their offer is related to non essential parts of the product, packaging materials, office supplies, etc. There are a number of factors that appear to be behind this lack of linkages. First, the production pattern of many TNC's is founded on a vertical integration that limits the possibilities of local suppliers to become part of the chain. Many TNCs source themselves from approved suppliers located elsewhere, which provide the same quality service/raw material to similar facilities of the TNC in other countries. Second, there has been a technological gap hard to overcome for local suppliers which, to a great extent, keeps them away from becoming part of the production chain of the TNC. Third, venture capital is not widely available so as to facilitate initiatives that allow local suppliers to modernize or to close the aforementioned technological gap. And finally, there is a cultural dimension wherein local producers do not yet feel quite comfortable while dealing with TNC's demands.

Among the 4.842 enterprises that comprise the formal industrial sector in Costa Rica, 95% are SMEs[8] with less than 100 employees.[9] According to some recent studies,[10] these

---

[8] Any discussion involving the reality of small and medium enterprises (SMEs) must start by clarifying the parameters used to consider a particular business as part of this business category. The criteria used for this purpose vary significantly, not only between countries, but also among different institutions in the same country. The chart below illustrates that different definitions used by diverse institutions in Costa Rica. One criticism against the use of this criteria has been that the definition of SMEs must be

SMEs –that is, enterprises with less than one 100 employees— represent 28% of the Costa Rican GDP, 90% of the total manufacturing enterprises and generate 50% of the salaries and 80% of the jobs in the manufacturing sector. The national institute of statistics indicates that the workers hired by SMEs *with less* than 20 employees represent 26% out of the country's total employees. Further, it also indicates that private enterprises *with less* than 20 employees provide 51% of the total jobs in the private sector.[11]

The importance of SMEs in the Costa Rican domestic economy contrasts with their relative weight in the external sector. The majority of SMEs in Costa Rica are geared towards the domestic market, and those SMEs that in fact export, only represent a modest share of total exports from Costa Rica. Indeed, despite comprising 62% of the total number of exporting enterprises in the country, in 1999 participation of SMEs in the country's total exports represented only 13% of the total value of Costa Rican exports. Further, most exports of these SMEs tend to be concentrated in agriculture and final consumption manufacturing products (mostly foodstuffs).[12] Furthermore, in most cases, SMEs target markets are located in other Latin American countries, and in particular in Central America and the Caribbean, rather than in the United States, Europe or Asia.

These figures suggest the existence of a segmentation within the export sector in Costa Rica. Two categories of enterprises can be distinguished. A first category comprises

---

more dynamic and not be restricted to the number of employees or volume of sales, specially in the context of a dynamic and open economy, where exports can fluctuate and where the criteria used by other countries should also be taken into consideration.

PRONAPYME	CABEI	CRIC	CCSS
Micro enterprise 1-9 employees Small enterprise 10-20 employees	Micro enterprise 1-5 employees Small enterprise 6-40 employees	Micro enterprise 1-5 employees Small enterprise 6-20 employees Medium enterprise 21-100 employees	Range-based classification 1-4 employees 5-9 employees 10-19 employees 20-99 employees

PRONAPYME: Programa nacional para la pequeña y mediana empresa, Program for SMEs.
CABEI: Central American Bank of Economic Integration
CRIC: Costa Rican Industrial Chamber
CCSS: Caja Costarricense del Seguro Social, Social Healthcare Institute
Thus, Broadly speaking, in Costa Rica a micro enterprise tends to comprise less than 15 employees, a small enterprise tends to comprise around 50 employees and a medium enterprise less than 1000 employees

9 Source: Caja Costarricense del Seguro Social (CCSS)

10 Source: Fundacion para el Desarrollo Sostenible (FUNDES)

11 Source: Instituto Nacional de Estadística y Censo (INEC)

12 Source: PROCOMER.

highly competitive enterprises that have successfully penetrated the most demanding international markets. This group comprises some Costa Rican manufacturing enterprises and all of the multinationals that have invested in Costa Rica in export-oriented production activities. Export activities of these companies evidence the following trends. They tend to:

- be the bigger exporters,
- concentrate the bulk of the value of Costa Rica's manufacturing exports,
- export manufactures with higher technological content, and
- be oriented to markets in industrial countries –mainly the United States.–

The second category of exporters is comprised by most SMEs[13], the export activities of which evidence the following trends. They tend to:

- target the domestic market, while gradually penetrating some specific export markets
- be small exporters, relatively to the first category of enterprises
- export agricultural products and manufactures with a lower technological content
- be oriented to sub-regional markets, where geographic vicinity, familiar cultural consumer patterns, and less competitive environments increase their export possibilities.

Within this context, there is a need to implement effective mechanisms to internationalize Costa Rican SMEs, attempting to enable these enterprises to participate from the benefits of free trade and to compete in international markets. To fulfil this objective, several programs are being undertaken by several governmental agencies in coordination with private sector initiatives.

1.7 Future Perspectives

In Costa Rica there were national elections on February 3rd, 2002. For the first time in Costa Rican political history none of the candidates reached the 40% of the votes cast as mandated by the Constitution to avoid a second electoral round. Thus, on April 7, 2000 voters cast their ballots again, choosing between the two candidates with the higher amount of votes. Mr. Abel Pacheco, candidate for the official party, *Unidad Social Cristiana* (a social-christian party) was finally elected by a significant majority of the total votes casted, and was elected as President of the Republic for a four-year term. With the election of President Pacheco comes a team of economic advisors who share the basic market-oriented principles that have guided previous administrations. Thus, the export-led development model that has been continuously implemented since the 1980s will not likely experience any significant setback in the near future.

[13] An exception of the predominant trend in the export behavior of most SMEs is the software sector, where business with few employees and initial capital have been able to become true "small multinational enterprises" operating in several countries, even beyond the Americas.

The little likelihood of major changes in economic policy unfortunately also has a negative side. Just like the three previous administrations, the new government will likely be prevented from fostering the dismantling of the remaining State monopolies in key sectors such as telecommunications, which are becoming a serious bottleneck in Costa Rica's economic development. Privatization is a controversial topic in Costa Rica, and no political group is assuming the political cost of explaining to the population the benefits of opening up those sectors both to domestic and foreign investment.

The current administration will also need to master the political skills required to deal with the most fragmented Congress in Costa Rica's history. Traditionally bipartisan, during the last election in February 2002, Costa Rican politics experienced a major transformation. Two new parties, *Partido Accion Ciudadana (PAC)*, with a left-centre orientation, and *Movimiento Libertario*, with a right-centre orientation, positioned themselves in the national political spectrum together with the two traditional biggest political parties, i.e. the social democrat *Partido Liberacion Nacional (PLN)* and the social cristian *Partido Unidad Social Cristiana (PUSC).* In the latest election no single political party obtained sufficient seats to dominate the Legislative Assembly. The ruling party, the PUSC obtained only 19 out of 57 seats, the PLN 17, the PAC 12, the ML 6 and two minoritarian parties one seat each.

Thus, in this political scenario, a significant degree of political negotiation will be required in order to legislate. Although it might be early to tell, the Pacheco administration seems to have the capacity to deal with these challenges, as evidenced by the recent approval of the Costa Rica-Canada Free Trade Agreement by 53 votes of the Congress.

On the economic front, despite the current economic trend difficulties originated in the external sector, Costa Rica's macroeconomic indicators remain stable. Contrary to other countries of the region, as shown in table 10 below, Costa Rica does not suffer a serious foreign debt problem, as during the last five years, foreign debt and its service has maintained manageable proportions.

Table 10.
Costa Rica: Total Foreign Debt and Debt Service 1996-2000

Year	Debt (US$)	As % of GDP	Service	As % of Exports
1996	2,858.9	31.7	580.7	20.1
1997	2,640.2	28.9	583.2	17.8
1998	2,872.4	27.4	405.3	7.4
1999*	3,056.5	19.5	533.6	8.0
2000*	3,150.6	20.3	591.0	10.0
2001**	3,326.5	20.9	469.4	12.3

Source: Central Bank of Costa Rica, Census and Statistics Department, 2001
* From 1999 onward, the basis for the calculation is the 1991 GDP. Before 1999, the GDP used was that from 1966
** As of September 30th, 2001

After having an average annual growth rate of the GDP in real terms during the 1990s equivalent to 5.4%, mirroring the situation in most parts of the world, since 2000, the Costa Rican economy has begun to decline, mainly as a consequence of a weak external demand for goods and services and a deterioration of the international terms of exchange. In that year, the growth of the GDP in real terms was 2.23 percent, well below the 8.2 percent registered in 1999, the GDP per-capita reduced its growth rate to -1.2 percent. Nevertheless, the inflation rate was just above of the previous year at 10.2 percent. Although in 2001 there were not impressive signs of recovery, Costa Rica is not in the verge of a critical economic situation in the near term. Although several current economic factors led the GDP to grow only in 0.9 percent in 2001, production did not experience a contraction, and although the rate of open unemployment increased, it was to 6.1 percent only. Inflation prevailed at 11 percent, a figure similar to previous years. The prospects for economic recovery are highly probable as most economic indicators will likely improve once the U.S. economy overcomes the recession.

The prospects for increasing FDI inflows seem positive also due to the stability that those flows have maintained in the tourism sector -- which in fact have increased despite the terrorist attacks in the U.S. -- but in particular due to the imminent initiation at the end of the year 2002 of the negotiations for a free trade agreement between the United States and the Central American countries. The establishment of a free trade area between the U.S. and the Central American economies will definitively represent not only the culmination of a process of trade liberalization, but also the consolidation in the long term of the preferential access of Central American exports to the U.S. market, a key factor behind the success of the investment policy of Costa Rica.

For establishing the basis for a sustainable economic growth, Costa Rica will, however, need to tackle two main challenges The first is to continue to strengthen its human capital which, to a great extent is enabling the country to attract the kind of FDI that most developing countries desire: flows in higher value sectors, in particular in high tech manufacturing and different kinds of services. To continue the process of strengthening the Costa Rican educational system is vital for the success of this developing strategy. The country has gone a long way in this regard. The challenge now seems to be concentrated in undertaking a qualitative leap: foster increasing English and computer skills literacy. The second challenge Costa Rica will need to cope is of an internal nature. The government will need to tackle its public internal debt, and continue the process of attempting to open the State monopolies in certain key services which have an impact on the competitiveness of the productive sector.

PART II
Investment Environment

2.1. Structure of the Economy

In 2001, Costa Rica had a GDP of US$16,381.9 million and a GDP per capita of approximately US$4,065.0 [14]. During the last decade the Costa Rican economy experienced a significant positive growth. In fact, the country's real GDP grew at a compounded annual rate of approximately 4.6% between 1998 and 2002. During the last two years the pace of the growth rate has significantly decreased, from rates higher than 8% in 1998 and 1999 to 1.8% in 2000 and 1.1% in 2001. This information is further detailed in Table 11 below, which sets forth information regarding the respective growth rates for real GDP expenditures for the periods indicated.

Table 11

Rates of Growth of Real GDP Expenditures

	For the Year Ended December 31,				
	1998	**1999**	**2000**	**2001(1)**	**2002(1)**
Private expenditures on final consumption....................................	5.4%	2.2%	1.0%	1.3%	2.5%
General Government expenditures on final consumption	2.2	1.8	1.4	3.5	4.5
Gross fixed capital formation.............	25.5	(4.1)	(0.9)	1.5	7.9
Domestic demand...............................	9.1	(1.8)	0.6	6.2	3.7
Exports of goods and services............	26.7	21.3	(0.3)	(9.2)	2.8
Aggregate demand	14.0	5.4	0.3	0.7	3.4
Less: Imports of goods and services...	25.2	0.4	(2.6)	0.0	4.6
Gross Domestic Product	8.4%	8.2%	1.8%	1.1%	2.8%

(1) Preliminary data.

Source: Central Bank.

[14] . In 2002, preliminary estimations indicate that total GDP will increase to US$16,886.5 million, leading to a percapita GDP of US$4,102.3 . Source: Central Bank of Costa Rica

Based on statistics from the Costa Rican Central Bank, in 2002 five broad sectors comprised the main share of the Costa Rican economy. These were the following:

- industrial manufacturing;
- wholesale and retail commerce, restaurants and hotels;
- transportation, warehousing and telecommunications;
- community, social and personal services;
- agriculture, forestry and fishing.[15]

Table 12 below shows in greater detail the relative contribution of each sector of the Costa Rican economy to the country's real GDP during the last five years.

Table 12

Percentage of Real GDP by Sector

	For the Year Ended December 31,				
	1998	**1999**	**2000**	**2001[(1)]**	**2002[(1)]**
Agriculture, forestry and fishing	11.2%	10.8%	10.7%	10.6%	10.2%
Mining	0.1	0.1	0.1	0.1	0.1
Industrial manufacturing	21.9	25.3	24.1	21.9	21.7
Electricity and water	2.7	2.7	2.8	2.9	3.0
Construction	3.8	3.5	3.6	3.9	3.8
Wholesale and retail commerce, hotels and restaurants	18.9	17.8	17.8	18.0	17.9
Transportation, warehousing and telecommunications	9.1	9.0	9.7	10.5	11.3
Financial intermediation and insurance	3.5	3.5	3.8	4.0	4.1
Real estate	5.1	4.9	4.9	5.0	5.0
Other business services	2.3	2.4	2.8	3.3	3.4
Public administration	2.5	2.4	2.4	2.5	2.4
Community, social and personal services (excluding public administration)	10.9	10.4	10.5	10.6	10.5
Less: Financial intermediation services indirectly measured (FISIM)	2.1	2.1	2.4	2.4	2.7
Value added at basic prices	90.0	90.7	90.8	90.6	90.6
Less: Taxes (net of subsidies)	10.0	9.3	9.2	9.4	9.4
GDP	100.0%	100.0%	100.0%	100.0%	100.0%

(1) Preliminary data. Source: Central Bank.

[15] Based on preliminary data, the fastest growing sectors of the Costa Rican economy in 2002 were transportation; financial intermediation and insurance, warehousing and telecommunications (which includes cellular phone services); and electricity and water. Source: Central Bank of Costa Rica

Industrial manufacturing is a key sector of Costa Rica's economy, generating on average approximately 23.0% of real GDP since 1998 and accounting for approximately 73.7% of total exports and 19.3% of domestic employment in 2002. The most important manufacturing sub-sectors are food processing and beverage production, chemicals, textiles and the manufacture of wood and leather products. The rubber, processed foods and dairy products industries are also significant exporters. The manufacturing sector absorbs a large share of agricultural and livestock production as raw material.

The Costa Rican industrial manufacturing sector grew by 2.2% in 2002 as compared to 2001, primarily due to an increase in electronic manufacturing and growth in production in FTZs Exports from FTZ industries have experienced rapid growth in recent years. Indeed, value added exports from FTZs represented 35.0%, 53.9%, 50.5%, 46.7% and 48.2%, of Costa Rica's total exports in 1998, 1999, 2000, 2001 and 2002, respectively. [16]

The industrial manufacturing sector contracted by 8.4% in 2001 as compared to 2000, and by 2.9% in 2000 as compared to 1999, primarily due to a decrease in electronic component manufacturing by Intel Corp. resulting partially from its need to improve plant and equipment for the production of a new generation of products. In 2001, exports of electronic components from Intel Corp.'s facilities decreased 44.9% as compared to 2000 and by 35.3% in 2000 as compared to 1999. This significant decrease stemmed from the sluggish demand for electronic products resulting from the downturn of the U.S. economy during this period.

The wholesale and retail commerce and hotels and restaurants sector, which captures a substantial portion of Costa Rica's gross tourism receipts, was the second largest sector of Costa Rica's economy from 1998 through 2002, generating on average approximately 18.6% of real GDP since 1998 and accounting for approximately 24.3% of domestic sector employment in 2002. The Government has developed a number of initiatives to promote tourism over the past 17 years, and such efforts have begun to render fruit as the tourism industry has experienced a sustained growth since 1997. This fact explains why the wholesale and retail commerce and hotels and restaurants sector grew by 2.2% in 2002, as compared to 2001, and by 2.1% in 2001, as compared to 2000.

Since 1996, when the sector surpassed exports of bananas, tourism has become the major source of foreign exchange for Costa Rica. Further, in 1999, this industry surpassed exports of all traditional products combined (bananas, coffee, beef and sugar) in 1999.

The *Instituto Costarricense de Turismo* (Costa Rican Institute of Tourism) is the principal governmental entity responsible for the promotion and regulation of the tourism industry. In 1985, Costa Rica enacted a law to encourage the growth of the tourism industry by granting this industry special tax exemptions, permitting accelerated depreciation on certain items and allowing duty-free imports of capital goods. As part of its objective to further reduce its fiscal deficit, the Government, after discussions with the tourism sector, eliminated certain incentives it had given to the tourism industry as of March 31, 1999.

[16] Source: Central Bank of Costa Rica.

Notwithstanding the elimination of these incentives, new investments in the sector are projected for the next three to five years.[17] In 2002, investments in the tourism sector reached approximately US$47.7 million.

The third largest sector of the Costa Rican economy in 2002 was the transportation, warehousing and telecommunications sector . The compound annual growth rate of this sector between 1998 and 2002 was approximately 9.0%. The telecommunications segment of the transportation, warehousing and telecommunications industry in Costa Rica is controlled by *Instituto Costarricense de Electricidad* ("ICE") and its subsidiaries, the sole provider of telecommunications services in Costa Ricas. The growth of the sector during the period has been primarily due to an increase in demand for telecommunications and cellular communication services of ICE and *Radiografica Costarricense Sociedad Anonima* ("RACSA").

The community, social and personal services sector of the economy is the fourth largest sector of the Costa Rican economy and consists of all health, education, entertainment, cleaning and domestic and professional association services. This sector grew by 5.8%, 3.4%, 2.6%, 1.8% and 1.9% in 1998, 1999, 2000, 2001 and 2002, respectively.[18] The rate of growth has been decreasing as a result of a slowdown in economic activity. The compounded annual growth rate of this sector between 1998 and 2002 was approximately 3.1%.

Agriculture, forestry and fishing is the fifth largest sector of Costa Rica's economy, which in 2002 generated approximately 10.2% of real GDP. In 2002, the agriculture, forestry and fishing sector contracted by 1.0% as compared to 2001, principally due to a reduction in market prices for the country's traditional export products. In 2001, this sector accounted for approximately 10.6% of real GDP, approximately 25.4% of total exports and approximately 15.7% of domestic employment.[19] The compounded annual growth rate of this sector between 1998 and 2002 was approximately 2.6%. During the last 11 years, Costa Rica has maintained a surplus trade balance with respect to agricultural products. Costa Rica's principal cash crops are coffee, bananas and sugar cane, the majority of which are grown for export.

In 2001, the agriculture, forestry and fishing sector increased by 0.7% as compared to 2000, principally due to an increase in the value of coffee and poultry, partially offset by a decrease in world-wide coffee prices. In 2000, the agriculture, forestry and fishing sector grew by 0.7% as compared to 1999, principally due to a 10.7% increase in the fishing sector, partially offset by a decline in the volume of banana exports as well as decreases in international banana and coffee prices. During 2000, traditional agricultural

[17] These projects include the US$105.0 million investment by Four Seasons Hotels and Resorts in the Papagayo's tourist region, the US$38.0 million, 350 room expansion of Hotel Costa Smeralda, the inauguration of the US$21.0 million Alegro Papagayo Hotel, and the proposed US$10.0 million Hilton Airport Hotel. During 2000, investments in tourism projects totaled approximately US$204 million, compared with US$24.2 million during 1999.
[18] Source: Central Bank of Costa Rica.
[19] Ibid.

exports declined to an estimated US$877.8 million and imports declined to an estimated US$141.7 million.

This sector grew by 4.5% in 1999, in spite of adverse weather conditions including the effects of *El Niño* and *La Niña*. During 1999, traditional agricultural exports reached an estimated US$969.4 million and imports reached an estimated US$151.7 million. This sector grew by 8.2% in 1998 in spite of the adverse effects on the coffee, banana and sugar cane crops caused by Hurricane Mitch and other adverse weather conditions including *El Niño* and *La Niña*. The growth in this sector in 1998 was primarily due to increases in banana and sugar cane production.

2.2. Infrastructure

Road and Rail Network

In Costa Rica there are two road systems that cover 35.877 km throughout the whole national territory. First, the national road system that includes the most important roads and covers 7.422 km. Second, the rural road system comprises roads of local importance that are generally maintained by municipal governments. According to data from the Direction of Sectorial Planning of the Ministry of Transportation, up to July of 2001, this rural road network comprised 28.455 km of roads.

Although there is no accurate data to determine the exact percentage of the national territory covered by the national road system, it is possible to affirm that, with the exception of those areas declared national parks or wild life refuges, the rest of the national territory is connected through the road network, at least up to the main town of each county and each district of the country.

Despite its extensive coverage, Costa Rica urgently needs an effective and operating system capable of enabling increasing private investment in the modernization and expansion of its road network. Since the debt crisis at the beginning of the 1980s, due to fiscal constraints, the capacity of the government to pursue and finance public works has decreased significantly. In a country where significant parts of the physical infrastructure supporting the productive sector remains in the hands of the State[20], the contraction in public investment meant almost a complete paralysis in infrastructure development for more than a decade. In Costa Rica, public works projects are urgently needed to increase the competitiveness of the productive sectors and to facilitate the attraction of investment and new technology.

Given the tight budget constraints to finance public investment in the country, promotion of public work concessions has been identified as the means by which these urgent needs can be satisfied. Highways, railroads, seaport terminals, networks of sewer systems and other public works concession projects have been promoted. However, some of these

[20] By Costa Rican Law, seaports, airports, railroads, sewage, water distribution, telecommunications and energy are State monopolies.

projects remain stuck in the planning phase. More than four years after the Law of Public Works Concessions was passed amidst great enthusiasm and an ambitious list of projects drafted, the number of public works concessions awarded has been much lower than what was originally expected.

Some of the factors mentioned and associated with this tremendously disappointing results are the following: the inevitable learning curve of public officials and private sector with the new system; various deficiencies in the concessions law and the prevailing view among public officials and public opinion that concessions are seen as public contract and not a true partnership between the public and private sector. Last but not least, another cause that seems to be affecting the proper operation of the concessions law is the profit margin of some of the proposed projects, which may be unattractive.

These apparent causes should be taken into consideration and solved, once for all, to enable public concessions to flourish in Costa Rica. Thus, the identification of mechanisms to enable this system of adjudication of public contracts to operate efficiently ranks among the most urgent needs the country currently faces in the field of infrastructure development.

There are, nevertheless, a number of projects -- both proposed and underway-- related to the construction, maintenance and repair of the Costa Rican highway system. In 1999, the government of Taiwan granted Costa Rica the funds for construction of a bridge over the Tempisque River in the province of Guanacaste, in the northwest part of the country. The funds were granted pursuant to a reciprocal foreign investment promotion and protection treaty between Costa Rica and the Republic of China (Taiwan), under which Taiwan may grant loans to Costa Rica in an amount of up to US$82.0 million for public infrastructure and other projects. Construction of the Tempisque bridge was completed in March of 2003, for a total cost of US$27.0 million. The access road to this bridge is expected to be completed in July 2003 at a cost of US$7.0 million.

The contract for the construction of the San Jose-Caldera Highway corridor, valued at US$150.0 million and linking the capital with Costa Rica's main port in the Pacific coast, was awarded to the Costa Rica-Argentinean company, Cartelone-Acosol, in December 2001. Construction of the highway is expected to begin in August 2003. In April 2002, the Government signed a contract for the US$125.0 million San José-Puerto Caldera highway concession with Cartelone-Acosol, a Honduran-Argentine consortium, which was the sole bidder for the concession. The National Concessions Board also expects to auction two concessions to construct two expressways through the outskirts of San José requiring an aggregate investment of approximately US$250.0 million.

In a clear contrast with the road network, Costa Rica has a limited railway system. Rail network coverage accounts to 278 kilometers distributed in three main routes: Limón – San Cristóbal (109 kilometers), Limón – Valle de la Estrella (59 kilometers) and San José – Puntarenas (110 kilometers). In 2001, a concession to upgrade and operate the country's railroad network was not awarded since the only bid submitted did not meet the terms of the concession. The concession was to upgrade, manage, operate and expand the national railroad network, which ceased operations in June 1995. The required investment is estimated to be approximately US$65.0 million for the 25 year concession.

Naval and Transport Infrastructure

Costa Rica has two main ports, one on the Atlantic coast (Puerto Limón) and another one on the Pacific side (Puerto Caldera). These ports a serviced by approximately 22 naval companies with services to more than fifty ports worldwide. Both of two main ports are administered by state companies. On the Atlantic coast, the Board of Port Administration for Economic Development of the Atlantic Versant (JAPDEVA) is in charge of its administration while on the Pacific coast, it is the Costa Rican Institute of Pacific Ports (INCOP) the entity responsible for its management. Recently, the port on the Pacific coast, i.e. Puerto Caldera, is being subject to concession for private administration. However the adjudication process has not yet been completed.

Customs clearance in Costa Rica lasts takes between 24 to 48 hours, depending on the modality chosen by the importer to nationalize and withdraw the shipment from the warehouse. If the importer initiates the procedures before the ship docks in port (advanced dispatch), they become completed upon arrival, once the vessel transmits the information to Customs. Such transmission lasts approximately 24 hours and the merchandise becomes available to the importer once it is discharged from the vessel. In doing so, it can be subject either to documentary review or physical review. If it becomes subject to physical review, the procedures last 24 hours more.

The normal procedure entails the initiation of the paperwork once the merchandise has already arrived. In such case, the procedures last approximately 24 hours, including the review of the merchandise, depending on the speed of the carrier in moving the container. Such timing may be reduced to half if the merchandise is discharged at a bonded warehouse. Once the shipment has been nationalized, the carrier needs four or five hours to program its move to San Jose. Also, the trip from Limón to San Jose last six hours.

As the case of the road system, there are significant efforts to upgrade Costa Rica's port facilities. However, the process has not been easy. In 2001, the National Concessions Board and the *Instituto Costarricense de Puertos del Pacífico* (Costa Rican Institute of Pacific Ports) solicited bids for five concessions for the modernization of the grain and tuna terminal facilities located in ports on the Pacific Ocean. Two concessions did not receive any bids, one was awarded to the sole bidder, and the remaining two sought but lost appeals. Written agreements with each of the prevailing bidders are expected to be finalized in the second semester of 2003. Taiwan's Development and Cooperation Fund is also financing a project relating to the expansion and equipment of the Dock of Moin in Puerto Limón, in the Caribbean Coast of the country, with a US$15.0 million loan.

Air Transport Infrastructure

Costa Rica has a total of 125 airports, 4 of them international and 31 private. The main international airport is the Juan Santamaría Airport[21], located near the capital city of San Jose, and handling 92 percent of the total international traffic. This airport is serviced by more than 12 airlines, direclty linking Costa Rica with more than 20 destinations in the Americas and Europe. Currently, such airport is under the administration of a private company.

In 2000, *Gestión Aeroportuaria AGI de Costa Rica, S.A.* ("Gestión AGI"), a company formed by the international firms Airport Group International, Bechtel Enterprises and Bechtel Corporation and local firms Motorola de Costa Rica, S.A., EDICA Ltda., CORMAR and Agencias Datsun, was awarded a 20-year contract for the operation, administration, maintenance, restoration, financing, construction and promotion of the Juan Santamaría International Airport in San José. Pursuant to the contract, the airport remains the property of the Government. Gestión AGI is responsible for the administration of the airport and is required to make capital improvements to the airport over the life of the contract at an estimated cost of US$180.0 million, of which improvements estimated at US$100.0 million must be made within the first three years of the concession. During 2002, it is estimated that Gestion AGI spent US$24.8 million on construction of the airport and that it will spend US$23.0 million in 2003 on additional airport construction.

Customs clearance at the Juan Santamaría Cargo Terminal is fast. The average clearance time is approximately two hours since most merchandise that enters or departs from that terminal is transported in aircrafts that remain in land for only a couple of hours. Importing procedures take about 24 hours, including withdrawal from the warehouse. Exporting procedures last approximately 8 hours.

Infrastructure in Telecommunications and Energy

In December of 2000 Costa Rica had an installed capacity of 983.358 fixed telephone lines. This is the equivalent of 26 fixed lines per 100 inhabitants (260 per 1000). In addition, there were 13.868 public phones, representing 3,6 phones per 1000 inhabitants. Based on the National Census of 2000, 54% of dwellings had a phone.

In Costa Rica, telecommunication services are a monopoly of the state. There is only a sole provider, the Costa Rican Institute of Electricity (ICE). According to ICE, subject to the existence of appropriate infrastructure, that is, numbers and primary/secondary nets, installation of a telephone line can be performed in approximately three weeks. Waiting periods may be longer if such infrastructure is not available. Based on the Trade Policy Review Mechanism (TPRM) for Costa Rica at the World Trade Organization (WTO), in the year 2000 there were 73,2 faults repaired per 100 lines.

---

[21] There is another international airport located in Liberia, Guanacaste, in the northwest part of the country, close to some of the most important beach tourist destinations. From Liberia major international airlines have begun international passenger services, linking that town with major cities in the United States and Canada.

ICE has made important investments in fiber optic infrastructure. One example is its participation in the "Maya" cable network. The installation of the "Maya" underwater cable was completed in October 2000 and began operations in December 2000. The underwater cable is used to connect with other underwater telecommunications cable systems and has terminal points in Costa Rica, the United States, Mexico, the Cayman Islands, Honduras, Panama and Colombia. The total cost of the "Maya" project was approximately US$200.0 million, of which ICE contributed US$10.0 million. In April 2002, ICE completed a project for the installation of Arcos underwater cable for the transmission of data and voice at a faster rate than fiber optic.

Currently, ICE is working on the "Demanda Cero" project, which seeks to address the demand for domestic telephone lines. ICE's short-term plan to meet the country's demand includes the creation of projects to satisfy such demand within one year by, among other things, the installation of a fiber optic network between the borders of Nicaragua and Panama and the upgrading of the telecommunications network through the introduction of ATM technology. This project is expected to be completed in 2004.

ICE is authorized to sell 400,000 new cellular phone lines, and it has executed a contract with Alcatel which will allow ICE to acquire 400,000 GSM (Global System Mobil) cellular lines for US$151.0 million, payable in six years. ICE expects that the services will satisfy domestic demand and expects to open 15,000 cellular lines per month, beginning on December 15, 2002. This expansion is expected to double ICE's current cellular phone capacity.

Computer hardware is increasingly becoming part of the telecommunication infrastructure of Costa Rica. According to the latest National Census conducted by the National Institute of Statistics and Census on June 2000, there were 131.519 personal computers. Based on that same source, there are in Costa Rica 3.810.179 inhabitants, meaning that there are 34.5 computers per 1000 inhabitants.

Electricity and Power

Hydro-electric energy is Costa Rica's main source of energy supply. In the year 2000, the annual production of electricity was 6 921 594 000 kwh. Based on National Institute of Statistics and Census on June 2000, the production per head is 1816.6 kwh.

As of October 31, 2002, 89.6% of the electric power utilized in Costa Rica was generated by ICE. The remainder of Costa Rica's electric power was generated by other public sector entities and private sector power producers. As of October 31, 2002, the total electric power generation capacity of the Costa Rican electricity sector was 1,945.8 megawatts. In 2002, the electricity and water sector grew by 5.2%, which was greater than the rate of growth in 2001, due to a slowdown in the economy.

In 2001, the electricity and water sector grew by 4.1%, which was lower than the rate of growth in 2000, due to a slowdown in the economy. The electricity and water sector grew by 6.4% in 2000 as compared to 1999, principally due to an increase in residential consumption and the demand generated by electronic component manufacturing. This sector grew by 6.2% in 1999, principally due to an increase in residential consumption, an increase in public lighting services and the demand generated from Intel Corp.'s two plants. This sector grew by 8.7% in 1998, primarily due to the general increase in industrial manufacturing. Residential demand has been increasing steadily for the past several years. The compounded annual growth rate of this sector between 1998 and 2002 was approximately 6.1%.

There are important projects underway in order to expand the hydroelectric capacity of the country. The Angostura hydroelectric plant, located in the Turrialba, in the central part of the country, began operations on December 3, 2000. The Angostura hydroelectric plant has a generation capacity of 177 megawatts, and has increased the national interconnected system's energy capacity by more than 12.0%. The Peñas Blancas hydroelectric project, located in the northern part of Costa Rica, began operations in September 2002 with a generation capacity of 37 megawatts. The project cost approximately US$70.0 million.

In 2002, the Legislative Assembly approved a loan to be made by the Inter-American Development Bank to finance a project called the *Sistema de Interconexion Electrico* (the Electric Interconnection System) ("SIEPAC"). The entire project is estimated to cost US$320.0 million and the bank has agreed to lend an aggregate of US$240.0 million to Costa Rica, Guatemala, Panama and other Central American countries to implement this system. The Electric Interconnection System is expected to run between Panama and Guatemala and to begin operations in 2006.

During 2001, ICE obtained a US$154.0 million credit from the Japan Bank for International Cooperation ("JBIC") for the financing of the Pirris Hydroelectric Plant, located in the mountains south of the capital city of San José. ICE began construction of the plant in 2001. This plant is expected to open in 2007 with a generation capacity of 128 MW. ICE is also building a plant in Moín, in the province of Limón, in the Caribbean Cost, which is expected to open in 2003, with a generation capacity of 72 MW, and a plant in Boruca, located in the south-east part of country, which is expected to open in 2012, with a generation capacity of 832 MW.

2.3. Human Resources

A high level of education across the different sectors of society is one of the most significant achievements of Costa Rica. Costa Rica's literacy rate is 95.5%.[22] According to the most recent World Development Indicators Report published by the World Bank (2002), 6 are the average years of schooling in Costa Rica. Further, based on data from the National Census 2000, out of 3.433.595 people in school age, 92.85% currently pursue studies at different levels. In Costa Rica there is a total of 7.156 primary and secondary schools, which means that there is one school per 532 inhabitants. As shown in

[22] Human Development Index, 2001.

table 14 below, in Costa Rica there are more than three million students at different levels, the bulk concentrated in primary and secondary schools.

Table 14
Costa Rica: Absolute and percentual share of population in school age pursuing studies at different levels

	Absolute	%
Preschool	111.934	3.5
Primary	1.814.407	56.9
Secondary	773.710	24.3
Technical	138.092	4.3
University	350.110	10.9
Total	3.188.253	100

Source: National Census 2000

University level education in Costa Rica is highly developed and diversified. Based on the CONESUP (Private University Superior Education National Board) there are fifty-four universities: fifty private and four public. Two of them are focused on business, two on medicine, two on law, two on arts and architecture, and one in tourism. In addition, there are fourteen institutions that offer specialized training. Out of these fifty-four universities, four are public, and added together comprise 6.1385 students. These university centers are the following: Universidad de Costa Rica (UCR), Universidad Nacional (UNA), Instituto Tecnológico de Costa Rica (ITCR) and Universidad Estatal a Distancia (UNED).

Furthermore, there are forty-five institutes of higher education in Costa Rica. In 2001, twenty-three of them offered some sort of technical education[23]. There is a total of twelve public institutes of higher education that grant diplomas, technical or non-university degrees. Among them, there are the four public universities referred to above. The most common courses offered by the public institutes of higher education are focused on business administration (with different emphasis) and education. The other eight institutes are university colleges that offer diverse technical courses: cattle raising, mechanics, business administration, information technology, natural resources, production, industrial training, etc.

In addition, there are fifty-three private institutions of higher education that grant diplomas, technical or non-university degrees. Seven of them are private universities, which offer as well other kind of higher degrees. The other forty-six institutions only grant non-university diplomas. The most common courses are: business administration with diverse emphasis, accountancy, audit, marketing, information technology, secretarial courses (bilingual or not bilingual), tourism, dental technician, and English.

[23]National Integrated System for the Competitiveness of Technical Education (SINETEC), Technical Education and professional Formation in Costa Rica, 2001

The *INA: Instituto Nacional de Aprendizaje*, is the national training institute that offers technical professions, mainly for people who is already working. The INA is an autonomous institution created in 1965. Its mission is to promote the vocational development of men and women in all areas of production in order to stimulate the economic development and improve their living standards and job status.

Relatively to other countries, university education in Costa Rica has a moderate cost. Based on a research made by CINDE, the average cost for a Bachelor's Degree in a public university is US$1460, while the cost for the same diploma in a private university is US $3263. The study program for a Bachelor's Degree in a public university lasts at least 4 years, representing a yearly cost of US $365. The study program for a Bachelor's Degree in a private university last at least 2 years and 8 months, representing a yearly cost of US $1224 the first two years, and US $816 the third year. The only one exception is for Health Sciences since the Medicine study program last 5,5 years, and each year costs in average US $3450.

Regarding tuition costs to obtain a diploma in a institute of higher education vary significantly. Based on data obtained by CINDE, it was found that the cost of a non-university degree depends on the course and the institute. In a private institute, the average cost for the entire course is US $1092. The average cost per subject is US$ 50 and the average registration fee is US$ 50 per quarter.

The figures referred to above clearly illustrate the significant advance accomplished by Costa Rica in education. However, despite those achievements, the country needs to reassess the role of education in the fostering the competitiveness of the country in an increasingly competitive world. Thus, another area where Costa Rica should devote attention in order to promote further systemic competitiveness of its economy is the field of massive education and strengthening the training of its current and future labor force. Despite having one of the highest literacy rates of the Western Hemisphere given its particular context Costa Rica must reassess its concept of literacy in order to include two urgently needed elements: English proficiency and computer literacy.

For Costa Rica to be fully able to integrate its economy into the international market, its population must undertake a qualitative leap in their education and be able to speak English and be able to manipulate at least the basic information technology skills. These two objectives become increasingly important considering the kind of FDI inflows reaching Costa Rica. Sectors such as electronics, business services and tourism require a highly skilled labor force. Within this context, English and computer literacy have gradually become a basic requirement to accede into any kind of professional, technical or even some sophisticated manual jobs. Thus, to provide the majority of the population with this basic skills has become increasingly important, not only as a means to promote better opportunities for all the inhabitants of the country, but also to ensure the competitiveness of the Costa Rican economy as a whole.

As far as the labor force is concerned, as of July 31, 2002, the Costa Rican labor force consisted of approximately 1.7 million persons, representing approximately 42.4% of the total population. [24] As table 15 below shows, in 2002, the unemployment rate increased to 6.4% as compared to 6.1% in 2001, due to an economic decline, primarily in the manufacturing sector of the economy. In 2001, the unemployment rate increased to 6.1% as compared to 5.2% in 2000, again due to an economic decline, primarily in the manufacturing sector of the economy. However, in 2000, the unemployment rate decreased to 5.2% as compared to 6.0% in 1999.

Table 15

Labor Force and Employment
(thousands of persons, except percentages)

	At July 31,				
	1998	**1999**	**2000**	**2001**	**2002**
Labor force..........................	1,376.5	1,383.5	1,390.6	1,653.3	1,695.0
Employed(1).........................	1,300.0	1,300.1	1,318.6	1,552.9	1,586.5
Unemployed........................	76.5	83.3	71.9	100.3	108.5
Unemployment rate(2)..........	5.6%	6.0%(3)	5.2%(3)	6.1%(3)	6.4%(3)
Underemployment rate(4)	7.5%	7.8%(3)	7.3%(3)	N.A.	N.A.

(1) To be considered employed, a person above the minimum age requirement must have worked at least one hour with remuneration or 15 hours without remuneration during the preceding week.
(2) Unemployed population as percentage of the labor force.
(3) Not comparable to prior years because of a change in methodology instituted in 1999 by the National Institute of Statistics in compiling data.
(4) Underemployed population as a percentage of the labor force. Workers are defined as underemployed if they work fewer than 47 hours per week and are actively seeking additional employment or if they work more than 47 hours per week, but earn less than the minimum wage.
N.A. Not Available. Source: National Institute of Statistics.

According to Costa Rica's 2002 Annual Household Survey, private economic activity employed approximately 1,586.5 thousand people in 2002, representing 93.6% of total employed persons in 2002, compared to 1,552.9 thousand people in 2001, representing 93.9% of total employed persons in 2001.

Despite the significant migration from Nicaragua to Costa Rica, the Costa Rican labor market has been able to maintain low unemployment rates. The majority of these immigrants find work in labor-intensive seasonal agricultural activities, in the construction sector and in the domestic services sector.

[24] Source: July 2002 Annual Household Survey.

In Costa Rica, employment in the private sector is generally at-will, although employers must compensate employees terminated without just cause. Such compensation includes a notice of dismissal and a severance payment bonus based on the number of years of service.

The Constitution requires that minimum wages be fixed in each sector. Subject to this limitation, employers and employees are free to set wages and salaries. Employees may enter into collective agreement mechanisms and direct arrangements for collective bargaining of their salaries or may make use of wages and salary arbitration mechanisms. Costa Rican law provides protection against the dismissal of pregnant women and provides additional employment benefits to the disabled.

Public sector employees may be terminated only for just cause. Wages and salaries of public sector employees are subject to two annual cost of living adjustments. Since 1978, Costa Rican law has prohibited collective bargaining by public sector employees, except in specific institutions which had collective bargaining agreements in effect prior to 1978. In addition, the Supreme Court eliminated arbitration of public-sector employment disputes in 1993.

In Costa Rica membership in labor organizations is limited. Membership in unions as a percentage of the total number of employed persons decreased from 15.5% (160,166 persons) in 1992 to 11.9% (185,075 persons) in 2001. More Costa Ricans participate in *Asociaciones Solidaristas* (Solidarity Associations) ("Solidarity Associations"). Membership in Solidarity Associations as a percentage of the total number of employed persons increased from approximately 14.9% (170,406 persons) in 1996 to 15.9% (251,833 persons) in 2002. This increase in membership in Solidarity Associations is primarily because Solidarity Associations are permitted by law to collect in advance certain amounts of money related to severance payments from employers to be administered for the benefit of workers, who also contribute a percentage of their wages on a monthly basis to the Solidarity Associations.

In 1996, in reaction to pension reforms which required teachers to make increased contributions to the pension system, the teachers union engaged in a strike which lasted for six weeks. There has been no other significant labor dispute since 1982. [25] In 2000, some members of the unions representing the employees of ICE and certain other public sector unions demonstrated in reaction to the preliminary approval of legislation regarding the restructuring of ICE. This subject may remain politically sensitive in the near future.

In Costa Rica, wages are specified on a monthly basis, with the exception of the minimum wage, which is specified per day. Therefore, in order to calculate a per hour rate, the monthly total is divided by 48 (amount of regular working hours in a week) and then multiplied by 4.33 (amount of weeks in a month). Thus, the equation is as follows:

[25] Nevertheless, based on information compiled by the Department of Labor Relations of the Ministry of Labor, in 2001, there were in Costa Rica 4 strikes, one in the public sector, which lasted 1 day, and three in the private sector, all of them related to banana sector. All three strikes lasted a total of 3 days.

monthly wage/ (48 * 4.33). In average, hourly US$ earnings in manufacturing 2000 was equivalent to US$ 1.62 .[26] Table 16 below illustrates the evolution of nominal wages during the last five years in Costa Rica.

Table 16

Average Monthly Wages (in U.S. dollars)

	As of June 30,				
	1998	**1999**	**2000**	**2001**	**2002**
Private sector.......................	$342.8	$359.6	$373.0	$384.1	$386.1
Agriculture..........................	285.8	294.4	288.0	280.7	275.7
Industrial manufacturing.....	$384.7	$410.1	$430.7	$451.0	$467.1

Source: Central Bank, based on information of the Caja Costarricense del Seguro Social ("CCSS").

In Costa Rica several guarantees apply to hiring and firing practices. Currently, there are only two requirements for hiring. The first one is an age minimum that employers must observe. Since legal age is acquired at 18, employees aged 15 to 17 years old need a special permit from the National Childhood Board to work. The second one is related to the work of foreigners, who require a working visa that, like in many countries, may not be easily awarded to non-management employees, especially if there are people in the country able to perform the job.

As to firing practices, an employer may terminate an employment contract with or without just cause. When termination occurs without just cause, the employee is entitled to severance indemnities including the following:

- Advanced Notice: both the employer and the employee are entitled to up to one-month advance notice, prior to termination. Instead of giving advance notice, the employer or employee, as the case may be, has the option to pay an equivalent amount of salary.
- Termination indemnification: upon termination without cause by the employer, employees have the right to one month of salary per year during which the employment relationship has been in effect, up to eight years. The indemnification amount is calculated on the basis of an average of the last six monthly salaries paid.

[26] Source: State of the Nation Statistical Compendium, October 2001.

- Regardless of the cause of termination, employees are entitled to get paid any outstanding proportion of the mandatory 13th month bonus, as well as any accrued vacation days.

In those cases where there is just cause, the employee is entitled to the payment of wages, proportional vacation time and Christmas bonus. This bonus ("aguinaldo") is an additional one-month salary that must be paid to all employees after one year of employment. It is payable each year during the first twenty days of December. If an employee has not worked for a full year, the bonus must be paid proportionally.

Just causes for termination are specifically listed in the Labor Code, and they include physical or moral acts or libel committed against another worker or employer during and out of working hours; criminal acts or property damage; endangering security and working conditions; unauthorized release of confidential information; and disobedience of instructions or orders.

Foreign individuals without residency status and/or labor permit are not allowed to work in Costa Rica. Local and foreign entities doing business in Costa Rica may apply for special authorization from the Immigration Office to bring temporary workers, namely high-ranked executives and/or technicians, into the country. In practice, local authorities are flexible in granting work permits to qualified foreign workers.

As regards to immigration rules applicable to foreign workers, in the case of non residents, the company asks for a temporary work permit at the Immigration Department, previous to the employee's arrival into the country. The expiration of the permit will be defined by the type of occupation and other considerations. Residents have nothing more to comply with.[27]

2.4. Public Governance: Transparency, Integrity, and Rule of Law

Costa Rica has a long tradition for the respect of the rule of law and democratic rule. Constitutional mechanisms for the orderly transfer of power from one government to another are very clear, established and accepted. The current Political Constitution, enacted in 1949, establishes in Article 134 that the Presidential term will last for four years and that actions that violate the alternating of power will imply betrayal to the Republic. Moreover, Article 149 establishes that the President of the Republic along with the Ministers of Government will be jointly responsible when they attempt against the principles of alternating in the exercise of the Presidency or in the free presidential succession. In practice, an orderly transfer of power every four years has taken place since the Constitution was enacted.

Costa Rica political system is a representative democracy with three different branches: executive, legislative and judicial. The president and two vice-presidents run on the same ticket and are elected for a four year-term. In late March 2003, the Costa Rican Supreme court overruled Article 50 of the Constitution, which prohibited presidential election thus

---

[27] **Source:** Labor Ministry, 2001; Costa Rica's Labor Code.

creating the possibility for re-election. Elections for electing the members of the Legislative Assembly also take place every four years, on the same day of the presidential election. The Legislative Assembly is unicameral and comprises 57 representatives "*diputados*" who cannot be re-elected for consecutive terms. The Judicial System is headed by the Supreme Court that comprises 22 justices appointed by the Legislative Assembly who are considered elected unless a two-thirds majority of Congress decides otherwise.

Effectiveness of the political system in formulating and executing policy during the last administration (1998-2002) could only be rated as moderate. Several variables explain this assertion. One of the most important is related to the composition of Congress. During this term, there were more political parties represented at the Legislative Assembly than ever before, making it very difficult to achieve agreements on critical issues. Further, as the official party did not have a majority, it required the support from other parties even for those projects that only required simple majority. As a result, chances for the Executive Branch to obtain approval and support for many projects became considerably difficult.

The lack of a clearly recognized hegemonic leader in the opposition party, due to internal divisions, exacerbated this difficult governance situation. Thus, the administration had trouble finding a counterpart with whom to negotiate in Congress. Consequently, it was very difficult for the administration to implement key bills aimed at modernizing and deepening the market-oriented reforms initially undertaken at the beginning of the decade. In fact, several proposals aiming at opening up the energy/telecommunications sectors had to be withdrawn due this situation.

In spite of this very complex political context, important projects such as the *"Ley de Concesión de Obra Pública"* - which allowed for the concession of the administration of the International Airport and the construction of a new terminal to private investors-, or the *"Ley de Protección al Trabajador"* - which introduced important changes to the pension regime - were enacted during this term. Moreover, free trade agreements with Chile, Canada and the Dominican Republic seeking to increase and improve market access to Costa Rican products have been signed by the current Administration. Two of them have been already approved by Congress and the third is expected to be approved soon.

On February 3rd, 2002, there were national elections to appoint a new President and new Members of Congress. As to the election of Members to Congress, once again it came out highly divided. In fact, the allocation of seats in the parliament became even more fractioned than before, emerging not two, but four main political forces. Thus dynamics that prevailed during the last administration may continue due to this dispersion of power. However, the new Congress was inaugurated on May, and it may be too early to predict the evolution of the political dynamics.

In Costa Rica, the quality of the bureaucracy and its ability to carry out government policy is also moderate. However, important efforts are being pursued to simplify and reduce business-related red tape. In 1998, the *"Oficina de Simplificación de Trámites"* was created in order to streamline and facilitate business in the country. The success achieved by this office in the short period that has passed by since it was created has been very significant. Some of the most important goals achieved by this office are, among others, the following:

1. Close coordination between institutions involved in the attraction and establishment in the country of foreign investors: it has significantly simplified the procedures to be followed in order to start up operations.
2. Improvements introduced to the Free Zone and Active Finishing Regimes: it allows companies to handle their operations more adequately.
3. Clarification of procedures and paper work for the registration of fertilizers and pesticides: it allows companies to save time and money.
4. Training offered to the municipalities: it enables them to perform adequately their functions.
5. Simplification of the procedures for local purchases for companies in Free Zones.
6. Elimination of unnecessary requirements to import machinery and raw materials.
7. Clarification of the procedures to obtain municipal construction permits
8. Breaking up of the monopoly that neglected the import of fertilizers, pesticides and animal feeding products.

Furthermore, the recent enactment of the *Law for the Protection of the Citizen*, which seeks to remove all unnecessary requirements to conduct business, may be perceived as a commitment to continue simplifying and improving the business climate.

Costa Rica's enjoys a positive record in terms of transparency and government probity. As table No. 18 shows, in the Americas, Costa Rica ranks among the top four countries with more transparent and probe administrations together with Chile, Trinidad and Tobago and Uruguay.

Table 18
2001 Corruption Perceptions Index for Latin American and Caribbean Countries

	Rank	**Score**
Chile	18	7.5
Trinidad and Tobago	32	5.3
Uruguay	35	5.1
Costa Rica	40	4.5
Peru	44	4.1
Brazil	46	4.0
Colombia	50	3.8
Mexico	51	3.7
Panama	52	3.7
El Salvador	55	3.6
Argentina	57	3.5

Dominican Republic	63	3.1
Guatemala	65	2.9
Venezuela	70	2.8
Honduras	71	2.7
Nicaragua	78	2.4
Ecuador	79	2.3
Bolivia	85	2.0

Source: Transparency International (www.transparency.org)

In Costa Rica the Constitution and certain legal codes rule and sanction certain conducts as white collar crimes. However, there is no specific law focused on white-collar crimes. In Congress there is a bill entitled "Law Against Embezzlement and Corruption", awaiting second debate, which deals specifically with this particular kind of criminal acts.

Although perceived as a problem by the Costa Rican public opinion, in the country there is no systematized data on the number of cases related with white-collar corruption brought before national courts, nor on the number of times that such kind of trials have ended in effective sanctions. However, empirical evidence suggests that the judicial system has been able to reach and successfully trial a significant number of important political figures. Paradoxically, this apparent success has generated a perception in the public that corruption in the public sector is widely diffused.

Indeed, based on the 2001 Report published by the Inter American Development Bank named "The Business of Growth: Economic and Social Progress in Latin America", Costa Rica holds the fourth best position in Latin America regarding the quality of its institutional environment. This index summarizes the opinions of business communities as to the rule of law and control of corruption. This ranking puts Costa Rica within the world average.

Costa Rica is one of a few Latin American countries where a legal body, jurisprudence and doctrine in administrative law has developed. In Costa Rica the time for the judgment on a particular case in administrative proceedings depends on the nature of the proceedings, the complexity of the matter, and the administrative authority before which it is being processed. Article 261 of the General Law For Public Administration provides that the maximum duration term of an ordinary administrative procedure is of two months; however, this type of proceedings normally take between six months and one year in average.

With respect to the terms established for obtaining the response on requests, Article 331 of the General Law for Public Administration establishes a one-month term, after which, in absence of an answer on behalf of the Administration, it is understood that the request, license or permit in question was approved by positive silence.

Article 18 of the Law on Alternative Resolution of Conflicts and Promotion of Social Peace (Law 7727) establishes that the Government can submit a controversy with subjects of private law, such as corporations, to arbitration. However, jurisprudence as to the specific kinds of matters subject to this special jurisdiction has been quite restrictive.

In case of an administrative/executive action, an administrative dispute can be resolved within an average term of six months to one year, in accordance with its complexity. In case the matter is referred to the knowledge of the court of appeals or "casación", the final resolution of the case might take an estimate of four to five years. There is not a special court in charge of the resolution of disputes in matters related to foreign investment. The regulatory scheme for foreign investment is contemplated by several laws and regulations, and the solution of eventual conflicts shall be carried out through regular courts and proceedings.

In 1989, Article 10 of the Political Constitution was amended, with the purpose of creating the Constitutional Court of the Supreme Court of Justice, which essentially hears and resolves cases related to the protection of the individual fundamental rights.
Pursuant to Article 7 of the Costa Rican Constitution, the stipulations contemplated in international treaties have a hierarchical supremacy over internal laws and regulations. The Constitutional Court has also held that if there are international provisions regulating the fundamental rights of individuals in a more complete manner than the Constitution, the former apply. Furthermore, under the country's constitution, private parties can directly invoke international agreements as applicable law in domestic courts.

As far as corporate governance is concerned, Costa Rica is one of the few Latin American countries with a competition policy legislation. The "*Ley de Promoción de la Competencia y Defensa Efectiva del Consumidor*", No.7472, dated December 20th, 1994, was published in the Official Journal La Gaceta on January 19th, 1995. The "*Reglamento a la Ley de Promoción de la Competencia y Defensa Efectiva del Consumidor*" was adopted by Executive Decree No. 25234 MEIC of January 25, 1996 and published in the Official Journal La Gaceta on July 1st, 1996.

According to Article 18 of the aforementioned law, it is the Commission for the Promotion of Competition the specialized agency in charge of implementing and verifying the compliance with the competition policy legislation. The Commission is advices by t*he Technical Unit of the Commission,* which has 12 employees, 9 of which are professionals in the areas of law and economics. The other 3 professionals considered as personnel support. For the conduction of certain studies, the Technical Unit may request the support of the Unit of Economic Studies of the Ministry of Economy, which has 10 professionals.

The Commission is part of the Ministry of Economy, however being a body with maximum legal de-concentration, the Commission is not accountable to the Minister, and constitutes itself the highest hierarchy in the administration for competition policy matters.

By comparison with legislation of industrial countries, Costa Rican legislation on competition policy is less repressive. According to Article 25 of the law, the maximum fine applicable is equal to six hundred and eighty times the lowest minimum monthly wage. However, when the Commission finds that the fault incurred is particularly serious, it can raise the fine up the higher amount between 10% of the annual sales obtained by the offender during the previous fiscal year or to 10% of the value of the assets property of the offender. Articles 16 (Mergers & Acquisitions) and 24, paragraphs c) and e), the existing legislation on competition allows the Commission to conduct only after merger controls.

2.5. Trade Regime

In Costa Rica the main responsibility for trade policy implementation remains with the Ministry of Foreign Trade (COMEX). Over the last twenty years, Costa Rica has followed a trade policy meant to integrate its economy into international markets.[28] The implementation of this policy is reflected largely in the increase in Costa Rica's exports, the diversification of its products and markets, the increase in foreign direct investment, and the generation of employment by the export sector.

Three decades ago, Costa Rica was significantly dependent on four traditional agricultural goods (coffee, bananas, sugar and beef). Today, the country exports approximately 3,000 products. The number of agricultural goods sold abroad, such as watermelons, pineapples, melons, tubers and ornamental plants, has increased. In addition, Costa Rica is exporting high- technology products, such as computers, medicines, and medical equipment. As a result, the four traditional products accounted for only 14.3% of Costa Rica's total exports for the nine-month period ended September 30, 2002.

Costa Rica has also increased its market diversification during the last decade. Costa Rica exports are directed to approximately 130 different destinations around the world. Approximately 53.0% of Costa Rica's exports are sent to the United States, 16.5% to the European Union, 13.1% to Central America, 5.5% to Asia, and 2.9% and 2.1% are directed to countries in the Caribbean and South America, respectively.

Costa Rica’s trade policy has three different but convergent dimensions: the domestic, multilateral and regional.

[28] This policy has been quite successful. Indeed, between 1995 and 2000, trade in goods and services rose from some 78% to 97% as a proportion of GDP.

On the domestic front, access for imported goods into Costa Rica's market has improved during the last seven years. Between 1995 and 2000, the average MFN tariff decreased from almost 12% to 7%. At 15% and 6%, average tariffs are considerably higher for agricultural than industrial products. As part of its market access commitments under the WTO Agreement on Agriculture, Costa Rica established tariff quotas for various agricultural products, (e.g. certain dairy and poultry products), although in almost all cases the filling levels have been low. Tariff reductions under preferential agreements have also contributed to greater access to Costa Rica's market.

Costa Rica bound all but five tariff lines at the WTO, most at a maximum ad-valorem rate of 45%; exceptions include mostly agricultural products, for which bound rates are in some cases as high as 233%. Closing the wide margin between applied and bound rates would further increase the predictability of market access conditions.

Imports are subject to domestic taxes applied uniformly with respect to their origin and in accordance with the national treatment principle, except for a few beverages. In addition, the domestic commercialization regime for alcoholic beverages discriminates between most imported and domestic products.

The use of non-tariff trade barriers appears limited. Costa Rica maintains various import restrictions and prohibition, generally for health, security or environmental reasons. No anti-dumping or countervailing duties were applied between 1995 and 2000, although four anti-dumping investigations were initiated. Likewise, with the exception of special safeguard measures applied to rice and beans under the WTO Agreement on Agriculture, no safeguard measures were taken.

There are no estimates of the global impact of programs to promote production and exports, although their number and diversity raise questions about their effectiveness and the economic distortions they might induce. To promote exports, Costa Rica maintains various special import regimes, notably the free zone regime. Export subsidies granted through a tax credit mechanism (Certificados de Abono Tributarios) were eliminated in late 1999 although some benefits are still being paid. .

As at early 2001, Costa Rica maintained a tax on banana exports; taxes on coffee and meat exports were eliminated in 1999. From May 2000, Costa Rica has applied quantitative restrictions to coffee exports, retaining 20% of its export supply. The European Union grants Costa Rica's banana exports preferential market access through tariff quotas. Canada and the United States apply import quotas to its textile and apparel exports under the WTO Agreement on Textiles and Clothing.

Competition legislation adopted in the mid 1990s has resulted in an increasing number of actions by the competition authorities. However, competition remains restricted in a few but important areas. For instance, in practice the external and internal commercialization of domestically produced sugar is controlled by a cartel. Likewise, the State holds a monopoly on the importation, refining and wholesale distribution of crude oil, fuels derived from oil, asphalt and naphtha. The State also regulates the price of several goods and services, including public services and the marketing of various agricultural products such as bananas, coffee and sugar.

During the last seven years, Costa Rica has promoted the expansion of export-oriented manufactures through special fiscal regimes, notably of electronics under the free zone regime. However, despite efforts to generate linkages between export-oriented activities and the rest of the domestic industry, spillovers have so far been limited. Moreover, fostering those activities disadvantages other industries not enjoying the same privileges. Apart from the special fiscal regimes, measures to promote industrial production have focused on small and medium size enterprises.

In spite of its decreasing share in GDP, agriculture remains an important sector because of its contribution to employment and export earnings. A small number of agricultural products for domestic consumption are protected through higher than average tariffs and safeguard measures. Agricultural production in general benefits from other support measures, including fiscal incentives and specific financing programmes. Notwithstanding such support, and in spite of the traditionally high productivity of Costa Rica's producers, its two major agricultural exports, banana and coffee, have come under considerable pressure in recent years. This reflects both adverse international market conditions as well as competition for factors of production, particularly land and labour, from other sectors.

No major changes affected the services sector between 1995 and 2000. Tourism remains a main magnet for foreign exchange and investment, but long-standing inefficiencies in some other service areas impose unnecessary costs on other activities. The State retains monopoly rights on insurance, telecommunications and energy distribution.

Notwithstanding growing private participation in the banking industry, state-owned banks, favored by current regulations, still dominate the industry. Faced with vocal opposition from interest groups, the Government was unable to pass legislation it considered of prime importance to modernize key service activities, notably telecommunications. Pressure for reform arises from the widening gap between decades-old legislation, changing technology and new market imperatives. Pressure for reform arises from the widening gap between decades-old legislation, changing technology and new market imperatives.

In the external front, Costa Rica has followed a “double track” liberalization strategy leading to new commitments at a multilateral and regional level.

Since its accession to the GATT in 1990, Costa Rica has participated actively in the multilateral trading system. Costa Rica is a founding member of the WTO, and the Marrakesh Agreement Establishing the WTO has become an integral part of its domestic legislation. Costa Rica was also the first Latin American country in signing the Ministerial Declaration on Trade in Information Technology Products (ITA), and also has ratified the financial services protocol to the GATS. On the other hand, Costa Rica's commitments under the GATS are relatively limited; in general, for the sectors included in its Schedule, only market access and national treatment for consumption abroad have been bound.

Costa Rica has used the multilateral dispute settlement mechanism to protect its trade interests. Its decision to pursue a claim against certain measures affecting trade in underwear in the United States represented the first textile-related dispute ever brought to the WTO dispute settlement forum. This case –which was won by Costa Rica-- represented a watershed in the evolution of the system and demonstrated the importance for small developing countries of having access to a rule-oriented international adjudication mechanism. In part due to this effect, both the authorities and the public at large hold a positive perception of the WTO and its impact on small countries. Recently, Costa Rica supported the launch of the Doha Development Round (the “Doha Development Round”), which is the current round of multilateral trade negotiations by and among the 144 countries that are members of the WTO.

The Agreement on Trade-related Aspects of Intellectual Property Rights (TRIPS Agreement) became part of Costa Rica's legislation through its ratification of the Marrakesh Agreement. Subsequently, Costa Rica has enacted or amended related domestic regulations to harmonize them with its international obligations and thus facilitate their application. Those changes were notified to the Council for Trade-Related Aspects of Intellectual Property Rights in late 2000.

At a regional level, since 1994, Costa Rica has been an active participant in the efforts to establish the Free Trade Area of the Americas (the “FTAA”) and remains committed to the establishment of the FTAA by 2005. Costa Rica has supported new negotiation initiatives and currently chairs the Government Procurement Negotiating Group, the goal of which is to increase market access to North America, Latin America and South America.

Currently, Costa Rica has bilateral agreements in force with Mexico, the Dominican Republic, Chile, and Canada, and is in the process of negotiating free trade agreements with Panama and several Caribbean countries. Furthermore, the Central American countries, including Costa Rica, recently began negotiating a free trade agreement with the United States, Costa Rica's main trading partner, which is expected to improve Costa Rica's ability to attract foreign investment and help Costa Rica pursue and consolidate economic reforms.

Since the free trade agreement with Mexico was entered into in 1995, Costa Rican exports to Mexico have increased more than 500.0%, while Mexican imports into Costa Rica have tripled. Beginning in 1998, Costa Rica has replaced Guatemala as the main Central American supplier to the Mexican market. Similarly, Mexico has become the second largest exporter of goods to Costa Rica, after the United States.

The free trade agreement with the Dominican Republic became effective in 2002. Costa Rican exports to the Dominican Republic increased approximately 38.0% during the first 10 months of 2002, compared to the same period in 2001.

The free trade agreement between Costa Rica and Canada, which became effective in November 2002, represents the first agreement signed by a smaller country and a G-7 country. Market access provisions in the agreement grant certain Costa Rican products, most notably refined sugar and textiles, preferential access to the Canadian market.
The foreign trade sector depends largely on the economies of the other Central American countries as well as the economies of the United States and the European Union. Together, Costa Rica exports approximately 82.6% of its export products to these areas. The economic slowdown in those countries, together with the uncertainty regarding the magnitude, duration and impact of the economic slowdown on the world's economic growth, are important causes for the slowdown in demand for the Republic's exports and therefore the slowdown of the Republic's production of goods for export.

The United States of America is Costa Rica's most important trading partner. For the nine month period ended September 30, 2002, trade with the United States accounted for approximately US$599.0 million, or 15.3% of total exports, and approximately US$1,161.0 million, or 21.6% of total imports. These figures do not include exports from Free Zones, which, if added, would increase the amounts to 49.2%; imports from Free Zones to 54.2%

Trade with members of the CACM has increased over the past five years as the economies of these countries have become more stable. Exports to CACM countries increased to US$388.5 million during the first nine months of September 2002 from US$354.9 million for the same period in 1998. Imports from CACM countries remained constant at US$228.8 million for the first nine months of 2002 when compared with the same period in 1998. In the first nine months of 2002, Costa Rica maintained a positive trade balance with each member of the CACM.

The devaluation of the Mexican peso in December 1994, together with a free trade agreement with Mexico that became effective January 1, 1995, led to a significant increase of Costa Rican imports from Mexico during 1995 and 1996. Imports from Mexico continued to increase in 1998, 1999 and 2000 at approximately the same pace as imports generally. However, imports from Mexico decreased by 2.6% in 2001 and 4.1% in the nine-month period ended September 30, 2002. Following the enactment of the bilateral free trade agreement, Costa Rica's exports to Mexico increased significantly in 1996 and continued to grow in 1997. Costa Rica's exports to Mexico declined sharply in 1998, grew at the same pace as exports generally in 1999, decreased by 6.6% in 2000, and decreased by 30.8% in 2001 from its level in 2000.

During the first nine months of 2002, exports to Mexico represented 1.2% of total exports, a proportion that has been generally maintained since 1998; while imports for the same period represented 4.8% of total imports. In previous years, this percentage has remained between 5% and 6% of total imports.

2.6. Investment Regime

In Costa Rica there is not any registration requirement for FDI, nor is any FDI project subject to screening or approval. Furthermore in Costa Rica there is not any specific legislation targeted exclusively foreign investment and there are not specific limitations applicable to foreign investments.

According to the jurisprudence of the Constitutional Tribunal established in 1989, by constitutional mandate, foreigners and nationals are considered equal and are granted the same rights and obligations. However, given that such constitutional mandate has been effectively implemented by jurisprudence, existing legislation discriminating against foreign investment may remain applicable until an citizen challenges such discrimination through a writ of "*amparo*", a special but informal and relatively fast procedure to safeguard basic civil rights.

For those sectors in which limitations to private participation exist, the same rules are applied both to nationals and foreigners. However, there sectors closed to domestic as well as foreign investment by public or publicly authorized private monopolies. They are the following:

- Coal deposits, oil sources and reserves, and any other hydrocarbon substances, as well as radioactive mineral deposits existing in the national territory and its seabed; mineral resources existing in the national territory and its seabed, regardless of the kind, physical state and nature of the substances that they content.

- Ownership of railways, naval ports and airports (their administration may be granted under concession)

- Import, refinery, distribution and wholesale distribution of crude oil, derived fuels, asphalt and naphtha

- Alcohol production

- Postal communication services

- Cable and wireless services

- Energy exploitation (forces that may be obtained from the waters of public dominion in the national territory)

- Water supply services; collect and disposal of sewage water and liquid industrial waste; aqueduct and sewage system services

- Insurance and reinsurance.

In Costa Rica there are no different corporate tax rates applicable depending on the nationality of the corporation, nor there are any special incentives or allowances applicable to foreign-owned firms. However, in the country there are other special incentives or allowances applicable to all corporations depending on participation on a special scheme. Given that most export-oriented FDI in Costa Rica locate in FTZs, it is worth explaining in greater detail what is entailed by this particular regime.

The **Free Zone Regime** ruled by law No. 7210 of November 23, 1990 encompasses a number of benefits and incentives granted by the Government to those companies that make new investments in the country. It applies not only to export processing industries but also to commercial enterprises, service companies, industrial parks managerial companies, research entities and companies operating shipyards and docks to build or repair ships.

Under this regime, companies are allowed to enjoy the following incentives for a certain period:

- 100% exemption from import duties and consular taxes on raw materials, parts and components
- 100% exemption from import duties and consular taxes on fuels, oils and lubricants not locally produced
- 100% exemption from import duties and consular taxes on machinery, equipment and certain vehicles
- 100% exemption from sales and consumption taxes on local purchases of goods and services
- 100% exemption from taxes on profits, dividends, etc., for a period of 8 (12) years and a 50% exemption for the following 4 (6) years for enterprises in more developed areas (lesser developed areas)
- 100% exemption from municipal taxes for 10 years (in certain areas)
- 100% exemption from taxes on profit remittances abroad
- Tax credit equivalent to 10% of salaries paid by enterprises in lesser developed areas
- Other non-fiscal benefits

The investment regime applicable to foreign investment in Costa Rica has also been complemented by a series of bilateral investment treaties (BITs) negotiated by the government, the majority of which have been negotiated during the last decade. As most countries of the continent, Costa Rica has negotiated BITs which grant the right of establishment to most FDI –that is the case of the BIT with negotiated with Canada -- as well as BITs which, following the European model, contain admission clauses. Table 19 lists all the BITs negotiated by Costa Rica up to date as well those which are in process of negotiation. In addition to the BITs, Costa Rica has also negotiated Free Trade Agreements (FTAs) which contain investment chapters. That is the case of the FTAs with Mexico and Dominican Republic.

Table 19
Costa Rica
Bilateral Investment Treaties (BITs)

BITs in force	**Concluded negotiations**	**Ongoing negotiations**
Argentina	Ecuador	Austria
Canada	Finland	Barbados
Chile	Bolivia	Brazil
China (Taiwan)	Poland	Denmark
Czech Republic		Greece
France		Ireland
Germany		Jamaica
Great Britain		Italy
Korea		Norway
Netherlands		Peru
Paraguay		Portugal
Spain		Rumania
Switzerland		Sweden
Venezuela		Uruguay

Source: COMEX

2.7. Investment Promotion Agency: Costa Rican Investment Board (CINDE)

Founded in 1982 with significant involvement of the Costa Rican private sector, and with substantial funding from the United States Agency for International Development (USAID), the Costa Rica Investment Board (CINDE) is a private, apolitical, non-profit organization whose mission is, on the one hand, to attract foreign direct investment in specific sectors of the economy; and on the other, to advocate for changes and constant improvement in the investment climate so as to increase the country’s attractiveness for the performance of certain economic activities where Costa Rica enjoys a competitive position. In view of the importance of its role, CINDE was declared of public interest by the Costa Rican government in 1984.

It is undeniable that the influx of foreign investment is of the utmost importance to Costa Rica, not only for balance of payment reasons, but most importantly as a significant contributor to the generation of employment, technology transfer and diversification of exports. Such recognition is reflected on the direct relationship established, more consistently since early 90's, between the national development strategy, the FDI policy and the developmental impact. It can be clearly observed that Costa Rica's success stems from the design and implementation of a developmental policy aimed at using FDI to resolve a developmental challenge. It was precisely the adoption of a strategy that focused on more sophisticated assembly activities, the use of highly skilled human resources and on a more targeted approach to attracting FDI that enabled Costa Rica to attract some of the most important high tech and services companies worldwide, i.e Intel, Abbott Laboratories and Procter & Gamble.

As a rule, foreigners have exactly the same rights as locals for conducting business in Costa Rica. Therefore, companies and individuals can establish operations in several ways and in almost every industry without limitations. This also means that the possibility of creating strategic alliances between foreign and local companies is only limited by the ability to identify the appropriate market opportunity and finding the right local partner.

Within that context, CINDE works to foster Costa Rica's development, by serving as a catalyst and facilitator for the investment process in the country. Its non-political stance, coupled with its broad-based interest position, allow CINDE to maintain excellent relations with both the public and the private sectors. More than that, given that CINDE's performance and chances to succeed are closely linked to the quality of "the product" it has to offer and how effectively it portrays Costa Rica as an ideal investment location, a continued and renewed improvement of the country's investment climate becomes key to adequately carry out this task. Therefore, although it goes beyond CINDE's scope of direct activity to actually materialize those changes needed to raise national competitiveness, the role the agency plays in highlighting issues and putting pressure upon the system to try to provoke those necessary modifications to the prevailing business environment is crucial. It should be borne in mind that CINDE enjoys a privileged insight and position that allows the agency to learn first hand about the main concerns of the investors, to fully understand the obstacles they face while operating in the country and even the reasons why certain projects decided in favor of another country. In consequence, CINDE's assessment and policy recommendations are valuable tools to establish national priorities in terms of education, availability of human resources with certain skills, infrastructure, availability of certain services at competitive costs, etc.

CINDE is organized to promote Costa Rica as a competitive investment site in three sectors that benefit from significant strengths and advantages that the country offers: Medical Devices, Electronics, and Services. A fourth sector, Special Projects, includes projects in areas such as textiles, tourism, and others.

Investment promotion executives support the work in each sector and specialized researchers analyze specific market segments and tendencies, identify subsectors of interest, study and generate relevant information and lists of potential investors.

CINDE's offices in New York and California proactively look for companies interested in expanding operations abroad and provide tailor-made services to investors. An additional team in Costa Rica advises on how to do business in the country, creates custom itineraries according to the investor's needs, and provides support during and after the establishment of operations. CINDE develops long-term relationships with those investors established in the country and is committed to provide them with continued assistance as may be required. It is not by coincidence that the most recent World Investment Report 2002 published by the United Nations Conference on Trade and Development (UNCTAD) distinguished CINDE as "a state-of-the-art IPA".

PART III.
Investor Perceptions and Policy Recommendations

1. Investor perceptions[29]

"My niche is not low cost, my niche is quality". This is a statement of a foreign investor who opted to locate a suit factory in Costa Rica less than five years ago, and to a great extent, reflects the perception that most international investors have of the country as a location to do business. Indeed, due to numerous factors, among others its social security and salary structure, Costa Rica's comparative advantage to attract FDI is far from relying on low-cost wages. In fact, relative to other countries of the region, average wages in Costa Rica are significantly higher. However, despite this fact, as this report has demonstrated, during the last decade Costa Rica has managed to be a success story as far as FDI attraction is concerned.

Foreign investors may not perceive Costa Rica as a cheap place to do business, however, they perceive the country as a place where —due to several reasons-- FDI can be instrumental for foreign firms to remain competitive in international markets. In this regard, four main variables seem to be key for foreign investors:

- Political stability and rule of law
- Productivity, education and culture of the work force
- Geography
- Preferential access to U.S. market

Foreign investors perceive Costa Rica as a stable country, not only from a political point of view, but also from a social perspective. The risk of armed conflict or social unrest is perceived as minimal. This view seem to stem from the fact that Costa Rica unilaterally abolished its armed forces half a century ago, and has the longest tradition of continuous democratic rule in Latin America. The political stability of the country is also associated to the development of a relatively expanded socioeconomic middle class, which has enabled the Costa Rican society to avoid the social polarization existing in other Latin American countries. These factors have contributed to the relatively calm political and socioeconomic environment the country enjoys today, a fact which has accurately being perceived by foreign investors.

Political stability is also associated with the strong rule of law and political transparency foreign investors perceive as existing in Costa Rica. Indeed, contrary to other countries of the region, corruption is not perceived as a problem to do business in Costa Rica. Further, although not perceived as particularly expedite, the judicial system is perceived as fair and impartial. The role of a free press as a tool to ensure political transparency and attempt to control any kind of power abuse is also recognized by foreign investors. Most major economic, social or political issue is subject to an open national debate through the

[29] The conclusions included in this section are derived from several activities conducted by CINDE, the Costa Rican Investment Board, including bilateral discussions, roundtables and a business survey comprising the top 20 foreign investors in the country.

mass media, allowing the different sectors of the society to identify where the interests of the different pressure groups lie.

Productivity, education and culture of the work force are other variables foreign investors perceive as key factors leading them to locate their investments in Costa Rica. Indeed, given the higher cost structure existing in the country, the quality of the labor force is perceived as pivotal for the competitiveness of foreign business located in the Costa Rica. The high educational level is valued not only because it is an asset in itself[30], but also because a skilled workforce is also able to learn other productive techniques more rapidly, making it more flexible and able to cope with the continuous productive changes generated by technological progress. Learning capacity is key for FDI projects entailing highly sophisticated productive processes, which often require additional specialized training for those employed in the project. Foreign investors in Costa Rica perceive the local workforce as productive and able, to such degree that those qualities offset the higher cost such labor force entail. However, foreign investors are also beginning to perceive Costa Rican workforce as numerically limited. In some sectors, foreign investors are planning significant expansion of operations and have expressed concern that the existing professional supply may not be sufficient to satisfy their demand in the near future. This is particularly true in sectors requiring sophisticated English proficiency and computer skills. Improving mass education in these two areas is then one of the objectives Costa Rican investment policy should pursue in the short term.

Geography is perceived by foreign investors as another variable which makes Costa Rica as an attractive location to invest. Geography is relevant from two perspectives. First, the country is centrally located, close to the United States – 2 and half hours flight time from Miami—and other potential export destinations. Second, the physical geography of the country, with its vast natural reserves, have also played a role in making top executives to like the living environment and favor Costa Rica as nice place to settle operations. The international reputation of the country as an environmentally friendly place also seems to add appeal to locate facilities in Costa Rica as the chances for having the investment projects being politically questioned on environmental concerns at the home base of the multinational tend to diminish.

Preferential access to the U.S. market has also played a key role in the investors' perceptions of Costa Rica as an adequate place to locate their investments. Indeed, most foreign investors are from the United States, and have opted to invest in Costa Rica to remain competitive in the U.S. market. This fact explains to a great extent why this sector is embracing the initiative to negotiate the CAFTA (the U.S. Central America Free Trade Agreement), as this treaty would lock in the market access conditions favoring their export-oriented investments in the country.

The perceptions of foreign investors as to the performance of the State in fostering an investment-friendly environment are mixed, although overall they tend to be positive. On

[30] Indeed, the most important FDI projects in Costa Rica during the last decade have required the availability of a significant number of professionals in different areas such as informatics, engineering, business administration and other technical careers.

the one hand, foreign investors have recognized that the national government has played a key role in attracting key FDI projects, and consider that the Costa Rican government understands the strategic importance FDI has for the development of the country. On the other, foreign investors perceive the performance of the State machinery as heterogeneous.

Infrastructure and administrative redtape when establishing the investment are aspects which foreign investors criticize, although they also recognize the efforts undertaken in the last four years to make the public administration more efficient and foster further private investment in the development of key infrastructure projects highly needed by the country. While the quality of the provision of some public services is ranked very positively among foreign investors, in particular health and education, the quality in the provision of other services, in particular, utilities such as electricity, telecommunication services and water supply receive a poorer evaluation. These are areas controlled by State monopolies, the reform of which have been subject to national debate for a couple of years. This is an area Costa Rica will need to seriously assess in order to maintain its competitiveness for FDI.

2. Conclusions and Policy Recommendations

Costa Rica represents a success story of a small developing economy attracting increasing flows of FDI flows. As demonstrated by this report, FDI inflows in Costa Rica not only have significantly grown during the last decade, but have also had a positive qualitative impact in the process of economic development of the country. This positive impact stems from the four main features of FDI in Costa Rica:

- green field investment,
- export-oriented
- focused on the manufacturing and
- services sectors.

Thus, FDI has meant not only increased foreign exchange, but also jobs in relatively higher paid sectors and a significant transfer of technology.

Thus, the pattern in the evolution of FDI inflows in Costa Rica during the last decade is clear, and can be explained in terms of several variables, both internal and external.

From an internal perspective, to a great extent it can be said that the Costa Rica is harvesting the results of decades of investment in its human development, in particular education. Further, Costa Rica is today benefiting from a continuous economic policy which has attempted to insert the Costa Rican economy to international markets. Indeed, despite that government administrations have changed every four years, since 1982, all the administrations have opted to maintain the basic market-oriented economic policy. This macro-economic policy continuity has enabled the country to begin to rip the benefits of the new development model. However, the reform process has not been completed yet. Compared to other Latin American countries, the pace of economic reform has been slower. This is particularly true in the services sector, where key areas still remain in the hands of State monopolies, and the reform of which is still subject to debate among the different segments of the Costa Rican civil society.

From an external perspective, the role of the CBI in enabling Costa Rica to attract increasing FDI flows has been extremely important. Indeed, as this report clearly shows, most export-oriented FDI is geared to the U.S. market. This pattern reveals that important U.S. based corporations have understood the importance of using FDI in Costa Rica as an effective means to safeguard and expand their market share in the United States and in other international markets. The success of this strategy has been, then, to position Costa Rica within a vertical integration productive strategy of both U.S. and non-U.S. multinationals. Nevertheless, the success of Costa Rica in attracting high tech FDI flows has yet to be complemented by linking the domestic productive sector to the former. Indeed, the Costa Rican productive sector is basically comprised by micro and small enterprises (MSEs). Despite some initial success stories, the linkages between these MSEs and the international corporations based in the country so far has been limited, and further work is required in this particular area to ensure that the benefits of FDI in the local economy are maximized.

The significantly positive results in terms of Costa Rica's export expansion and diversification clearly suggests the path that Costa Rican investment policy should follow in the future. Costa Rican policy makers understand that the future of the development of the country lies, to a great extent, in two main objectives: to position the country in international markets, and to link its domestic productive apparatus to the dynamic international corporations based in the country, developing and strengthening the "clusterisation" concept and strategy . Therefore, investment policy should be targeted to deal with those two fronts: the external and the internal.

On the external side, Costa Rica urgently needs to lock in its preferential access to foreign markets, in particular the United States. This policy objective entails to pursue an active trade policy in multilateral and regional fora. In this particular front, the Costa Rican government has done its homework. The negotiation of CAFTA will definitively represent a watershed in Costa Rica's investment policy. CAFTA will enable Costa Rica not only to lock in its preferential market access conditions to the United States, but also, CAFTA will be instrumental in better positioning the country in the minds of international investors. Smaller economies like Costa Rica, which lack a broad and attractive domestic market to lure FDI, are more dependent on signaling mechanisms to lure FDI. In this regard, the negotiation of CAFTA will be a key signal to U.S. investors that Costa Rica is an attractive and safe place to invest. Thus, on this particular respect, the main challenge Costa Rica should face in the near future is to use the momentum generated by the CAFTA negotiations to position the country in the international investment community.

On the internal side, as this report clearly demonstrate, to a great extent, Costa Rican policy makers have very different worries about a series of domestic problems that affect other countries of the region. Costa Rica can profit from political stability, strong and transparent institutions, a strong rule of law and a productive, flexible and educated workforce. However, despite the significant achievements in these fronts, Costa Rica still has to find efficient means to consolidate them and undertake a qualitative leap in its process of economic development. This report demonstrates that the Costa Rican investment policy should focus on at least three main goals:

- promoting the modernization of the country´s infrastructure,
- continuing improving the education of its human capital and
- fostering backward linkages between FDI and domestic SMEs.

Since the debt crisis at the beginning of the 1980s, due to fiscal constraints, the capacity of the government to pursue and finance public works has decreased significantly. In a country where significant parts of the physical infrastructure supporting the productive sector remains in the hands of the State, the contraction in public investment meant almost a complete paralysis in infrastructure development for more than a decade.

In Costa Rica, public works projects are urgently needed to increase the competitiveness of the productive sectors and to facilitate the attraction of investment and new technology. Given the tight budget constraints to finance public investment in the country:

- Promotion of public work concessions has been identified as the means by which these urgent needs can be satisfied.

- Thus, the identification of mechanisms to enable this system of adjudication of public contracts to operate efficiently ranks among the most urgent needs the country currently faces in the field of infrastructure development.

This report has recognized the significant development accomplished by Costa Rica in the field of education. Despite having literacy rates comparable to industrial economies, Costa Rica needs to

- reassess the role of education in the fostering the competitiveness of the country in an increasingly competitive world.

Thus, another area where Costa Rica should devote attention in order to promote further systemic competitiveness of its economy is the field of mass education and strengthening the training of its current and future labor force. Given the particular characteristics of FDI inflows in Costa Rica, the country should

- reassess its concept of literacy in order to include two urgently needed elements: English proficiency and computer literacy.

To provide the majority of the population with these basic skills has become increasingly important, not only as a means to promote better opportunities for all the inhabitants of the country, but also to ensure the competitiveness of the Costa Rican economy as a whole.

Promotion of backward linkages between FDI and domestic MSEs is the third area on which investment policy in Costa Rica should focus. Despite comprising 62% of the total number of exporting enterprises in the country, in 1999 participation of MSEs in Costa Rica's total exports represented only 13% of the total value. Within this context, there is a need to

- implement effective mechanisms to internationalize Costa Rican MSEs, attempting to enable these enterprises to participate from the benefits of free trade and to compete in international markets.

The three areas mentioned above could be taken into consideration for an investment policy reform agenda in the context of the CRII.