



OECD Economic Surveys Costa Rica

February 2016

OVERVIEW

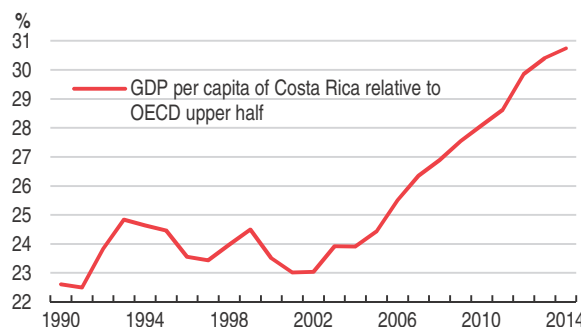


Executive summary

- *Costa Rica's economic, social and environmental achievements are impressive*
- *Budgetary problems have emerged*
- *Policy and institutional reforms will contribute to stronger and more inclusive growth*

Costa Rica's economic, social and environmental achievements are impressive

GDP per capita is increasing



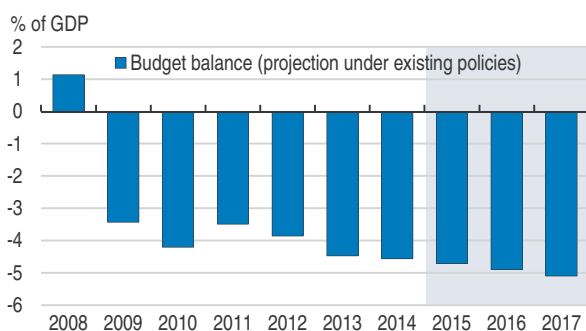
Source: OECD, National Accounts Database and World Bank, World Development Indicators.

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Costa Rica succeeds in combining rising living standards with sustainable use of natural resources. Incomes per capita have nearly doubled in real terms over the past three decades. Almost universal access to health care, education and pensions has been achieved. Careful management of natural resources has emphasised the protection of forest and the development of renewable energy sources, providing foundations for the strong eco-tourism industry. As a result, the well-being of most Costa Ricans is high, as attested by long life expectancy, poverty rates low by Latin American standards and above-average perceptions of life satisfaction.

It is urgent to restore fiscal sustainability

Budgetary problems are persisting



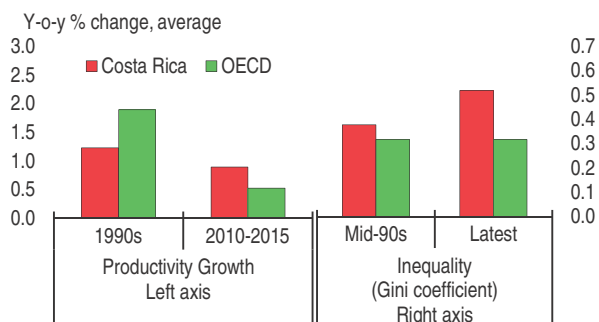
Source: Ministry of Finance of Costa Rica and OECD Economic Outlook 98 Database.

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The public deficit and debt have risen since the start of the 2009 global crisis. Rating agencies have downgraded Costa Rica's debt to below-investment grade and its country risk spread has risen. To restore the fiscal balance it is urgent to raise more tax revenue and curb spending, notably the fast-increasing public-sector wage bill. Improving the fiscal framework by enhancing its transparency and predictability, and reinforcing central government control over public finances would strengthen public-finance management.

Policy and institutional reforms will contribute to stronger and more inclusive growth

Inequality is rising and productivity growth slowing down



Source: OECD, Economic Outlook 98 Database; OECD, Income Distribution Database; Estado de la Nación.

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Despite strong performance, socioeconomic challenges remain. Policy reforms and institutional changes could put Costa Rica on a path of stronger and more inclusive growth. The main priority is to improve the framework of competition policy and state-owned enterprises' governance. Productivity would be enhanced by promoting innovation, access to finance and transport infrastructure. Such reforms need to go hand in hand with making Costa Rica a more inclusive society, especially for women, by improving the quality of education and enhancing the effectiveness of cash transfers in reducing poverty, thus expanding opportunities and sharing prosperity more widely.

MAIN CHALLENGES	KEY RECOMMENDATIONS FOR 2016-17
Restore fiscal sustainability and enhance monetary credibility	
<p>Tax revenues are low and spending is rising fast, pushing public debt to high levels. The public administration is highly fragmented and the Ministry of Finance has limited control over total public expenditure</p>	<p>Cut the central government deficit by 2% of GDP during 2016-17 and an additional 1.5% thereafter by approving and implementing the proposed tax reform, combatting tax evasion, eliminating tax exemptions without an economic or social rationale, and curbing expenditure growth.</p>
<p>The central bank's independence in the conduct of monetary policy can be improved</p>	<p>Introduce a medium-term fiscal framework with a clear and verifiable expenditure rule.</p> <p>Improve public spending efficiency by strengthening the authority of the Ministry of Finance to control overall public-sector expenditure and introducing performance-based budgeting.</p>
<p>Banking-sector competition and financial systemic risks remain concerns</p>	<p>Strengthen the effectiveness of monetary policy to achieve price stability with appropriate institutional reforms, especially by delinking the designation of the President of the Central Bank from the political cycle, and improving accountability rules such as clear motives for his/her dismissal.</p> <p>Establish a deposit-insurance scheme covering all banks to help level the playing field in the banking sector, accelerate the adoption of Basel III principles, and release publicly the results of banks' stress tests.</p>
Make growth more inclusive, especially for informal workers and women	
<p>The labour-market gender gaps are high</p>	<p>Increase the supply of publicly-funded childcare services to facilitate women participation in the labour market.</p>
<p>The minimum wage structure is very complex. One out of three workers is being paid below the minimum wage</p>	<p>Simplify the minimum wage structure and enforce compliance with the law.</p>
<p>The share of informal employment is high by OECD standards and increasing</p>	<p>Adopt a comprehensive strategy to reduce high labour market informality by strengthening enforcement, reducing administrative burdens to entrepreneurship, and enabling the poor to become formal workers.</p>
<p>Spending on education is high, but outcomes are poor. Repetition and drop-out rates are high</p>	<p>Establish better educational outcomes as the main policy target, with special emphasis on improving the performance of disadvantaged students and schools.</p> <p>Develop an apprenticeship system that closely involves employers.</p>
Adopt policy and institutional reforms to boost productivity growth	
<p>Competition is weak and the role of state-owned enterprises is pervasive in many sectors</p>	<p>Give the competition commission more independence and eliminate anti-trust exemptions.</p> <p>Improve the corporate governance of state-owned banks and enterprises by adopting the <i>OECD Guidelines on Corporate Governance of State-Owned Enterprises</i>.</p>
<p>Low productivity growth and barriers to entrepreneurship are hampering income convergence</p>	<p>Strengthen the institutional design to align policies to boost productivity, improve the business environment and reduce barriers to entrepreneurship.</p>
<p>Transport infrastructure is deficient due to a complex institutional setting</p>	<p>Streamline the institutional and legal framework of public-work agencies to achieve better policy design and execution in transport and other infrastructure sectors.</p>

Assessment and recommendations

- *Recent macroeconomic development and short term prospects*
- *Overhauling the Costa Rican fiscal policy framework*
- *Public debt is rising*
- *Monetary policy is moving towards inflation targeting but financial dollarisation remains high*
- *Promoting inclusive and sustainable growth in Costa Rica*
- *Boosting potential output growth and productivity while protecting the environment*

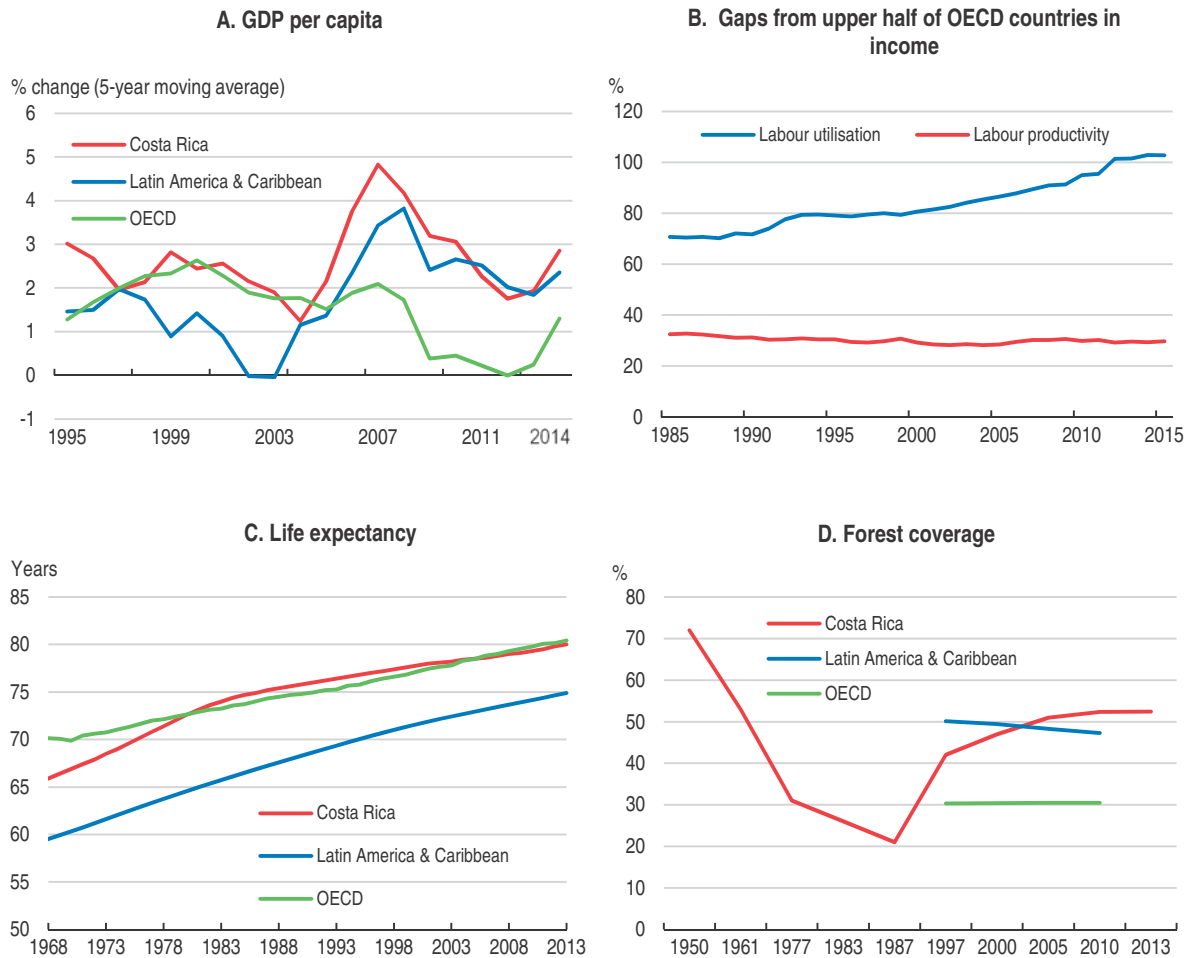
Costa Rica's strong performance combines rising living standards and a sustainable use of natural resources. In the past three decades, real GDP per capita has nearly doubled (Figure 1), as the economy has evolved from a rural and agriculture-based economy to one with high value-added industries linked into global value chains. The process of opening up to international trade and attracting foreign direct investment (FDI) that started in early 1980s has diversified the country's production structure, boosted exports and labour force utilisation (Figure 1).

Virtually universal health care, pension and primary education systems have led to relatively low infant mortality, long life expectancy (close to 80 years) and low poverty by Latin American standards. Costa Rica has also built a world-renowned green trademark and a strong eco-tourism industry based on wise management of natural resources focusing on forest protection and renewable energy sources. These successes are reflected in well-being indicators, which are comparable or even above the OECD average in several dimensions (Figure 2). Costa Ricans' life satisfaction is high when compared to OECD countries (Figure 3). Costa Rica ranks also above the OECD average in the community dimension, indicating a high quality social support network. It ranks similar to the OECD average in health and environment. By contrast, education stands out for its large gap with OECD countries.

However, challenges have emerged in Costa Rica's development process. Intel's recent decision to replace its manufacturing plant by an R&D centre suggests that Costa Rica should keep up its structural reforms to shift from labour-intensive sectors toward more knowledge-intensive activities. Also, while export-oriented firms are dynamic and innovative due to inward FDI and well-developed links with global value chains, domestic firms concentrate on low value-added activities, employ unskilled workers and often operate in the informal economy, which account for about 40% of total employment. Spillovers from FDI to local firms are negligible and the country's overall productivity growth has been disappointing. During the recent financial crisis, fiscal problems have resurfaced, with fast-rising public deficit and debt, calling the fiscal sustainability of current policies into question. As a result, in 2014 rating agencies downgraded Costa Rica's debt to below-investment grade.

This first *Economic Assessment of Costa Rica* argues that the government should focus on:

- Boosting productivity to avoid the middle-income trap and undertaking structural reforms focussing specifically on competition, corporate governance of state-owned enterprises, innovation, education, access to finance and transport infrastructure.
- Making Costa Rica more inclusive by improving social policies, the quality of education, and reducing informality, thereby expanding opportunities and sharing prosperity across all Costa Ricans, especially women.
- Strengthening the institutional framework, notably reducing fragmentation; it is crucial to enhance the Ministry of Finance's control over public finances and deficit reduction.

Figure 1. **Costa Rica's economic, social and environmental track record is strong**

Note: Panel A: Annual growth of GDP per capita at PPP, constant 2011 international USD (5-year moving average). Panel B: OECD calculations based on The Conference Board Total Economy Database™. Panel C: Life expectancy at birth for all population. Panel D: Latin America & Caribbean (all income levels) and OECD members data comes from the World Bank, World Development Indicators; forest area data refers to land under natural or planted stands of trees of at least 5 meters *in situ*, whether productive or not, and excludes tree stands in agricultural production systems (for example, in fruit plantations and agroforestry systems) and trees in urban parks and gardens. For Costa Rica, data comes from the Ministry of Environment, Energy and Telecommunications of Costa Rica; forest coverage refers to some form of forest such as mature forest, secondary forest, deciduous forest, etc.

Source: OECD Health Statistics 2015; World Bank, World Development Indicators; The Conference Board Total Economy Database™; and, Ministry of Environment, Energy and Telecommunications of Costa Rica.


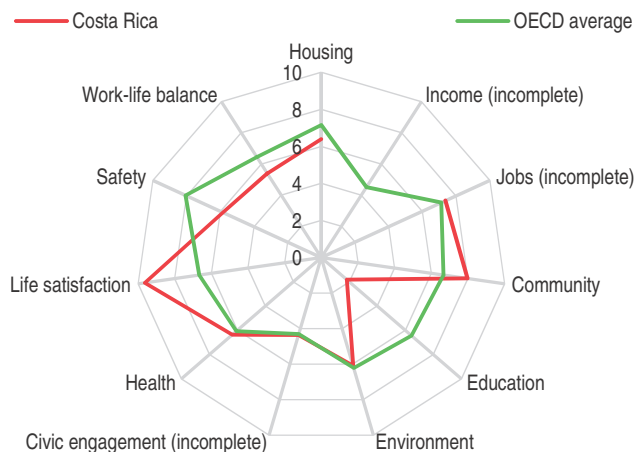
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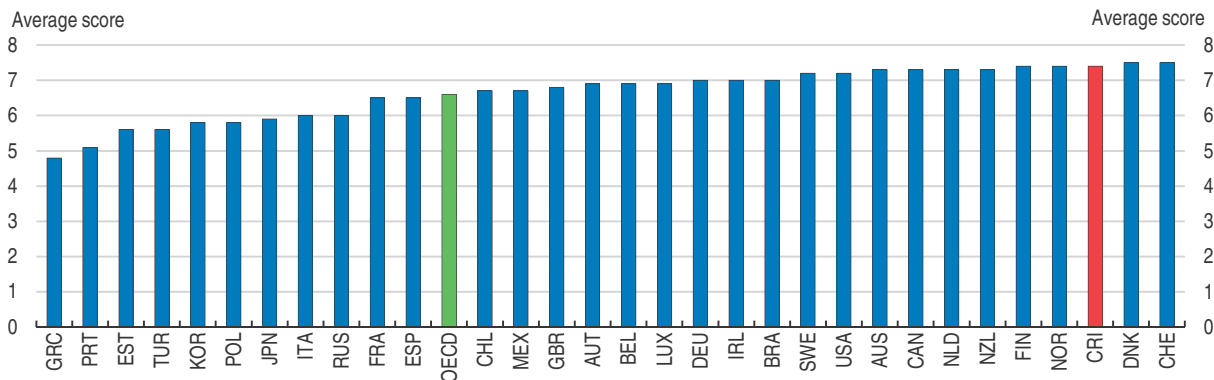
Figure 2. Well-being indicators are comparable with OECD average
 Better Life Index approximation (preliminary and incomplete)



Note: Each well-being dimension is measured by one to four indicators taken from the OECD Better Life Index set. Normalised indicators are averaged with equal weights. Indicators are normalised to range between 10 (best) and 0 (worst) according to the following formula: (indicator value - minimum value) / (maximum value - minimum value) x 10.
 Source: For Costa Rica: National Institute of Statistics and Censuses (INEC); National Electoral Tribunal (TSE); and Gallup (2015), Gallup World Poll Database. For OECD average: OECD Better Life Index Database.

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Figure 3. Life satisfaction is high
 Life satisfaction, average score 2014



Note: The reference year is 2014 for all countries with the exception of 2013 for Chile. The indicator considers people's evaluation of their life as a whole. It is a weighted-sum of different response categories based on people's rates of their current life relative to the best and worst possible lives for them on a scale from 0 to 10, using the Cantril Ladder (known also as the "Self-Anchoring Striving Scale").
 Source: OECD Better Life Index - Edition 2015 Database and Gallup World Poll Database (Gallup, 2015).

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Table 1. Key indicators
2014 or most recent year available

Indicator	Costa Rica	Latin America and Caribbean average	Costa Rica ranking (the lower the value means that the country is better ranked or smaller in terms of surface and population)		
			World	OECD plus Costa Rica	Latin America and Caribbean
Country size					
Surface area (1 000 km ²)	51	601	127	26	19
Population (1 000)	4 938	18 279	118	29	18
Labour force (1 000)	2 348	9 913	116	30	18
GDP at PPP (current billion USD)	71	264	83	31	14
External trade (billion USD)	36	88	98	34	12
Indicators of development					
GDP per capita at PPP (current USD)	14 374	13 867	82	35	14
Gini coefficient (0-1 scale)	0.487	0.490		34	9
S90/S10 income decile share	32.3	28		35	
Female labour force participation rate (%)	51	57	138	33	23
Share of women in parliament (%)	39	20	18	9	4
Human development index	0.76	0.72	68	33	11

Note: Latin America and Caribbean (all income levels, as per the World Bank, except for seven countries for which there are no recent data such as Aruba, Cayman Islands, Curacao, St. Martin, Turks and Caicos, Virgin Islands) average is unweighted and based on the number of countries with available data for each indicator. World includes around 215 countries, although data sometimes is not available for all of them. Regarding Costa Rica ranking, the lower the value the better ranked the country. External trade is the sum of exports and imports of goods and services (current USD). Gini coefficient refers to Gini (disposable income, post taxes and transfers); data for OECD and Costa Rica comes from OECD *Income Distribution Database (IDD)*, provisional estimate for Costa Rica for 2015; for Latin America and Caribbean, it comes from *World Bank World Development Indicators*. The S90/S10 ratio is the share of all income received by the top decile divided by the share of the first, or the ratio of the average income of the top decile to that of the first. Preliminary data for Costa Rica for 2015. Female labour force participation rate refers to the % of female population ages 15-64 (modeled ILO estimate). Human Development Index is a composite index measuring average achievement in three basic dimensions of human development – a long and healthy life, knowledge and a decent standard of living. The index measured on a scale from 0+ lowest to 1+ highest possible value. Source: World Bank, *World Development Indicators*; OECD *Income Distribution Database (IDD)*; ENAHO 2012, and UNDP Human Development Reports, Table 1: Human Development Index and its components.

Recent macroeconomic development and short term prospects

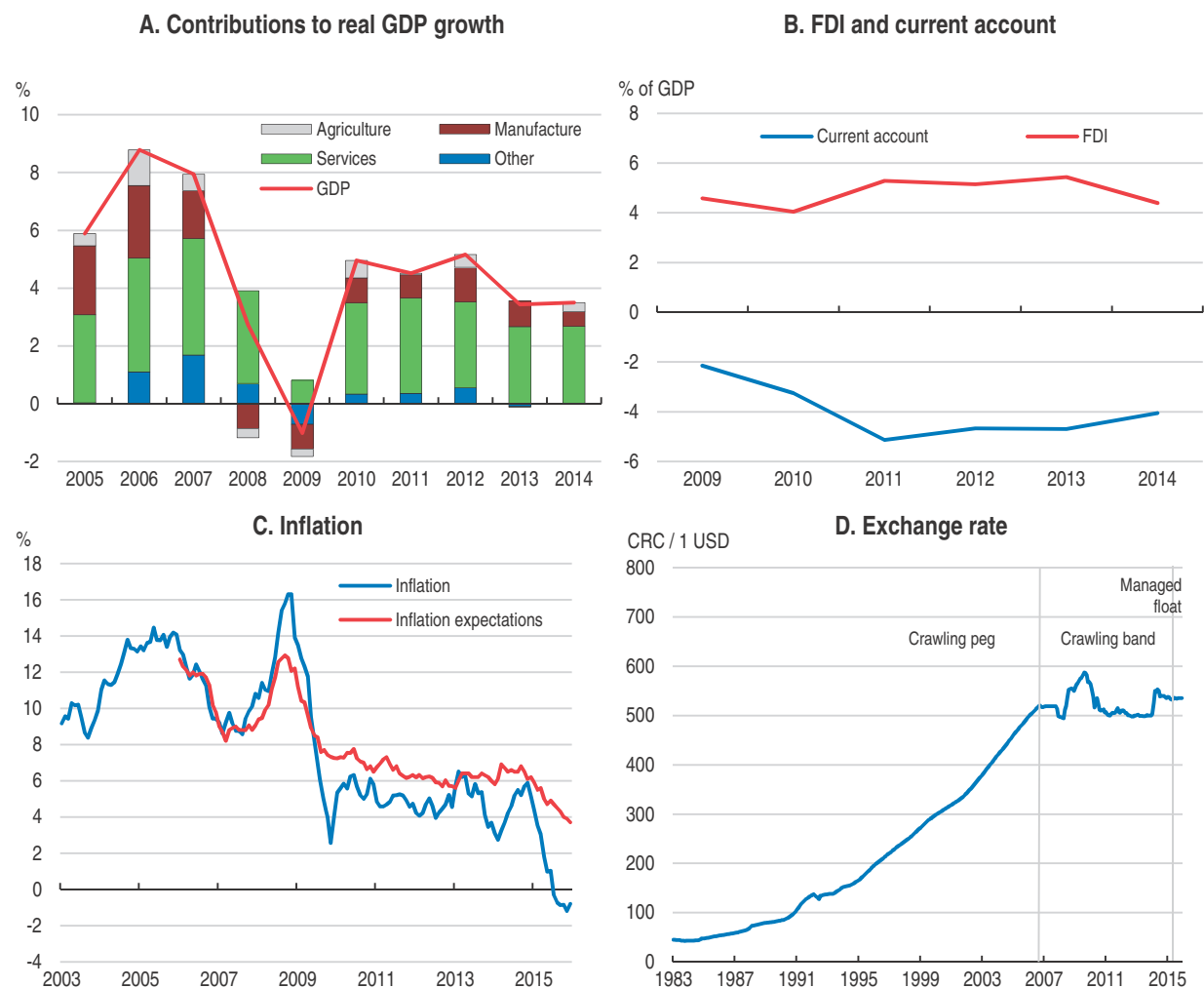
The economy is recovering from a sharp slowdown

The 2009 global crisis hit Costa Rica and the economy went into recession, with GDP slowing from about 7.5% over 2005-07 period to -1% in 2009 (Figure 4). The rebound was rapid, but growth has since been less buoyant than before the crisis and the labour market remains weak, with high unemployment and rising informality. Inflation has been on a declining trend since 2009 and even turned negative in mid-2015, reflecting falling commodity prices, spare capacity in the economy and exchange-rate appreciation. Besides, inflation expectations have declined, albeit less markedly.

GDP growth is estimated to have fallen below 3% in 2015, mainly on account of the Intel plant closure and its significant impact on exports. The El Niño phenomenon also hit agriculture. Low inflation has boosted households' purchasing power, buttressing private consumption. Public infrastructure investments are also supporting activity. With the economy slowing down and inflation sharply lower, the central bank (BCCR) has adopted a supportive monetary policy stance. It cut the benchmark interest rate from 5.25% in January 2015 to 1.75% in January 2016, well below the nominal neutral interest rate of 4.6% – as estimated by an expectation-augmented dynamic Taylor rule, as in Magud and Tsounta (2012).


Activity is set to accelerate in 2016-17, as global growth and export markets gain momentum gradually. Unemployment is likely to remain above 9%. Inflation has

Figure 4. The crisis has left lingering effects



Note: Panel C: Inflation expectations are one year ahead.

Source: Central Bank of Costa Rica; National Institute of Statistics and Censuses (INEC); Inter-institutional Foreign Direct Investment Group.

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undershot the previous central bank target range of 3-5%, owing to low oil prices and the stability of the exchange rate. In January 2016, the central bank lowered the inflation target range to 2-4%, reflecting persistently low inflation and in line with inflation developments in main trading partners. Inflation is projected to gradually move to the new target range as the economy strengthens. The expected gradual normalisation of US monetary policy might result in lower capital inflows and currency depreciation.

As Costa Rica is a small open economy, shocks to its trading partners, notably the United States, will have an important impact on growth, though its limited exposure to China (5% of exports) protects it from the import decline of that country. Terms of trade improved in 2015, and further declines in energy prices would raise incomes and growth. On the downside, the normalisation of US monetary policy could put pressure on the exchange rate, causing tensions in the financial system and, as the private's sector is highly dollarised, hurting consumption and investment. Failure to implement the proposed fiscal reform (see below) would result in deficit and debt increases, calling the

fiscal sustainability of current policies into question. In addition, Costa Rica could face large shocks whose effects are difficult to assess and that, for this reason, have not been factored into the projection (Box 1). On the positive side, Costa Rica is well protected by the high level of international reserves held by the Central Bank (about USD 8 billion, 15% of GDP) and by the favourable currency composition of sovereign debt (about two thirds of central government debt is denominated in domestic currency).

Table 2. Macroeconomic indicators and projections

Annual percentage change, volume (1991 prices)

	2011	2012	2013	2014	2015	2016	2017
	Current prices, billions CRC	Percentage change, volume (1991 prices)					
GDP	20 852	5.2	3.4	3.5	2.9	4.1	4.2
Private consumption	13 596	4.2	3.3	3.9	4.4	4.4	4.5
Government consumption	3 731	1.0	2.8	3.5	3.1	2.1	2.0
Gross fixed capital formation	4 168	8.0	12.3	4.5	8.3	6.1	4.3
Final domestic demand	21 495	4.8	5.5	4.0	5.1	4.4	4.0
Stockbuilding ¹	396	0.1	-2.7	-1.7	1.4	-0.2	0.0
Total domestic demand	21 891	4.8	2.6	2.4	6.5	4.2	4.0
Exports of goods and services	7 759	9.3	3.6	-1.7	-8.2	4.6	5.7
Imports of goods and services	8 798	8.7	2.1	-4.0	-2.0	4.9	5.4
Net exports ¹	(1 039)	0.4	0.9	1.2	-3.3	-0.1	0.1
Other indicators							
Unemployment rate ²	-	10.2	9.4	9.6	9.5	9.3	9.2
Consumer price index ³	-	4.5	5.2	4.5	0.8	1.5	2.4
Current account balance ⁴	-	-5.3	-5.0	-4.9	-4.0	-4.0	-3.9
General government financial balance ^{4, 5}	-	-3.9	-4.5	-4.6	-4.7	-4.9	-5.1
General government debt ⁴	-	35.6	36.6	39.7	43.7	45.3	46.6

1 Contribution to changes in real GDP, actual amount in the first column.

2 Average of quarterly data.

3 Annual average per cent change.

4 As a percentage of GDP.

5 Based on information included in the budget law for 2015. It does not include the effect of tax reforms bills currently under discussion in the Parliament.

Source: OECD (2015a), OECD Economic Outlook 98 Database (updated).

Box 1. Main vulnerabilities surrounding Costa Rican economy's prospects

Uncertainty	Possible outcome
Environmental risks and natural disasters	Changing weather patterns, such as stronger El Niño phenomenon and global warming in general, could disrupt agricultural production and related manufacturing activities. Severe earthquakes would affect infrastructure and other constructions.
International economic developments	Disruptions in international financial markets might put pressure on the exchange rate, causing tensions in the banking system as the private sector's debt is highly dollarised.
FDI flows	A sudden stop in FDI flows, due to international market turbulence and incapacity to tackle infrastructure and education bottlenecks, will hurt prospects to climb the value added chain and slow considerably or stop the convergence process in GDP per capita.
Access to international sovereign bond markets	Failure to introduce fiscal consolidation measures would result in the budget deficit rising to higher levels, with the risk of foreign investors stopping to buy Costa Rican sovereign bonds.
Reform process	Continued fragmentation in the Legislative Assembly might make the timely approval of comprehensive reforms difficult.

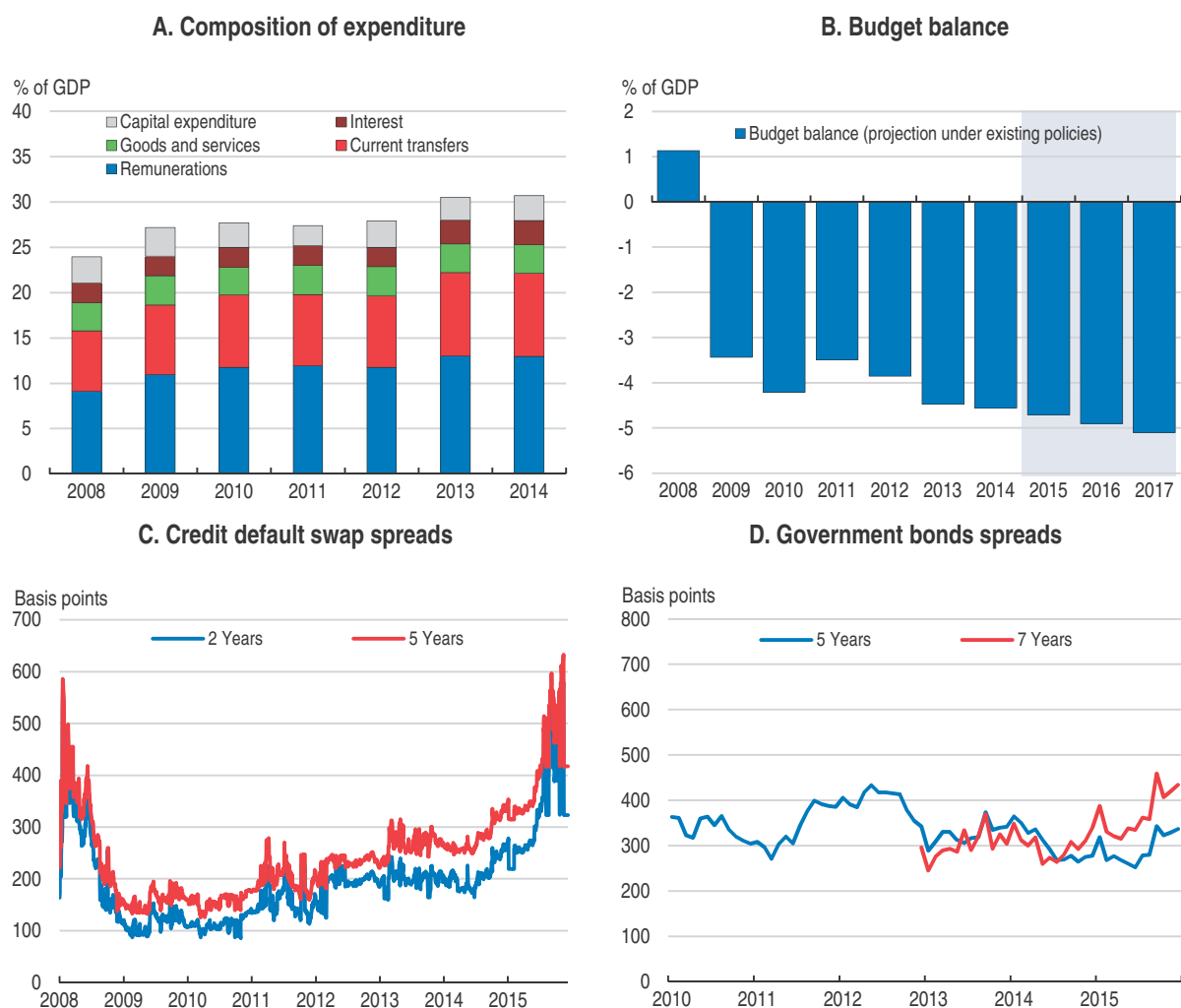
The government has proposed a wide-ranging tax reform to start tackling fiscal problems

The general government budget deficit is expected to reach 4.7% of GDP in 2015, from a slight surplus in 2008, and to exceed 5% of GDP in 2017, based on existing policies. The rise in the public deficit is mostly attributable to increases in government spending, due largely to the fast rising public-sector wage bill (Figure 5). Public debt has grown rapidly from 28% of GDP in 2009 to more than 40% in 2015 and the ratio of debt to tax revenue has increased from 1.3 to 1.7 times over the same period. Credit default swaps spreads have increased and agencies have lowered Costa Rica's credit rating below investment grade, although government bond spreads are at the same level as in 2012.

The government is aware of the fiscal challenge and since 2014 has sought to reduce the growth of current non-interest expenditure. Spending restraints and tax reform are necessary. The government is working to bring the budget back to a medium-term sustainable path. The central government budget deficit increased from 5.7% of GDP


Figure 5. **The fiscal outlook is challenging**

General government, % of GDP at market prices



Note: Credit default swaps refer to two-year and five-year senior debt, mid-rate spreads. Costa Rica government bonds spread is relative to US government bonds.

Source: Ministry of Finance of Costa Rica; OECD (2015a), *OECD Economic Outlook 98 Database*; Thomson Reuters; and Bloomberg.

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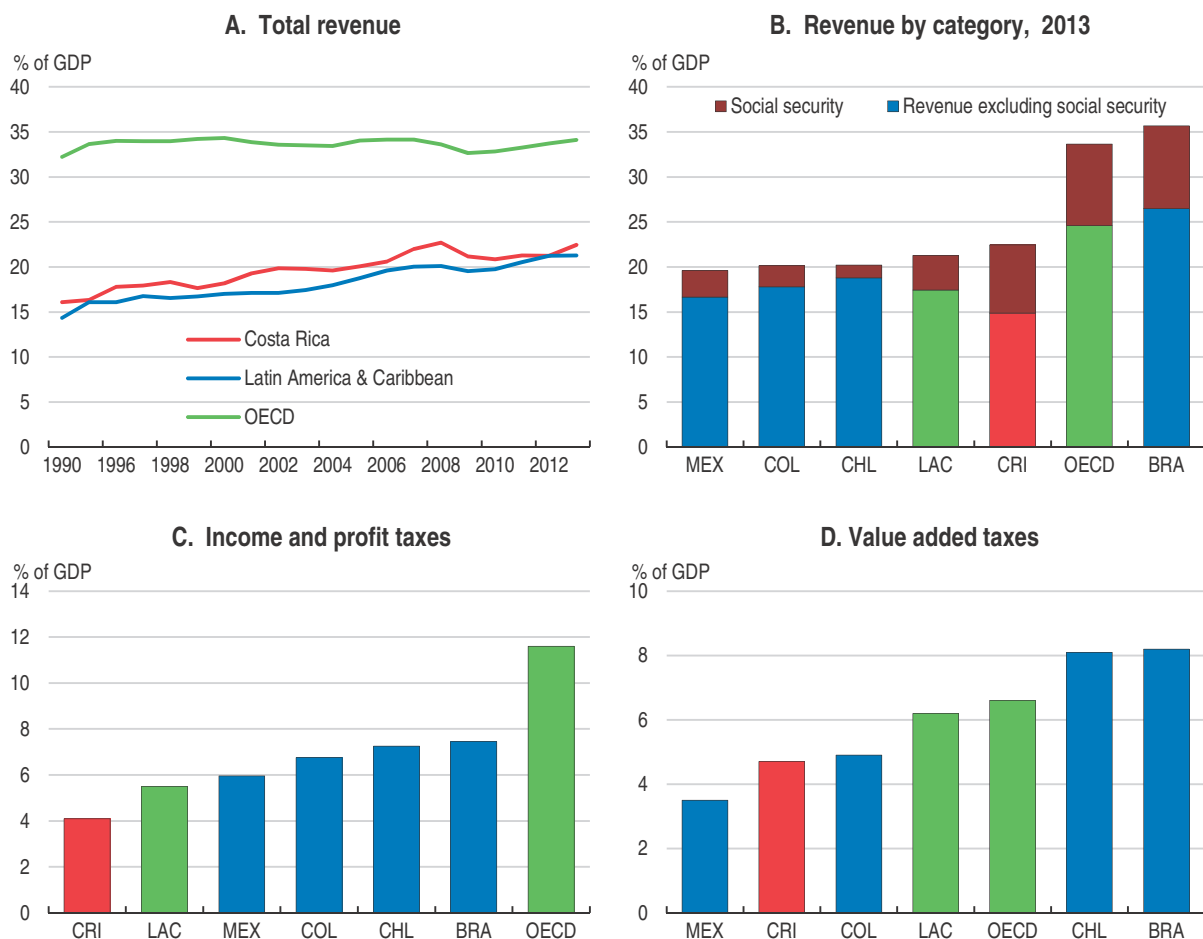
in 2014 to about 6% of GDP in 2015, partially an account of rising interest payments, which have reached 2.8% GDP. The budget approved by Congress for 2016 implies that the deficit might increase further in the absence of new measures. The package of tax reforms envisaged by the government, as discussed below, together with stricter expenditure control by the Ministry of Finance, if legislated and implemented, would lead to a deficit reduction of about 2% of GDP during 2016-17.

Tax revenue is close to the Latin American average but substantially lower than in OECD countries (Figure 6). The overall fiscal system is overly reliant on social security contributions, which account for about 34% of total government revenue, against 18% in Latin American and 27% among OECD countries. The contributions of income taxes and VAT are lower than in other Latin America countries and, especially, OECD countries because of tax evasion, a narrow tax base and low marginal tax rates. The current standard VAT rate is 13%, considerably below the 19.1% average rate for OECD countries. A large amount of personal income is not taxed since the tax-free threshold is around twice the average wage in the private sector – much higher than OECD countries and comparable Latin America countries such as Mexico and Chile.


To start tackling the fiscal problems, the Government has proposed two bills to increase revenue by about 2% of GDP. Most of the increase, about 1.3% of GDP, is to come from the introduction of a full-fledged VAT system; around 0.6% of GDP from income tax reforms, and the rest from a revision of taxes on sales of property. According to the government, these bills should increase overall revenue by 1.56% of GDP during the first year after their approval, by another 0.45% in the second year, and another 0.08% in the third. The reform is consistent with OECD evidence showing that broadening tax bases and relying more on VAT reduce the detrimental effects of higher taxes on economic growth and employment (OECD, 2008; OECD, 2010b).

The proposed VAT bill will broaden the base to include most services, which are currently exempt, and increase the rate from 13% to 14% in the first year and to 15% in the second year. While broadening the tax base, the VAT bill still contains numerous exemptions and reduced rates. VAT exemptions benefit mostly well-off taxpayers (Barreix, 2014) and complicate tax administration; for these reasons they should be repealed, especially as the bill also introduces an innovative VAT refund system to compensate the poorest 40% households. The VAT refund system is a positive step as, if implemented correctly, will drastically reduce the regressivity of the VAT reform. The proposed VAT reform will not have a significant impact on inequality, but it is expected to lower the poverty rate by about 3 percentage points.

The government also proposes to introduce two new top brackets in the personal income tax, with rates of 20% and 25%, at 5 and 10 times the average income, which would slightly raise the progressivity of the personal income tax (Figure 7). However, average tax rates would remain very low and the tax-free threshold would still be high. As a reference, while on average for OECD countries a worker earning the average wage pays 25.5% of her gross wages in personal income tax and social security contributions, in Costa Rica that figure would not be reached even at 10 times the average wage. Besides, in Costa Rica the income-tax-free threshold is almost twice the average wage – against about 0.3 times the average wage in OECD countries on average. As a result, only around 14% of Costa Rican wage earners pay any income tax. Income taxes could generate more revenue by lowering the tax-free threshold and bringing more households in the tax net.

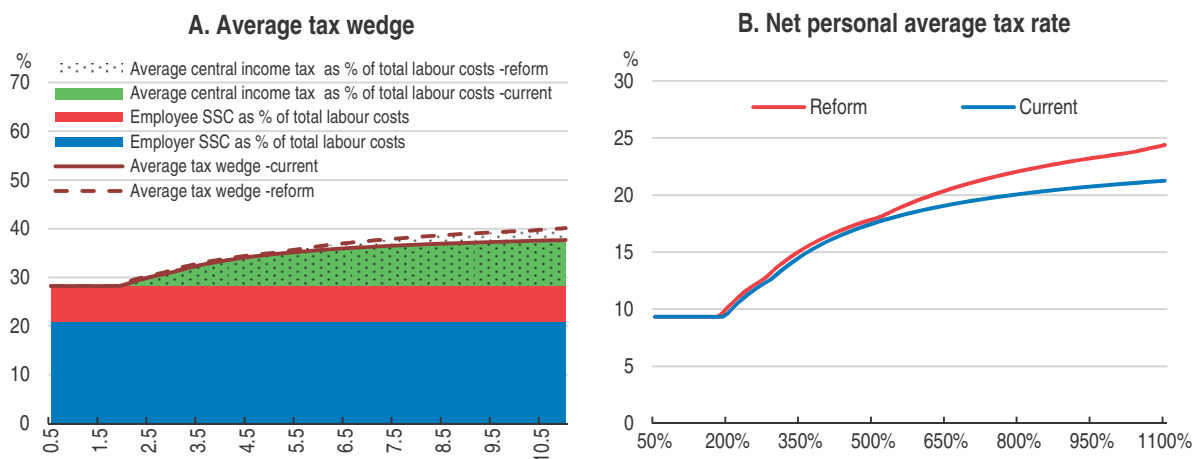
Figure 6. **Fiscal revenue in Costa Rica is lower than in OECD countries**

Note: Data expressed as percent of GDP at market prices. OECD is an unweighted average of 2012 data for member countries. LAC is an unweighted average of 20 Latin America & Caribbean countries. Chile and Mexico are also part of the OECD group. Panel A: OECD data for 2013 calculated by applying the unweighted average percentage change for 2013 in the 30 countries providing data for that year to the overall. Panel B: Mexico and OECD data for 2012. Panel C: OECD average for 2013 estimated by applying the unweighted average percentage change for 2013 in the 31 countries providing data for that year to the OECD average for 2012. Panel D: OECD data up to 2012. Source: OECD (2015d), OECD Revenue Statistics; IDB/CIAT (2015), *Latin America and the Caribbean Fiscal Burden Database, 1990-2013*.

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The government should reassess the usefulness of the numerous tax expenditures, which reduced government revenue by almost 6% of GDP in 2013 (Ministerio de Hacienda, 2014b). Currently there are more than 1 200 tax expenditures. Only about one-fifth of exemptions have a time limit and nearly half are badly defined (Estado de la Nación, 2014). The government has proposed to eliminate some of these tax exemptions by taxing capital gains and profit remittances to foreign shareholders at a flat rate of 15%. However, some entities would remain exempt from income taxes, such as large cooperatives in the agricultural sector. Comprehensive evaluation of tax exemptions and expenditures, such as what the export promotion agency recently conducted (PROCOMER, 2015), should be used more widely to inform decisions.

The corporate income tax rate will be kept at 30% but the tax schedule for SMEs will switch from two brackets (10 and 20%) to four (from 10 to 25%). Although the change in how the tax brackets' thresholds are determined (from gross income to profits) is welcome, overall the reform will increase the complexity of the tax system by raising the number of

Figure 7. **The tax reform will raise the progressivity of the personal income tax by little**

Note: Data for 2015 Q2. The tax wedge is the difference between labour costs to the employer and the net take-home pay of the employee expressed as percentage of total labour costs (gross wages plus employer social security contributions); the net personal average tax rate is computed as the personal income tax and employee social contributions expressed as a percentage of gross wage earnings (OECD, 2015e). The average wage used as CRC 407 857 per month, computed for workers in sectors B to N of the International Standard Industrial Classification revision 4, data provided by INEC from ECE survey.

Source: Estimation based on OECD (2015e), *OECD Taxing Wages Model*.

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tax rates. Multiple tax rates result in unequal treatment of similar taxpayers and curtail SMEs' growth (OECD, 2015j). Evidence from OECD countries indicate that preferential tax treatments for SMEs are not likely to be justified; eliminating or reducing them could free resources for cuts in the statutory corporate tax rates (OECD, 2010b). Moving to two corporate tax rates – one for larger companies one for SMEs – or, even better, to a single one might be a simpler and more efficient way to raise revenue.

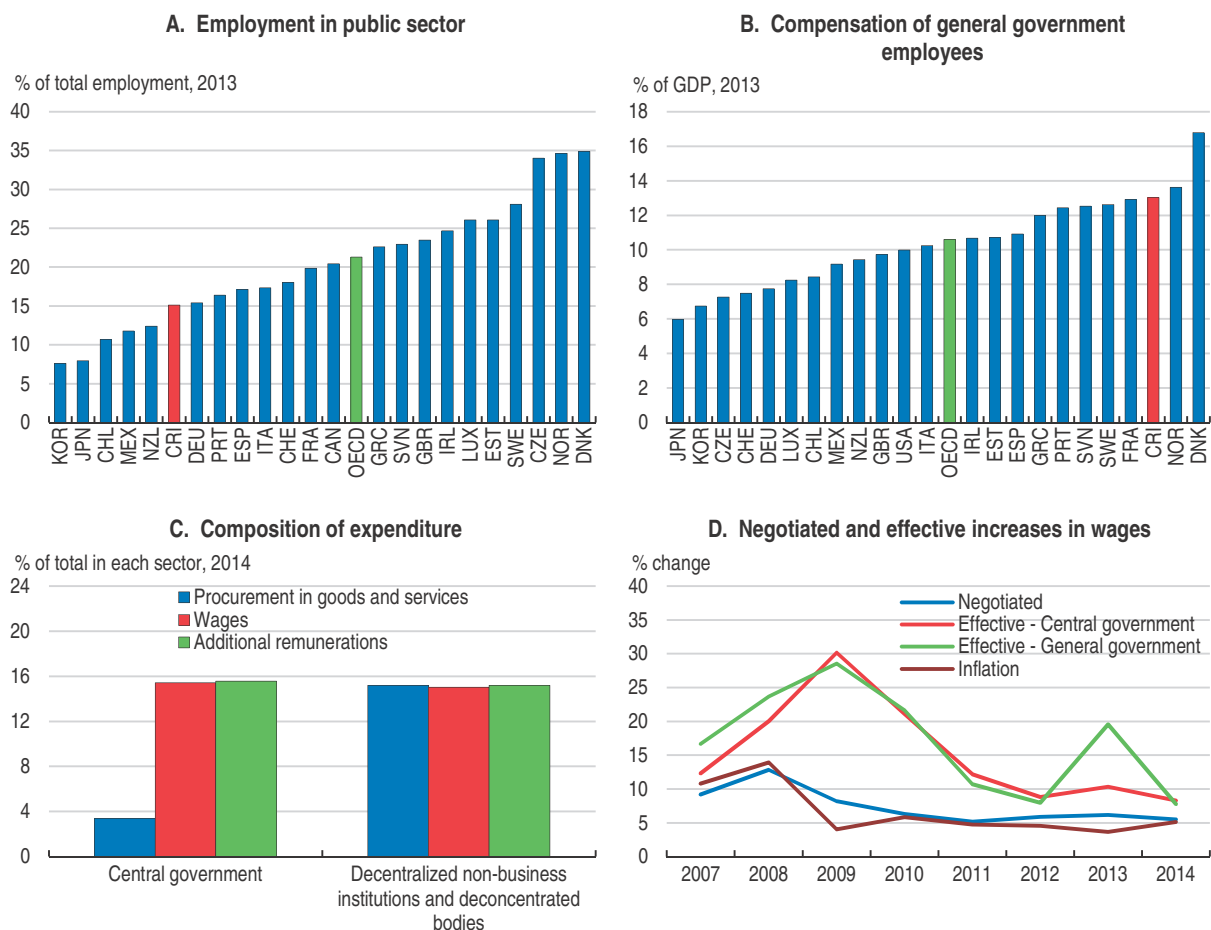
Another important aspect of the reform enhances the administrative and punitive capacities of the tax administration, which is warranted given that tax evasion in Costa Rica amounts to around 8% of GDP (Ministerio de Hacienda, 2013). Brys (forthcoming) presents in detail remaining aspects of the tax system and reform.

In the medium-term, Costa Rica would greatly benefit from a rebalancing of the tax mix. Shifting taxation away from social security contributions towards less distortive or more progressive taxes – such as VAT, or income and property taxes – would have a positive effect on stimulating growth and formal employment in addition to reducing inequality and poverty (more below).

Public employment reform is urgent to control the public sector wage bill

Costa Rica's public-sector wage bill as a share of GDP is higher than in most OECD countries, even though its public employment share is among the lowest, and public-sector wages account for a large share of total government expenditure (Figure 8). Also the public-private sector wage difference is large especially for low-skilled employees and for employees of public-sector agencies outside the central government (Figure 9).

Reforming public-sector employment to improve the quality of public services as well as to control the growth in the public sector wage bill is urgent. Reforms of the public employment regime should centre on simplifying and making more transparent the

Figure 8. **Public employment is low and the wage bill high**

Source: OECD (2015n), *OECD Government at a Glance 2015*; National Institute of Statistics and Censuses (INEC); Ministry of Finance; Comptroller General Office; official diary *La Gaceta of Costa Rica*.

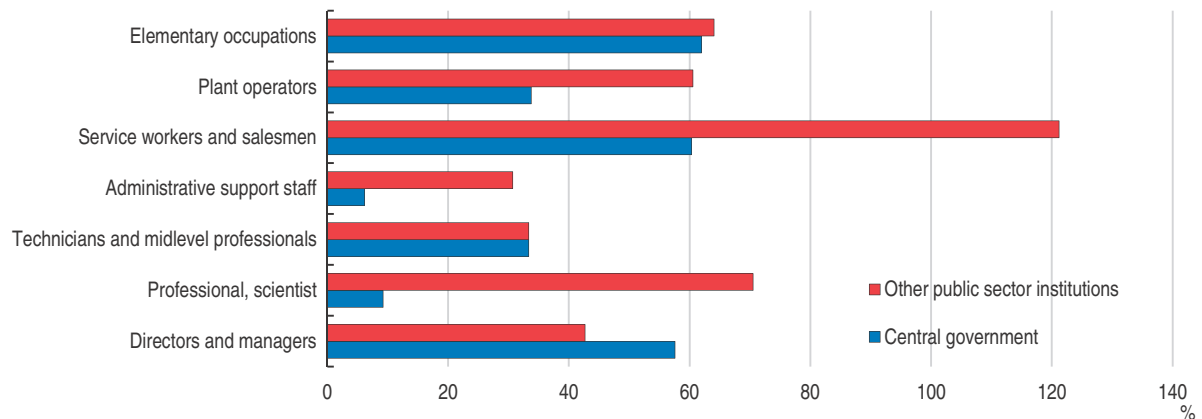
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different remuneration schemes across the whole public sector. Last September, the Government created a Joint Commission formed by legislators, representatives from the executive, trade unions and private sector to address three issues: quality of public services, remuneration systems of the public sector and sustainability of pension regimes. The Government has also taken action to re-negotiate abusive clauses on collective labor agreements, particularly in state-owned enterprises. More efficient and fair management of compensation should also tie salary increases to performance evaluation and not just to seniority. In this matter, the Government presented to the Legislative Assembly a bill that limits the pay increases for the whole public sector and also establishes a new performance management system.

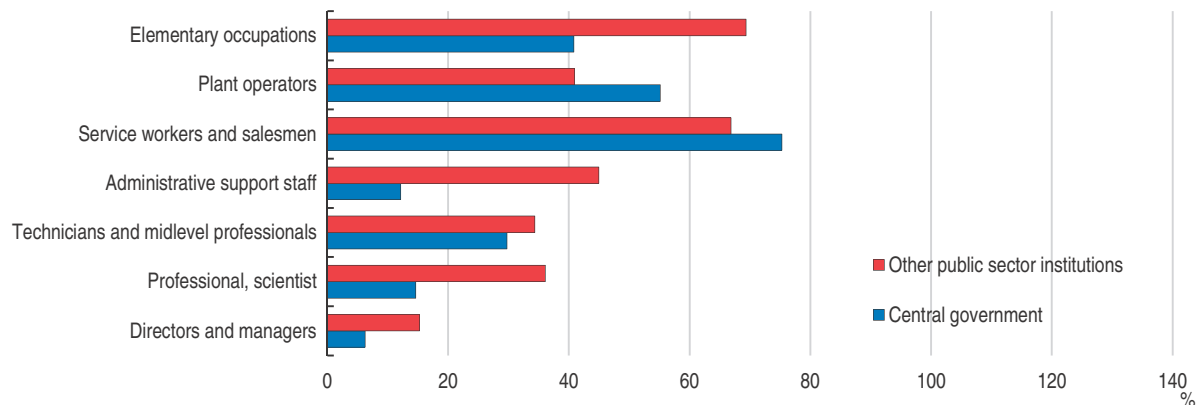
Controlling the public-sector wage bill is made difficult by a highly fragmented public employment regime. Remuneration in the public sector comprises a base salary and several additional remunerations; the Civil Service Regime alone has close to 190 additional types of remuneration (MIDEPLAN, 2012) and other public employment regimes, such as those of agencies outside the central government, state-owned enterprises, the Supreme Court of Justice and the Legislative Assembly, have also several additional types of remuneration. Additional remunerations are so high they often are

Figure 9. **The public-private sector wage gap is large**
 % difference relative to private sector, total gross income average


A. 2010



B. 2014



Source: OECD calculations based on ENAHO.

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above base salaries. The heterogeneity of pay schemes generates distortions and inequalities as positions with similar requirements have dissimilar pay, which also hampers workers' mobility (CGR, 2009; Academia de Centroamérica, 2014).

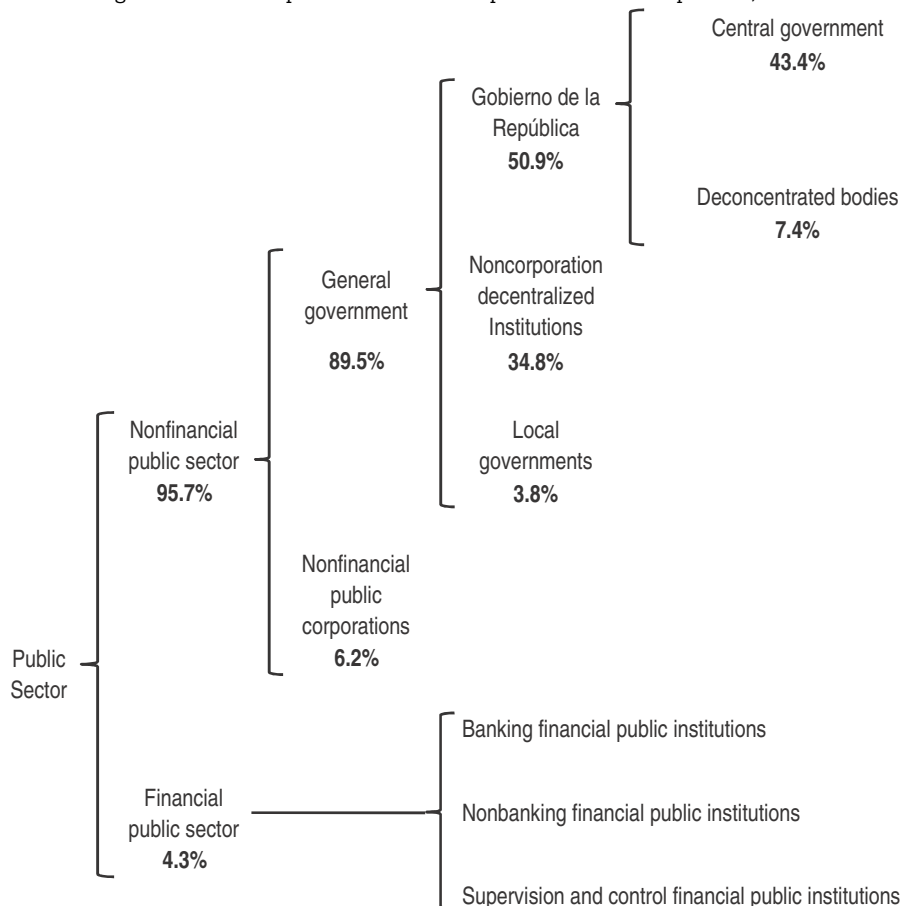
Overhauling the Costa Rican fiscal policy framework

Costa Rica's public sector is highly fragmented, resulting in the Legislative Assembly approving less than half of total public sector expenditure (Figure 10). Spending not subject to parliamentary approval includes agencies with some degree of autonomy, namely "deconcentrated" and decentralised institutions and public corporations. The yearly budgets of these institutions, as those of the public corporations, do not have to be approved by the Legislative Assembly but by the Comptroller General, and approval is from a legal rather than a policy standpoint. In addition, there is no effective mechanism to ensure that these agencies' objectives are aligned with those of the central government

(OECD, 2015f). Strengthening the control of the Ministry of Finance over public-sector expenditure is therefore necessary to durably improve public-finance management and rationalise transfers to public-sector agencies outside the central government.

Figure 10. **The public sector of Costa Rica is highly fragmented**

Organisation of the public sector with expenditure share in percent, 2014



Source: Ministerio de Hacienda (2014a), Ministerio de Hacienda (2014c).

Reducing mandated spending and revenue earmarking would make the budgetary process more flexible in responding to unexpected shocks. In 2014, around 70% of central government expenditure was mandated by constitutional and other legal provisions (Table 3); This, plus, debt servicing, leave only about 17% of the Central Government's budget for discretionary spending. Such extensive use of revenue earmarking and mandated spending contrasts with the principles OECD Recommendation on Budgetary Governance and should be reduced (OECD, 2015b). Reducing budget rigidities could be complemented with the introduction of performance budgeting that would enable to allocate and revise spending based on output targets. Performance budgeting could strengthen incentives to raise public spending efficiency but these should be balanced by the risk of making the yearly budget overly complex and the difficulties in defining unambiguous targets (OECD, 2015).

The Ministry of Finance publishes annually a "Medium-term fiscal and budgetary framework", but this does not enforce boundaries for spending (OECD, 2015c). The

Table 3. **Costa Rica's central government budget is excessively rigid**
2014

Total budget expenditure	100.0%
Constitutional and legal mandates	69.0%
Debt service	14.1%
Others	16.9%

Note: Others include procurement of goods and services, capital spending, transfers to "de-concentrated" agencies and wages other than education and the judiciary.

Source: OECD calculations based on Ministerio de Hacienda (2014).

constitution contains provisions for implementing a sustainable fiscal policy that are consistent with the OECD *Principles of Budgetary Governance*, but to date these remain unheeded. A fiscal rule is currently being designed in collaboration with the IADB and the World Bank. Introducing an explicit spending rule would enable more effective control of current government spending. Drastically increasing the share of total public expenditure under the oversight of the Ministry of Finance, as highlighted before, is also a pre-requisite to implement an effective expenditure rule. OECD countries provide several examples of expenditure rules as, in 2012, 21 out of 34 members had one (OECD, 2013b; OECD, 2014b).

Public debt is rising

Increased deficits have resulted in rising public debt. The proposed fiscal reform will be just enough to stabilise the debt-to-GDP ratio, but not if growth turned out to be below the historical average (Figure 11). Hence, additional fiscal measures will be necessary to reduce the debt ratio or stabilise it at current levels if growth turned out less than assumed (Figure 11). Moreover, as a small open economy subject to shocks, Costa Rica should build up precautionary fiscal buffers, which calls for prudent debt levels.

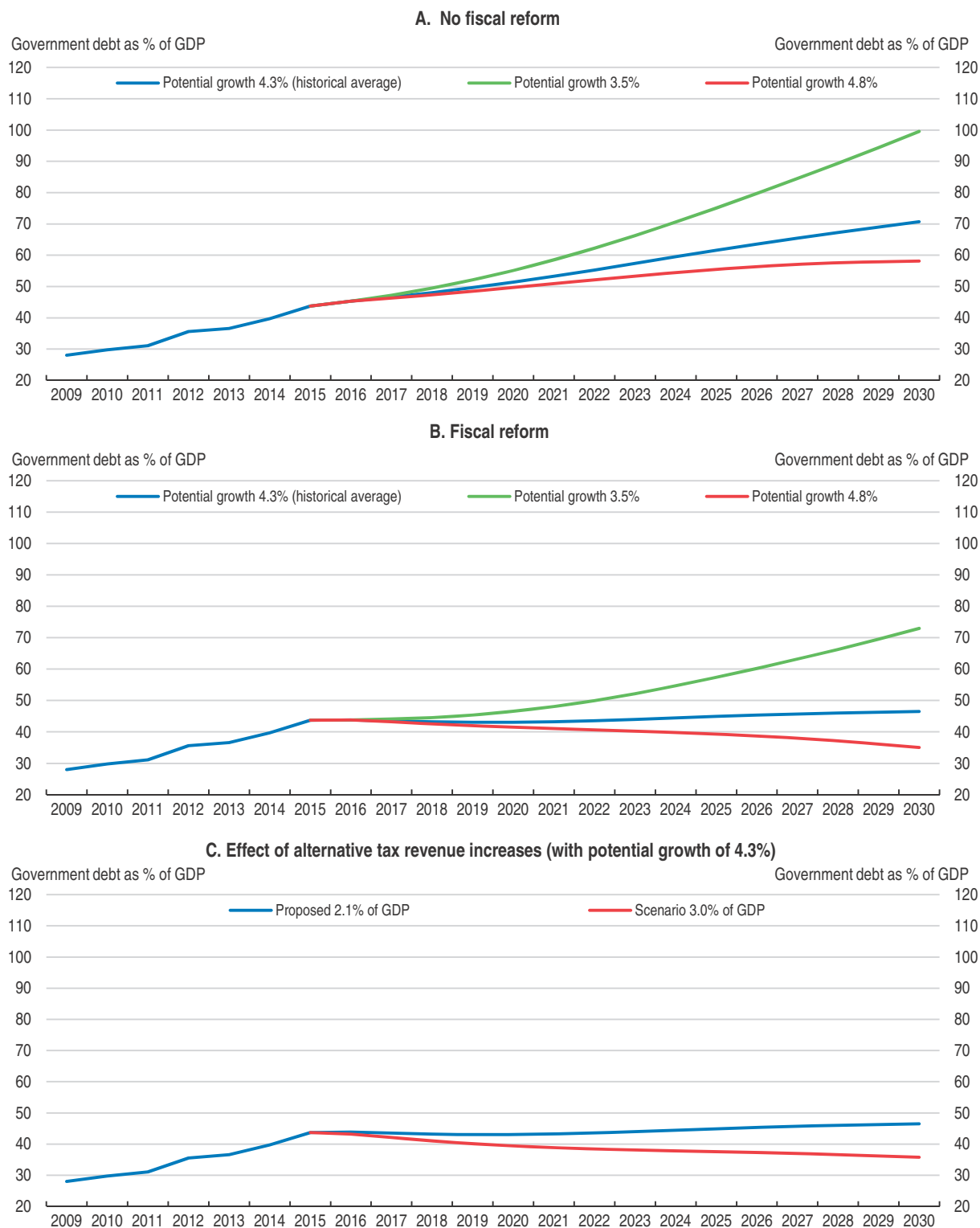
Enhancing public debt management institutions would also improve debt sustainability. In Costa Rica, debt management is split between two agencies of the Ministry of Finance (Mendis, forthcoming). A single agency tasked with both cash and debt management would improve the understanding of debt vulnerabilities, lower costs, help to develop deeper markets for domestic debt and increase resilience to external shocks (Mendis, forthcoming).

Monetary policy is moving towards inflation targeting but financial dollarisation remains high

Over the past decade, the monetary policy framework has gradually been moving towards inflation targeting, which has strengthened the overall macroeconomic policy framework. This move should be accompanied by strengthening the effectiveness of monetary policy to achieve price stability through appropriate institutional reforms. More specifically, delinking the designation of the President of the Executive Board from the political cycle, introducing clear motives and rules for his/her dismissal and depoliticising the composition of the Executive Board would enhance the operational independence of the BCRR. Empirical evidence indicates that operational and procedural independence of central banks is associated with lower and more stable inflation (e.g. Crowe and Meade, 2008).

Together with the ongoing shift to inflation targeting, Costa Rica has moved from a crawling peg regime to an exchange-rate crawling band and then to a managed float since early 2015. Evidence suggests that this has reduced the pass-through of exchange rate movements to core inflation (Figure 12). The BCCR continues to intervene in the exchange

Figure 11. Debt sustainability hinges on fiscal reform

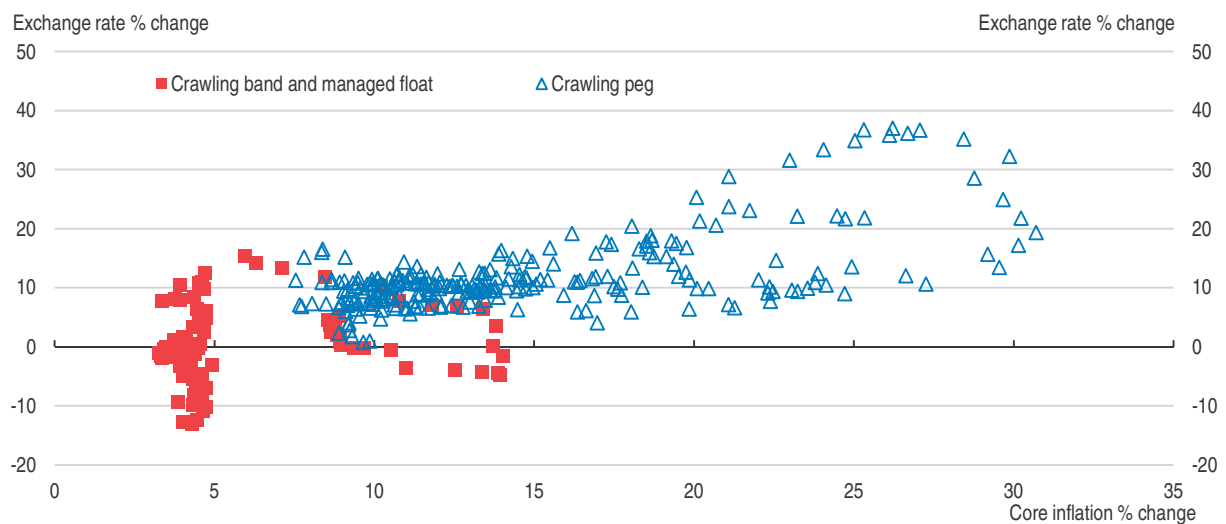


Note: All estimations assume a fiscal multiplier of 0.3 (IMF, 2015a), and expenditure growing at the same pace as nominal GDP. The proposed reform is assumed to be approved in 2016 and increase revenue by 2.1 percentage points of GDP over 3 years. Expenditure is assumed to grow by 9% in nominal terms, roughly equal to nominal GDP, and stabilise at around 31% of GDP. Alternative scenarios increase revenue by 2.5% and 3% of GDP over three years.


Source: OECD calculations.

market, so as to avoid large fluctuations in the exchange rate, which could be destabilising in a highly-dollarised banking system (Ostry, Ghosh and Chamon, 2012). However, the BCCR does not seek to influence the level of the exchange rate, leaving its determination to market fundamentals. Evidence shows that exchange-rate interventions have reduced exchange-rate volatility (Figure 13). Nonetheless, this transitional regime involving foreign exchange interventions should not be allowed to last longer than necessary, since permitting the currency to float more freely will induce agents to incorporate exchange rate risk in their decisions, thus lowering dollarisation. Costa Rica would be well served by a fully-fledged inflation targeting regime, accompanied by a free float, as successfully experienced by other Latin American countries such as Mexico, Colombia, and Chile.

Figure 12. **The transition towards inflation targeting has lowered the exchange rate pass-through**

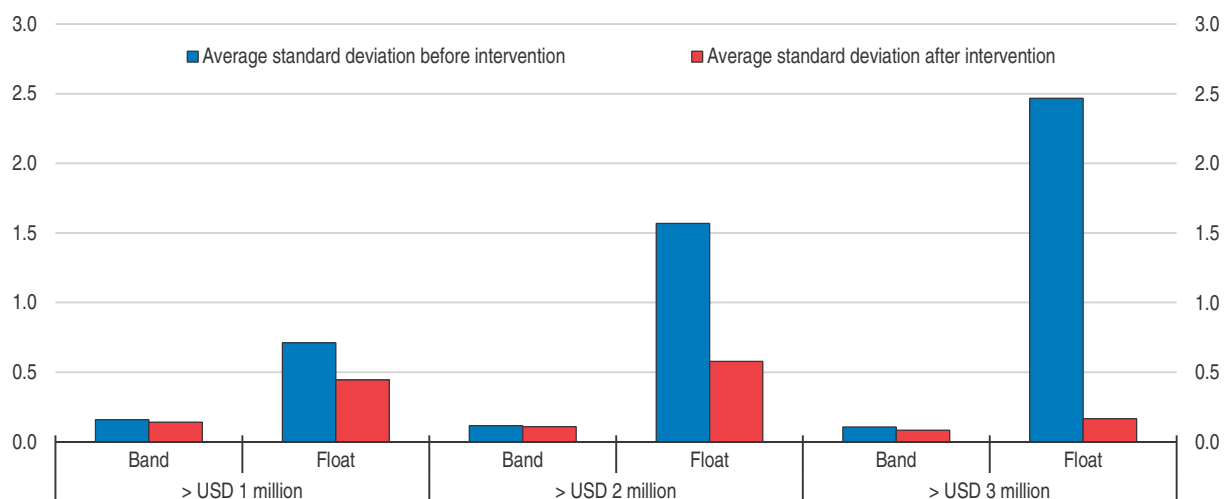


Note: Graph shows the 12-month core inflation against the exchange rate 12-month per cent change 6 months before, for the crawling peg period (January 1985 to November 2006) and a the crawling band and managed float regimes (November 2006 onwards).
Source: Central Bank of Costa Rica.

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Costa Rica's financial system is highly dollarised, especially bank loans, which constitutes a significant vulnerability (Figure 14). Financial dollarisation increases the likelihood of crises after a depreciation of the local currency. It is also associated with slower and more volatile output growth and less stable demand for money and usually entails low financial depth (Levy-Yeyati, 2006). So far, the shift to a managed float, which should in principle raise the perception of currency risk, has not reduced the level of dollarisation (Figure 14). Nonetheless, this should eventually happen as families and businesses start pricing exchange rate risks (ise and Levy-Yeyati, 2003; IMF, 2015b). Experience from other Latin American countries indicates that the adoption of a floating exchange rate contributes to a decline in foreign currency-denominated liabilities with a lag of three years from the change in exchange rate regime (Kamil, 2006).

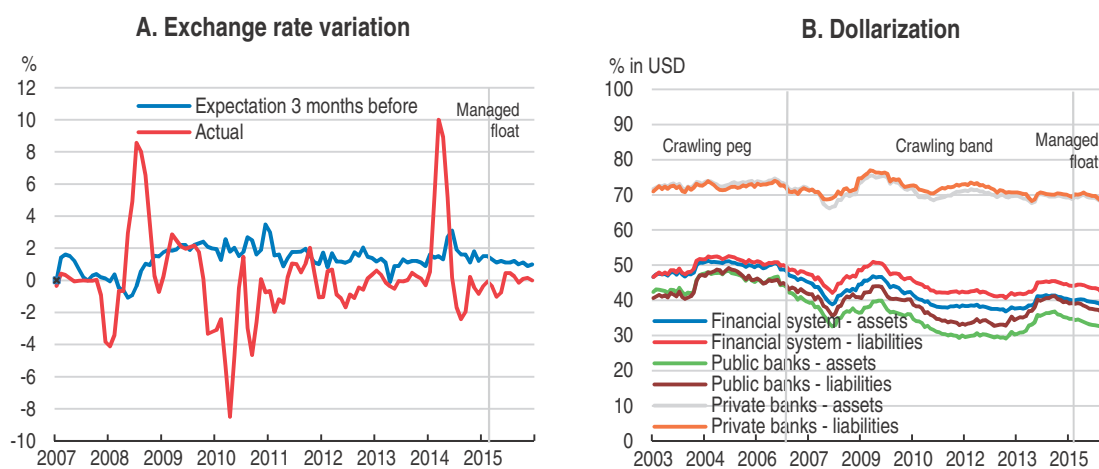
To speed up de-dollarisation, in early 2015 the Central Bank imposed a 15% reserve requirements for all foreign funding in the financial system. This requirement should be maintained and if necessary increased. Also, the BCCR and SUGEF, the banking regulator, need to incentivise the use of derivatives to manage exchange rate risks. The basic regulatory framework of derivative instruments is already in place. Authorities should

Figure 13. **Central bank's interventions lower foreign exchange rate volatility**

Note: Standard deviations of the average exchange rate in the Monex foreign exchange market computed over 3-hour periods before and after Central Bank interventions. The crawling band exchange rate system operated from October 2006 to February 2015, when a managed-float regime was formally adopted.

Source: OECD calculations and Central Bank of Costa Rica.

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Figure 14. **Exchange rate expectations have been stable and financial dollarisation is still high**

Note: Panel B: Percentage of liabilities/assets in USD.

Source: Central Bank of Costa Rica; General Superintendence of Financial Institutions (SUGEF) of Costa Rica.

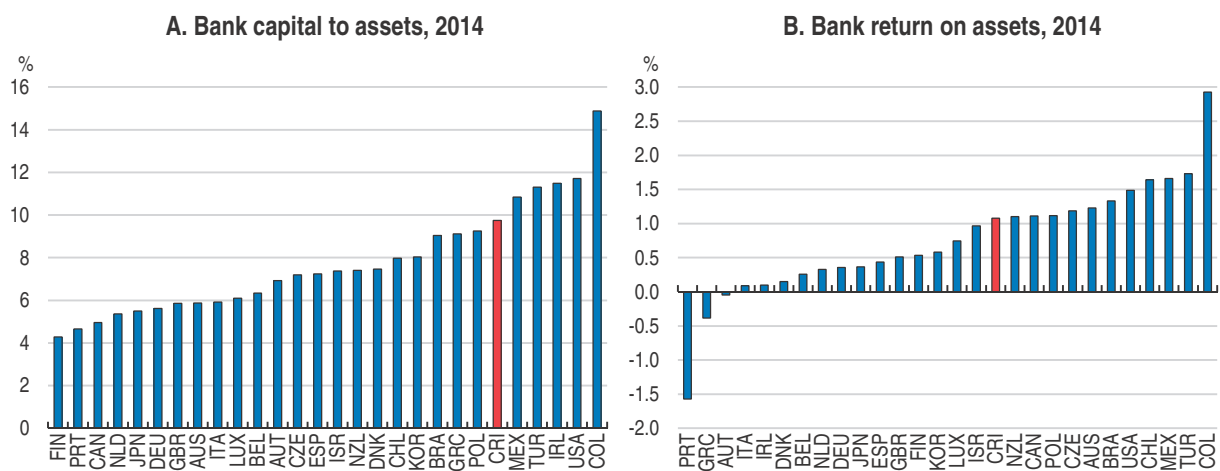
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press for the issuance of more standardised derivative contracts to be traded in organised markets, instead of over the counter, and with lower minimum requirements, which presently are too high for SMEs.

Apart from dollarisation, the banking sector appears solid by standard metrics. Banks' capital-to-asset ratios have remained above the regulatory benchmark of 10% and capital mainly comprises Tier 1 instruments (Basel I) (Figure 15). The liquidity profile is strong, despite a rising loan-to-deposit ratio that leads to the use of foreign funding instead of deposits, and Basel III standards are being progressively adopted. Actions are needed to

reinforce the macro-prudential framework and bring it closer to current practices in OECD countries, where recent initiatives have concentrated on credit and capital measures (OECD, 2013a). In Costa Rica, accelerating the adoption of Basel III principles, publishing the results of the stress tests carried out by the SUGEF would increase transparency and foster market discipline; establishing a bank resolution regime and using tools such as capital surcharges for systemic institutions, loan-to-value ratio and capital buffers would make the system more robust. Moreover, regarding the attributions and resources of SUGEF, bank supervisors should be granted additional legal protection and regulation should be amended to allow SUGEF to conduct supervision of banking groups on a consolidated basis and its funding scheme, heavily dependent on the Central Bank, should be aligned with international standards and rely on charges on regulated institutions.

Figure 15. **Banks' capital-to-asset ratios are higher than in peer countries**



Note: Panel B: 2013 for Germany. The return on assets (ROA) measures banks' profitability relative to their total assets.

Source: IMF Global Financial Stability Report, Financial Soundness Indicators (FSI) Tables, April 2015.

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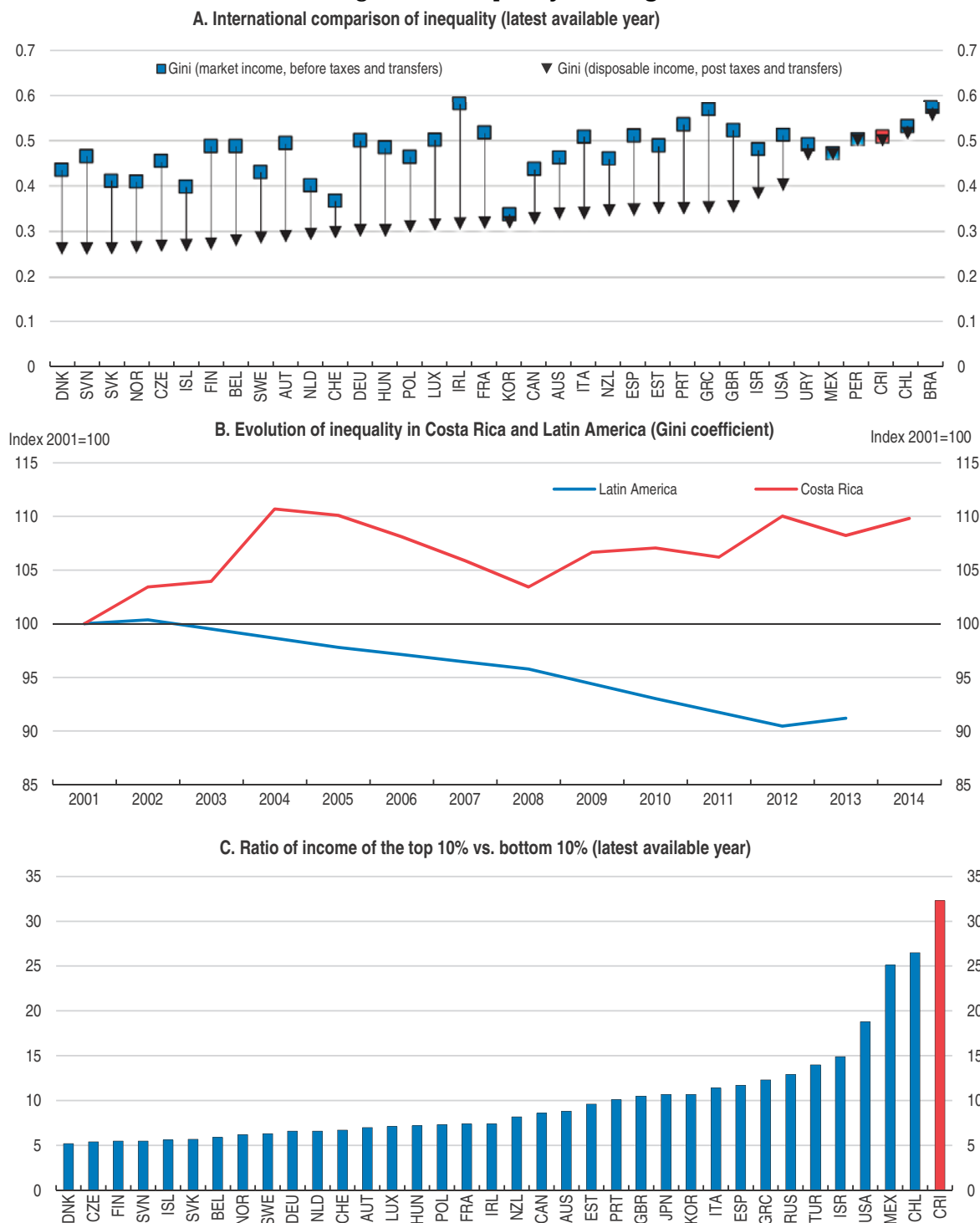
Promoting inclusive and sustainable growth in Costa Rica

Costa Rica stands out among Latin American countries in several social dimensions: poverty rates are among the lowest in Latin America; life expectancy has improved markedly; and subjective well-being is relatively high (Gallup, 2015). Nevertheless, a number of crucial challenges have emerged that should be promptly tackled.

Inequality has increased since the mid-1990s (Figure 16, panel B) to high levels by OECD standards (Figure 16, panel A). This is in stark contrast with many other Latin American economies, which have recently made significant progress in reducing inequality and poverty. Households at the top of the income distribution get a large share of national income: the top 10% gets 32 times the average income of the bottom 10%, compared to an OECD average of 10 times (Figure 16, panel C). Interestingly, rising public-sector salaries made the largest contribution to inequality between 2010 and 2014 (Table 4 and Gabriel and Gonzalez Pandiella, forthcoming), particularly salaries of qualified workers in public agencies outside central government.

Costa Rica's ability to lower income inequality through taxes is small. Direct taxes contribute to redistribution less than in other countries in the region (Sauma and Trejos, 2014), as Costa Rica raises more revenue from social security contributions and less from

Figure 16. Inequality is rising



Note: Panel A: Provisional estimates for Costa Rica for 2015. Data for Uruguay, Peru, and Brasil is based in per capita concept while data for OECD countries and Costa Rica is based in equivalised income. Panel B: Latin America data refers to a simple average and has been interpolated based on data published by ECLAC-CEPALSTAT, *Social Indicators and Statistics Database*. Costa Rica data comes from Estado de la Nación. Due to methodological differences, the level of the underlying Gini coefficients in this panel is not fully comparable with Panel A. Panel C: Provisional estimate for Costa Rica for 2015.

Source: OECD Income Distribution Database (IDD); Lustig et al. (2013); ECLAC-CEPALSTAT, *Social Indicators and Statistics Database*; Estado de la Nación, *Compendio de Indicadores Sociales* (2015).

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personal and corporate income taxes than most countries in Latin American (OECD, 2015d) and the OECD. At the same time, the progressivity of the personal income tax is weak, and the income threshold below which no personal income tax is paid is high. Taxes on capital income at the personal level are also relatively low in Costa Rica, and tax evasion of liberal professions is large (Brys, forthcoming).

Table 4. **Relative contribution of each source of income to total inequality**

	2010	2011	2012	2013	2014	Average 2010-14
Relative contribution of different sources (%)	100	100	100	100	100	100
Qualified public sector employee salaries	31.2	32.5	29.7	31.0	31.1	31.1
<i>Central government</i>	12.3	13.8	13.1	14.5	14.6	13.6
<i>Other public agencies</i>	18.9	18.7	16.6	16.5	16.5	17.4
Unqualified public sector employee salaries	1.5	1.7	1.3	1.5	1.5	1.5
Qualified private sector employee salaries	26.0	26.6	28.0	28.2	30.2	27.8
Unqualified private sector employee salaries	3.6	3.7	3.4	2.6	3.6	3.4
Other employees salaries (e.g. domestic service)	0.6	0.7	1.0	0.3	0.2	0.5
Professionals and tech. self-employed business income	5.5	4.0	3.8	6.2	3.4	4.6
Others self-employed business income	3.4	3.7	5.5	3.9	2.8	3.9
Employers business income	8.6	10.1	8.6	9.3	10.4	9.4
Capital income	11.0	9.4	10.3	9.0	9.1	9.7
Contributory pensions	8.5	7.8	8.0	8.0	8.1	8.1
State transfers	-0.8	-0.7	-0.7	-0.8	-0.9	-0.8
Other transfers (private and non-monetary)	1.0	0.6	1.1	0.7	0.8	0.8

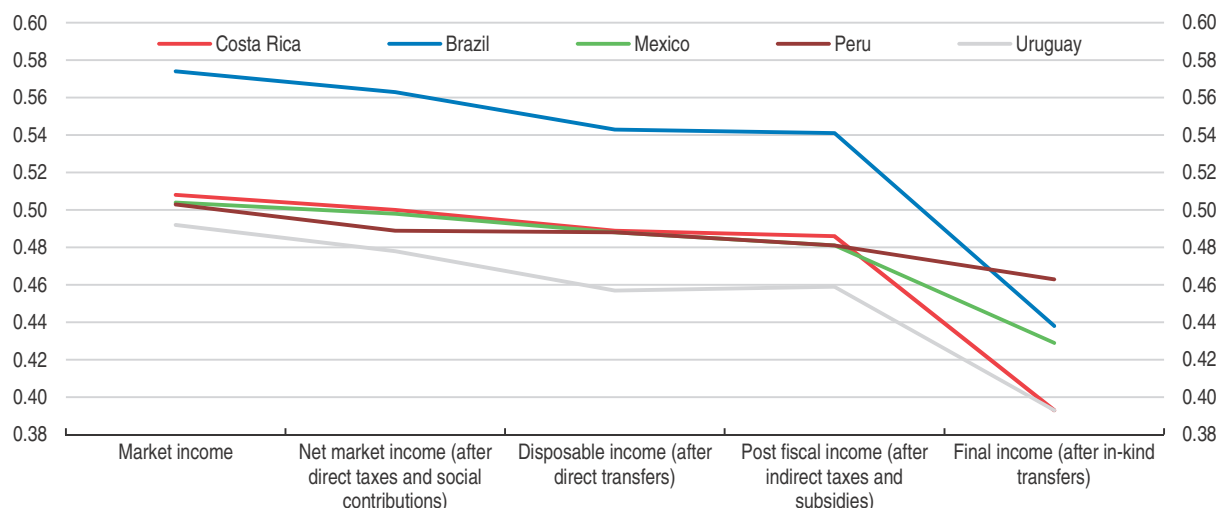
Note: These calculations are based on the income categories reported in ENAHO, which includes contributory pensions, non-contributory pensions and transfers provided by IMAS. This is in line with Sauma and Trejos (2014), Lustig et al. (2013), Estado de la Nación (2014) and Trejos and Oviedo (2012). The underlying GINI coefficient is based on the per capita income concept and therefore is slightly different from those based on the equivalised income concept such as those reported in Figure 16 (panel A) and Figure 1.2 (panel A).

Source: Gabriel and Gonzalez Pandiella (forthcoming).

By contrast, transfers in kind (education or health) are effective in reducing inequality (Figure 17). Anti-poverty cash transfers are also effective, though they could be better targeted as a quarter of the social benefits provided by FODESAF (Family Allowances Fund) – the main government mechanism to finance social assistance and fight poverty – goes to middle and high income households (Table 5).

Poverty has remained largely unchanged over the last two decades. In 2015, it reached 22% of households, according to national definitions of poverty, while extreme poverty affected 7% of households (INEC, 2015a). Structural reform to address institutional fragmentation and lack of coordination in social policy is needed to reduce poverty. At present, different institutions offer similar schemes using different eligibility criteria and different registries of beneficiaries. Moving towards a unified framework, based on a single list of beneficiaries, would contribute to better targeting and lower leakages. Efforts in that direction have started. For example, IMAS, the institute for social assistance, has integrated its information systems with those of other social assistance programs, and the budget for the creation of a national registry of beneficiaries has recently been approved. In a tight fiscal context, it is important to evaluate social programmes and to focus resources on those that are effective and to scale down those that are not. Evaluation would also help to establish targets for government agencies, which is also needed to improve government efficiency. IMAS is also gradually executing *Puente al Desarrollo*, a strategy to reduce extreme

Figure 17. **Transfers in-kind reduce inequality**
GINI coefficients of different types of income, 2010



Source: Sauma and Trejos (2014a) and Lustig et al. (2013).

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Table 5. **Distribution of beneficiaries of social programmes by income quintile**
% of beneficiaries in each income quintile (2013)

Programme	Income quintiles				
	I	II	III and IV	V	
Youth centres (Centros infantiles)	57	25	18	0	100
School meals	42	27	28	4	100
School scholarships (Avancemos)	49	29	21	1	100
Non-contributory pensions	64	15	19	2	100
Family welfare centre (Promoción y bienestar familiar)	50	28	21	1	100
Family housing fund (Bono familiar vivienda)	30	23	39	8	100
Insured on the account of the state	70	16	14	1	100
Total Fodesaf	51	25	22	2	100

Source: Estado de la Nación (2014).

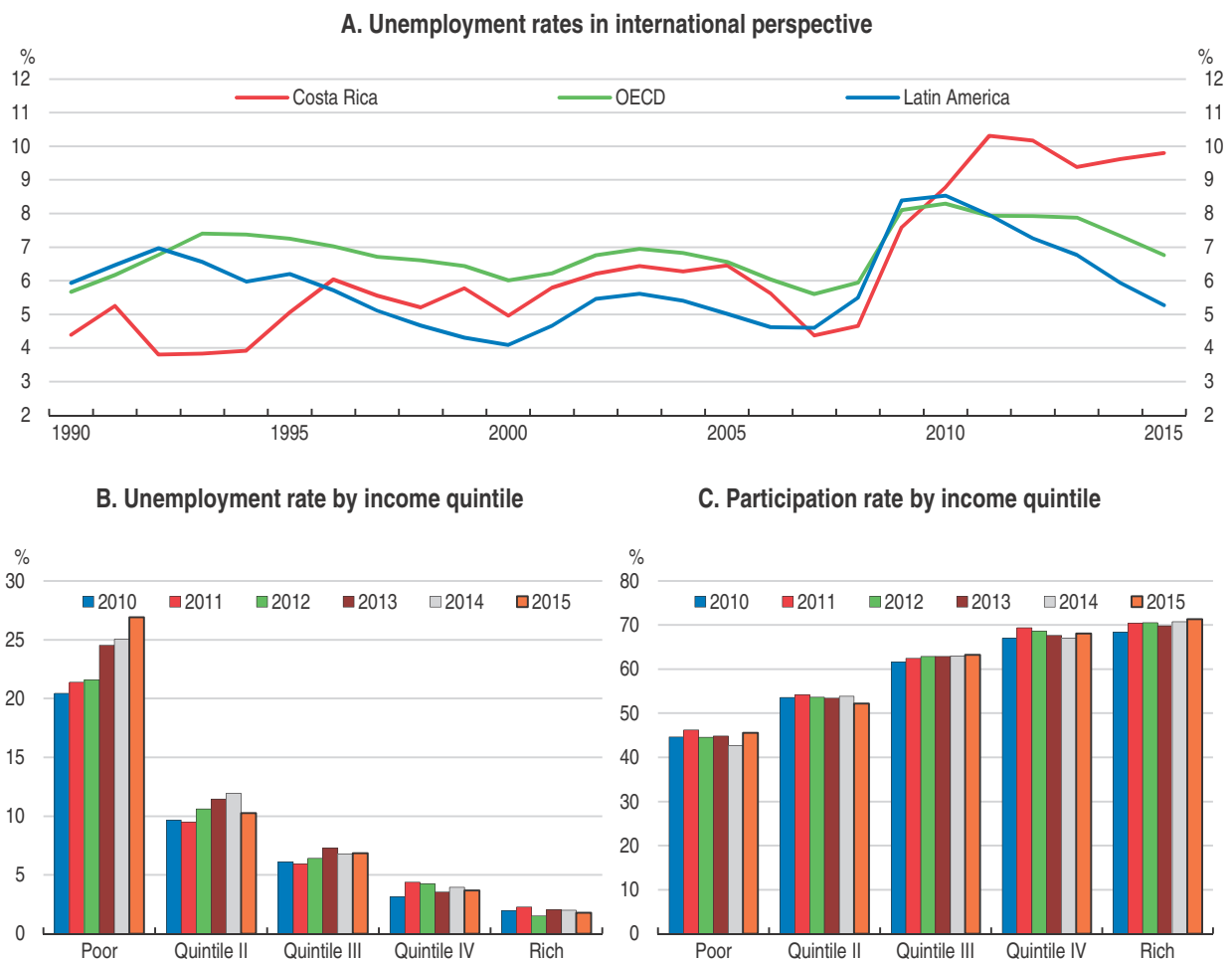
poverty, and has also started the compilation of social maps, which help to geographically monitor and target efforts, and of a multidimensional poverty index (INEC, 2015b).

Making the labour market more inclusive

With growth remaining slow since the crisis, labour-market indicators have deteriorated (Figure 18). Women face higher unemployment rates and their labour market participation is especially low, with only slightly over half of working-age women participating in the labour market (Figure 19). Youth unemployment reaches 24%. All this highlights the need to put in place targeted policies to make the labour market more inclusive.


The informal sector is smaller than in other countries in the region, but high by OECD standards (Figure 20, panel A). Contrary to many Latin America countries, informality has been increasing rapidly (Figure 20, panel B) and now exceeds 45% of total employment. This reflects weak economic growth, resulting in slow job creation in manufacturing

Figure 18. Unemployment is high and hits the poor hard



Note: Panel A: Unemployment rate data for Costa Rica before 2010 comes from ENAHO and after 2010 from Encuesta Continua de Empleo. Both series are not comparable.

Source: OECD (2015a), OECD Economic Outlook 98 Database; INEC, Encuesta Continua de Empleo y Encuesta Nacional de Hogares.

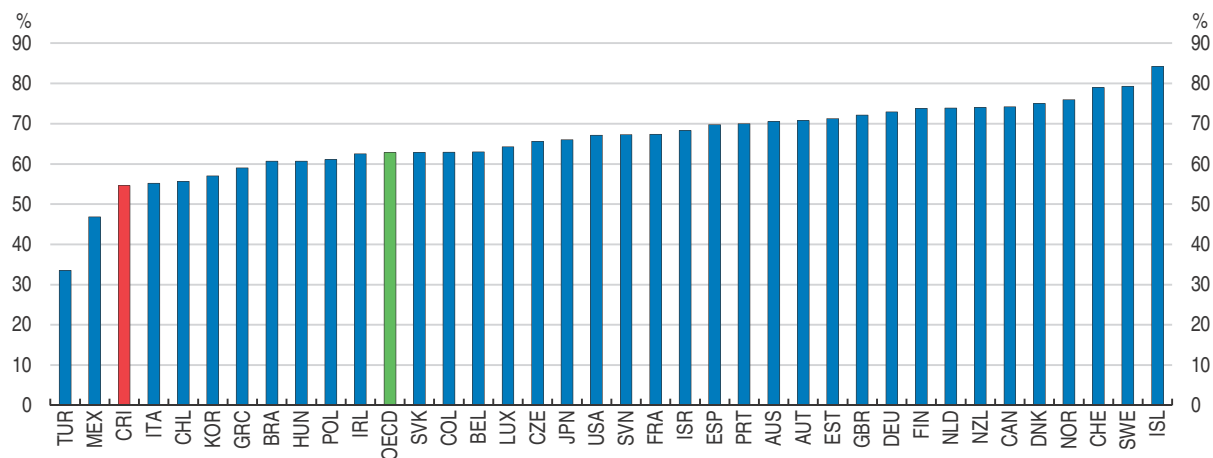
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(where the informality is lower) and by a rise in employment in agriculture, and especially, domestic work services (where the informality rate is higher). The Costa Rican labour market is also characterised by duality: traditional sectors employ low-skilled and low-paid workers with precarious contracts, while exporting industries, such as those operating in the free trade zones, employ high-skill individuals and offer new job opportunities. The ongoing shift away from traditional and labour-intensive activities into higher value added activities has increased demand for high-skilled labour and contributed to a rising skill mismatch. This has translated into a rising high skills wage premium and structural unemployment rate, thus exacerbating income inequality.

Costa Rica faces four fundamental challenges to make its labour market more inclusive: improving the quality of the education system (see below); improving incentives for employers and workers to stay in or move to the formal economy; facilitating the acquisition of new skills by unemployed workers; and raising women's participation in the labour market.


Figure 19. **Female labour market participation is low**

Women labour force participation rate (age 15 to 64), 2014



Note: Data for Brazil is 2013.

Source: OECD, *Labour Force Statistics Database*.

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Boosting employment in the formal sector

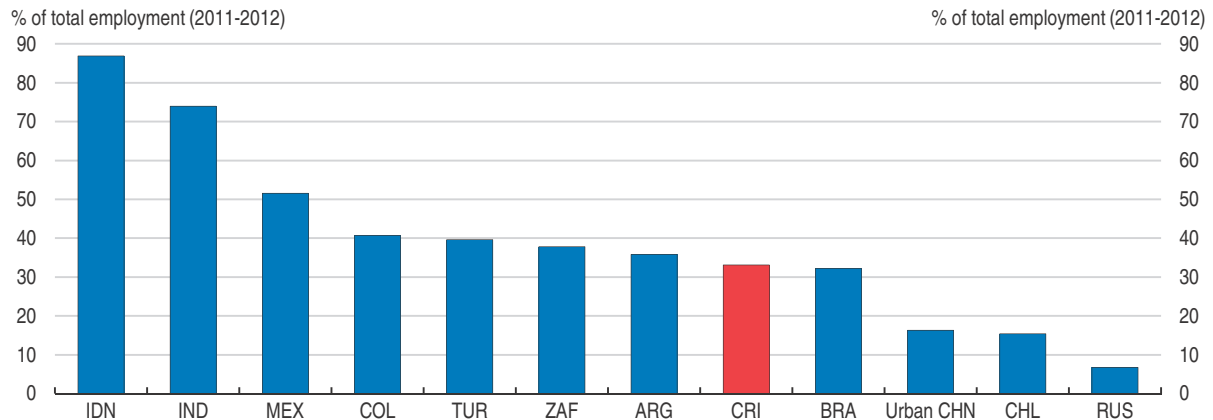
Reducing informality requires a comprehensive strategy, with actions covering multiple dimensions such as fiscal, labour market, social policies, education or business regulations. Reducing non-wage labour costs, simplifying some labour market policies, improving training and education, strengthening enforcement, and adapting business registrations procedures to the needs of micro and small firms will help to boost formal employment. Several studies (e.g. Ramirez-Alfaro, 2010) show that high employer social security contributions are the main obstacle for a business to become formal. The total social security contributions rate is 36%, of which 26 percentage points are borne by employers (Figure 21) and the rest by employees. Out of the total contribution, the social security actually receives 23.5% of the salary as the rest is used to finance other institutions, such as public banks, or social programmes.

In the medium-term, a gradual reduction of social security contributions would help to raise formal employment. Across-the-board cuts in social security contributions are easier to implement and administer but could imply losses of fiscal revenues. Targeted cuts may be more difficult to administer but would contribute to broaden the tax base. Experiences of countries that have introduced targeted cuts in employer social security contributions suggest that they can be effective in increasing formal employment and cost-effective if they are targeted at those accounting for the bulk of the non-employed or informal employment (IMF, 2014). Costa Rica could then focus on those sectors of the economy where informality is rampant, such as agriculture, construction and domestic work services that account for 60% of all informal employment. The government should also avoid using social security contributions to fund public banks or antipoverty programmes, but use other more progressive taxes instead, and fight domestic and international tax evasion, as these are less distortive ways to raise revenue.

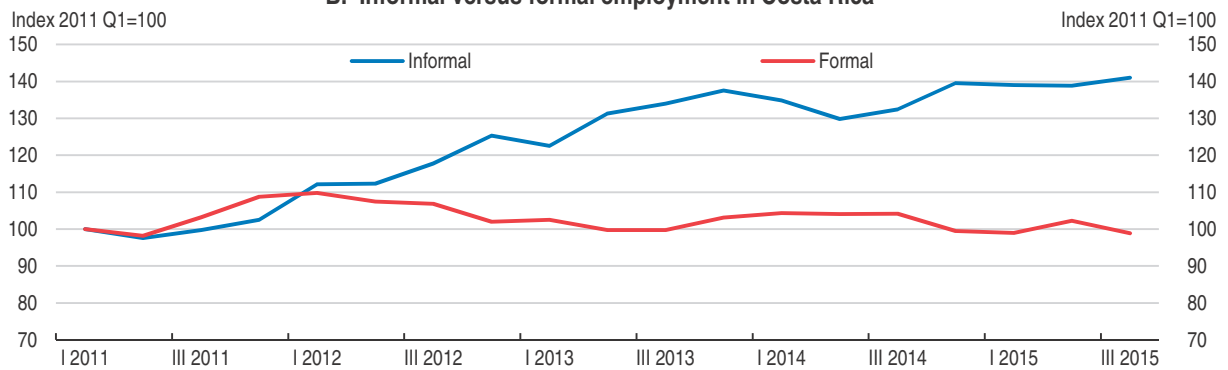
While the level of the minimum wage is not excessively high in Costa Rica relative to other countries in Latin American, its structure is complex. There are more than two

Figure 20. **Informal employment is increasing**

A. Informality in international perspective



B. Informal versus formal employment in Costa Rica

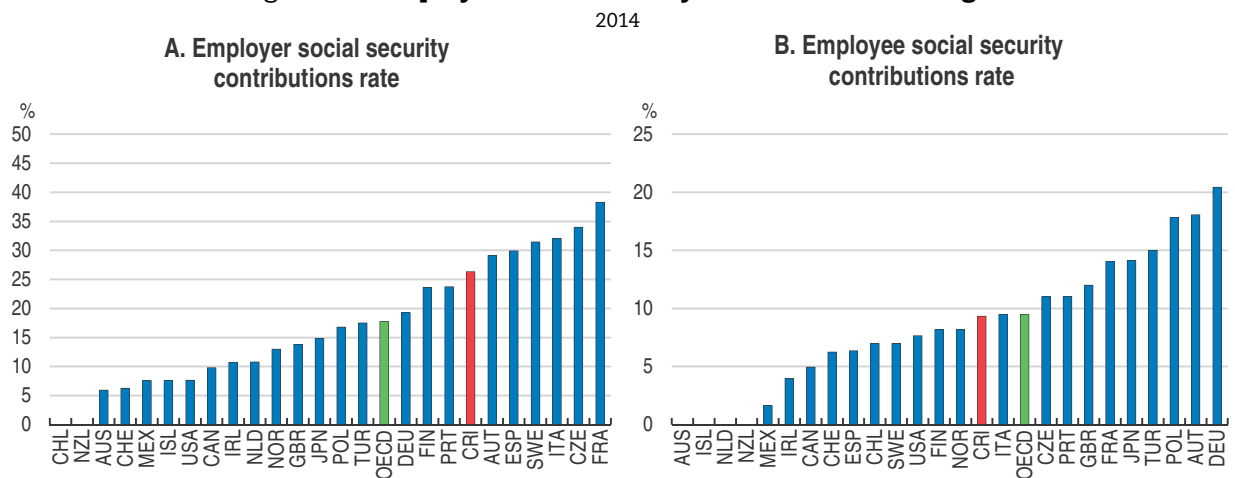


Note: Informality is defined to include: i) employees who do not pay social contribution, except for Colombia where contract status is used; and ii) self-employed who do not pay social contributions (Brazil, Chile, China, India, Indonesia, Turkey) or whose business is not registered (Argentina, Colombia, Costa Rica, Mexico, South Africa). The figures for China are for 2008 and 2009. All figures for Indonesia are for 2007.
 Source: OECD (2015c), *OECD Employment Outlook*; INEC, *Encuesta Continua de Empleo (ECE)* 2015.

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Figure 21. **Employer social security contributions are high**

A. Employer social security contributions rate **B. Employee social security contributions rate**



Source: OECD, *Tax Database* and Caja Costarricense de Seguro Social.

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hundred minimum wage categories, differing across sectors and occupations. Such a large number of minimum wages may reduce compliance and make them harder to enforce (Rani et al., 2013). Indeed, one out of three workers in Costa Rica is being paid below the minimum (Estado de la Nación, 2014). Simple minimum wage systems are most likely to improve compliance (OECD, 2015c), and therefore the number of categories should be sharply reduced. In addition, there is an urgent need to improve enforcement mechanisms.

Informality affects the less educated the most. Half of the workers with only primary education are employed in the informal sector. This suggests that providing Costa Ricans, especially those with less education, with more job-relevant skills will be fundamental to abate informality (more below). Formalising a business is also more difficult in Costa Rica than in most countries in Latin America and the OECD countries. Administrative burdens for sole proprietor firms are relatively high according to the OECD's Product Market Regulation indicators (see below), and in the World Bank's index of ease of business creation, where Costa Rica ranks 121 out of 189 countries. One of the major perceived obstacles is the difficulty and expense of obtaining a licence. OECD best practices suggest that limiting licensing to those activities where it is justified on health, safety or environmental grounds, and reducing the associated cost are important steps to curb informality. Establishing a one-stop point for issuing or accepting all notifications required to register a business would also help, especially for micro and small firms.

Helping the unemployed get back to work

As other Latin America economies, Costa Rica prioritises social programmes such as conditional cash transfers, and the provision of basic in-kind services to socio-economically disadvantaged groups. But there is no unemployment insurance scheme in Costa Rica and, in case of unemployment, workers are compensated through severance pay. Public employment services provide basic intermediation services but need to expand services, coverage and effectiveness (Mazza, 2013). Improving active labour market policies would be particularly beneficial for low-skilled workers, as they are likely to gain the most from active support and guidance concerning the skills needed to find formal employment and how to obtain those skills. Policies should be targeted on those experiencing more difficulties in finding a job. In this sense *Mi Primer empleo*, a recently launched scheme providing financial incentives to employers that hire young and female workers is welcome but should be carefully evaluated as soon as possible to ascertain its effectiveness.

Active labour market policies should encompass effective training programmes. Training programs for unemployed have been found to increase employability both in the OECD and in Latin America (Ibarrarán and Rosas, 2009), where they have been associated with higher probability of getting a formal job. For many Costa Ricans learning new skills will be the only way to take advantage of new employment opportunities. Thus, social assistance programs should include training opportunities and be made conditional on attending them. An area where Costa Rica faces significant skill shortages that could be partly addressed via retraining of unemployed workers is technical occupations. The National Learning Institute (INA), the main provider of technical training in Costa Rica, plans to develop a dual vocational track (OECD, 2015g). Such tracks should be made available to the adult low-skilled unemployed.

Increasing female labour market participation

The lack of child-care facilities in Costa Rica contributes to low female labour market participation. Public childcare is provided by *Red Nacional de cuidado*, involving IMAS, PANI (*Patronato Nacional de la Infancia*; National Children’s Trust), CEN-CINAI (*Centros de Educación y Nutrición – Centros Infantiles de Atención Integral*; Education and Nutrition Centres – Children’s Comprehensive Care Centers) and the Ministry of Education. Only 15% of children below three years old attend child care facilities in Costa Rica. In addition, children whose parents have a high education level are more likely to attend (Estado de la Nación, 2015). At the same time, the proportion of female-headed households has increased notably in the last 25 years (Estado de la Nación, 2014) and they face higher probability of falling into poverty. OECD evidence suggests that the availability of affordable, high-quality early childhood education and care is a key factor explaining cross-country differences in women’s labour market participation (OECD, 2012b). Access to good quality child care not only encourages greater female labour supply but improves school outcomes and mitigates social inequalities (Ruhm and Waldfogel, 2011). Therefore the authorities should expand the number of places available in early childhood education for children below 4 years old, specifically targeting low income households.

Complying with labour rights

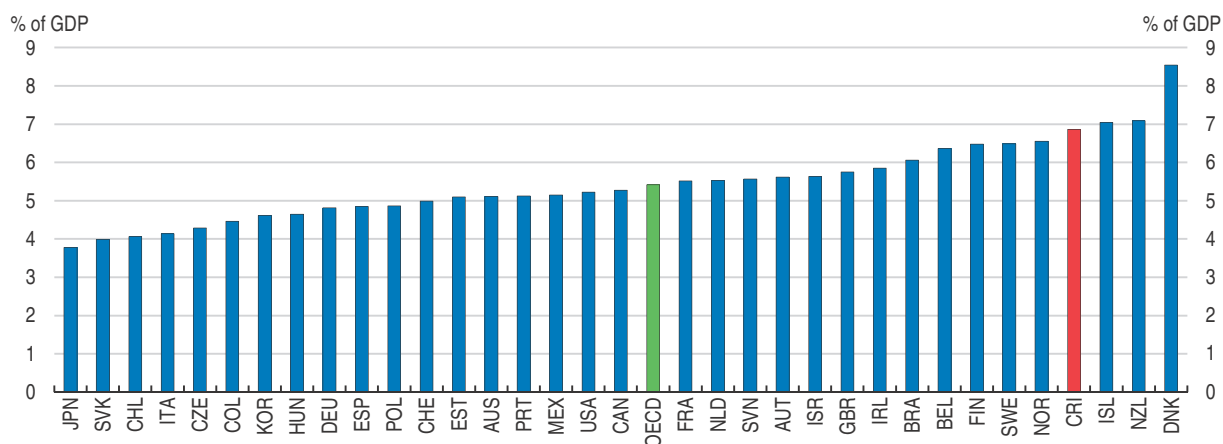
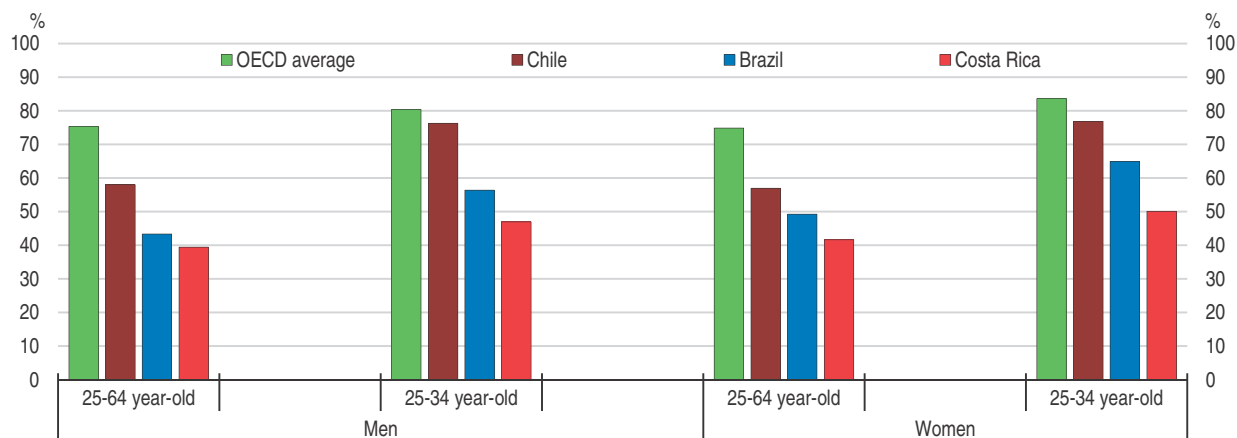
Costa Rica has made gradual progress in increasing compliance with labour rights. The number of workers not enjoying any of the labour rights recognised in the legislation, such as sick leave, holidays, overtime or social security insurance, has been falling, although it still reaches 7% of all workers (Estado de la Nación, 2014). However, one out of three workers is still being paid below the minimum wage. Vigilance should continue to ensure better compliance. Another area which requires monitoring concerns trade union rights. The number of collective agreements in the private sector is low and direct agreements with non-unionised workers are frequent. Existing laws prohibit anti-union discrimination, but enforcement has been weak. Costa Rica has attempted to promote trade union labour rights in recent years and a new law was approved in the late 2015. The new law explicitly bans any form of discrimination in the workplace, besides shortening labour related disputes, by introducing oral arguments in courts and establishing out-of-courts resolution mechanisms. However, the law still prohibits strikes in public services considered as essential – such as police but also hospitals and ports – and allows for hiring temporary staff to replace striking workers. The government should continue legal reforms so as to comply with ILO conventions and recommendations.

Improving the quality of education

Costa Rica is one of the pioneers in universal access to primary education in Latin America. Spending on education amounts to 6.9% of GDP and there is a constitutional mandate to raise it to 8%. The historical commitment to education has translated into high literacy rates and almost full enrolment in primary education. In the OECD, only some Nordic countries and New Zealand spend a higher share of GDP on education (Figure 22, panel A). Despite the high level of spending, the gap in educational outcomes with respect to OECD countries is the largest among the available well-being indicators (Figure 2). Average school attainment remains low, as only 40% of the workforce has completed secondary education (Figure 22, panel B). The results are not better for recent cohorts and are lower than in OECD and other Latin America countries such as Chile, Colombia,


Figure 22. **Spending on education is high but outcomes are low**

Latest available year

A. Total spending**B. Percentage of population with at least secondary education**

Note: Panel A: Latest year available. Year 2013 for Costa Rica and 2012 for Korea. 2011 for the rest. Panel B: Year 2014 for OECD average and Costa Rica, 2013 for Chile and Brazil.

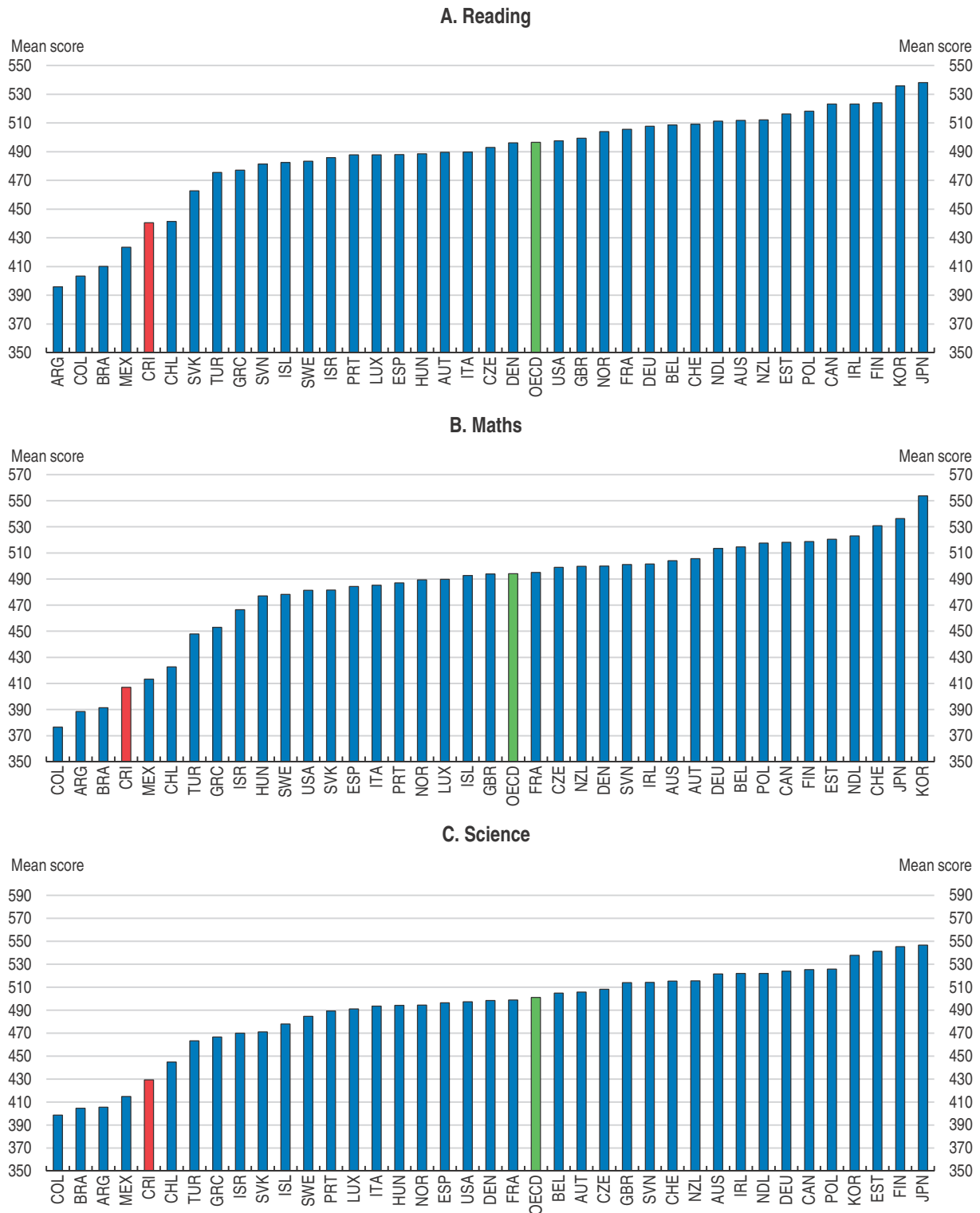
Source: UNESCO Education Database; OECD (2015o), *Education at a Glance 2015*.

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Venezuela or Panama. The quality of education is also comparatively low according to OECD's PISA tests, which show low scores in all subjects (Figure 23).

Higher expenditure on education does not guarantee better student performance (OECD, 2012c); how money is spent is critical. High-performing systems tend to allocate resources more equitably across socio-economically advantaged and disadvantaged schools (OECD, 2013c). Thus, Costa Rica should move away from an exclusive emphasis on increasing spending as a policy target and instead establish better educational outcomes as the main target. There is also a need to improve efficiency and evaluation mechanisms, and enhance accountability across the entire education system, including universities. A significant share of recent increases in spending was dedicated to raising teachers' wages, which increased by more than 20% in real terms in the period 2009-13 (Estado de la Nación, 2015). This could be beneficial if it leads to hiring more high-quality teachers. In general, the countries that perform well in PISA attract the best students into the teaching profession by offering them higher salaries and greater professional status (OECD, 2013c).

Figure 23. PISA scores can be improved



Source: OECD (2014d), PISA 2012 Results: What Students Know and Can Do (Volume I, Revised edition, February 2014).

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Improving teacher's professional development and harmonising their qualifications would also help to improve the quality of teaching.

An additional challenge is to spread education benefits more fairly across the society. Gaps in the access to education depend on household income, and have widened in the last two decades (Estado de la Nación, 2014). Inequities in education outcomes start early. Many students repeat grades in lower secondary schools and end up dropping out. Focusing early and targeted support on those students with a higher risk of leaving the education system would be more efficient and yield better outcomes than grade repetition. The recently launched *Yo me apunto* programme seems a very promising initiative in this direction.

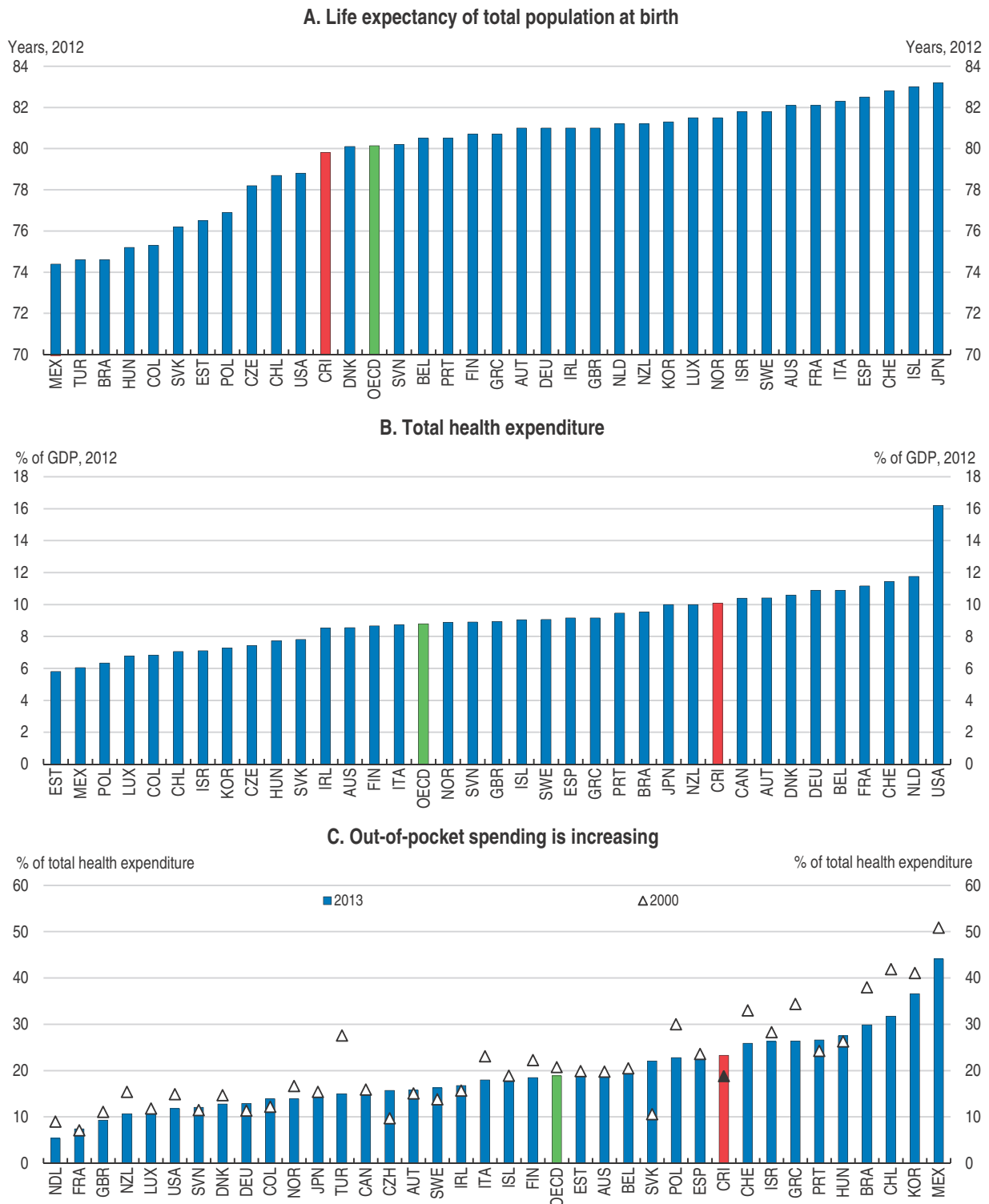
Another action that could contribute to curb drop-outs at secondary level and tackle high youth unemployment is to reinforce the vocational technical track. This has proved to be an effective tool across OECD countries to improve educational outcomes and employability, especially when vocational programmes are designed and implemented to be responsive to labour market needs. Costa Rica is in the process of discussing the implementation of a dual system in vocational education. International experience suggests that a key element for a successful development of dual education is to give employers a central role in workplace learning and to develop apprenticeship schemes (OECD, 2015g).

Increasing efficiency in the health system

Costa Rica has a long-standing commitment to provide universal health care to its entire population, which has translated into health outcomes similar to those of OECD countries (Figure 24, panel A). Health spending has continued to grow, and is now 10% of GDP, above the average in OECD countries (Figure 24, panel B). However, users still face long waiting times, out of pocket spending is raising and is now higher than the OECD average (Figure 24, panel C). This is generating inequities in access and quality of treatment, and increasing patient dissatisfaction.

Modernising the health system is a key to improving quality while preserving universal access. Performance is hampered by excessive fragmentation and outdated and dispersed information systems. Updating the information system is a crucial step to improve the management of the system with better information on performance indicators, such as unitary costs and waiting lists. In this direction, progress is underway to roll-out the single digital medical file, which will provide real time statistics and performance indicators. Resources need also to be allocated more effectively, moving away from a historical allocation towards an allocation that takes into account changing demographic patterns and disease trends. This should be accompanied by introducing diagnosis-related funding schemes, i.e. hospitals should be compensated according to patient characteristics. OECD evidence shows that diagnosis-based schemes are very effective at containing costs without prejudice to the quality of services, as they provide stronger incentives to control spending than fee-for-service schemes, which can result in service oversupply (Pisu, 2014).

Figure 24. **Out-of-pocket spending is high and increasing despite high health spending**



Source: OECD, Health Statistics Database; World Bank, World Development Indicators; WHO, Global Health Expenditure Database.

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Boosting potential output growth and productivity while protecting the environment

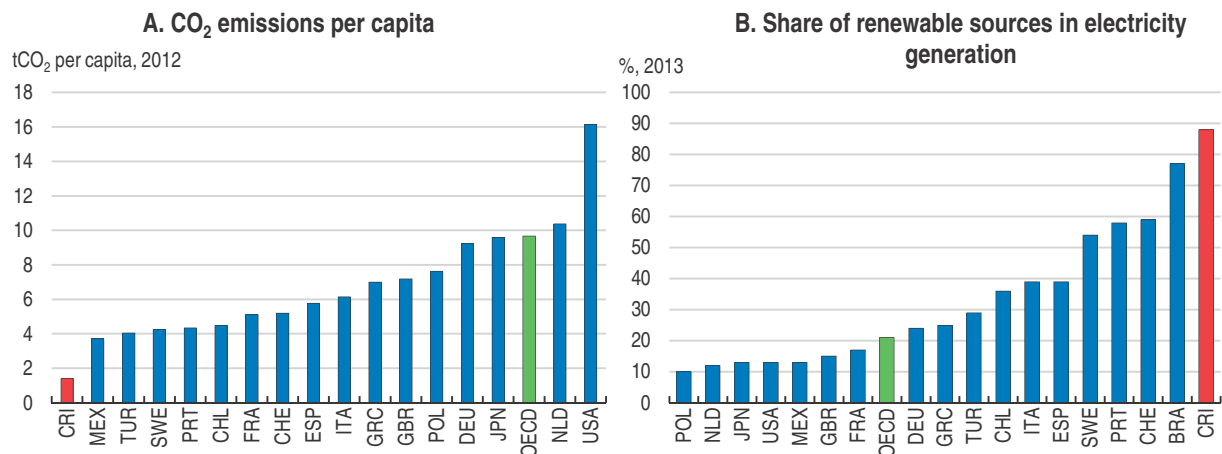
In the latest decades, Costa Rica has managed to combine rising living standards with a world-distinguished green trademark centred on forest conservation, reforestation and national parks, in addition to a sustainable use of national resources. Costa Rica is the only tropical country that has substantially reversed deforestation (World Bank, 2015). The green trademark has supported economic development as it has spawned a strong ecotourism industry, with a positive impact on incomes in rural areas (Robalino and Villalobos, 2014). In addition, tourism is an important source of foreign exchange reserves as in 2014 it accounted for more than 20% of total exports (higher than the total exports of coffee, bananas and pineapples) (ICT, 2014). To continue on this path, Costa Rica will have to tackle two intertwined challenges relating to raising productivity growth and strengthening further environmental protection in the wake of rising urbanisation and climate change.

Sustaining environmental protection to reinforce the green trademark


Costa Rica is the pioneer of Payments for Environmental Services (PES), which have allowed the country to reverse deforestation. Forest cover increased from 26% in 1983 to 52% today (World Bank, 2015). In the context of the recent climate change negotiations, Costa Rica has announced ambitious targets to decarbonise its economy while reiterating its aspiration to align its economy towards carbon neutrality by 2021 and establishing a long term goal for decarbonising its economy throughout the rest of the century. The latter encompasses a target to reduce total net emissions (i.e. taking into account CO₂ removals by forests) by 25% by 2030 compared with 2012 and other ambitious milestones for 2050 and 2100 (MINAE, 2015). Overall, the most important environmental and climate change challenges Costa Rica faces concern the impact of increasing urbanisation and emissions from the transport sector.

Costa Rica generates about 90% of its electricity from renewable sources – well above the level in OECD countries – mostly from hydropower and, to a lesser extent, geothermal sources (Figure 25). However, considering the projected rise in energy demand it is necessary to increase and diversify the energy supply from renewable sources by boosting the use of geothermal, solar, wind and biomass energy sources also with the participation of the private sector. The transport sector accounts for 70% of carbon emissions. This is explained by the persistent increase in the number and use of motor vehicles, in particular private cars, which grew by 68% from 2003 to 2014, in the context of a scarce and inefficient public transportation system. Tackling emissions from the transport sector will be crucial to make progress towards the decarbonisation target. A meaningful reduction in emissions from the transport sector will only come from more decisive steps in the design and implementation of a public transport network. Costa Rica has also put in place a number of initiatives to foster the use of clean cars and encourage that the vehicle fleet becomes more energy efficient. However, these initiatives may take a long time to deploy their effect.

Costa Rica is also a pioneer in carbon pricing. In 1997, Costa Rica enacted a tax on fossil fuels, whose revenue funds the Payments for Ecosystem Services. In 2012, it established the Domestic Voluntary Carbon Market, whereby carbon credits can be generated and exchanged among companies and individuals. Further efforts are ongoing to consolidate and expand this market accompanied by other recent initiatives, such as the creation of certificates of carbon neutrality for companies and several sectoral mitigation programmes,

Figure 25. **The high share of renewable in electricity contributes to low emissions per capita**

Source: IEA World Energy Statistics and Balances, World Indicators Database; IEA CO₂ Emissions from Fuel Combustion Statistics, Indicators for CO₂ Emissions Database.

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the so-called Nationally Appropriate Mitigation Actions (NAMAs). These efforts should be pursued as they will keep Costa Rica at the forefront of abatement mechanisms.

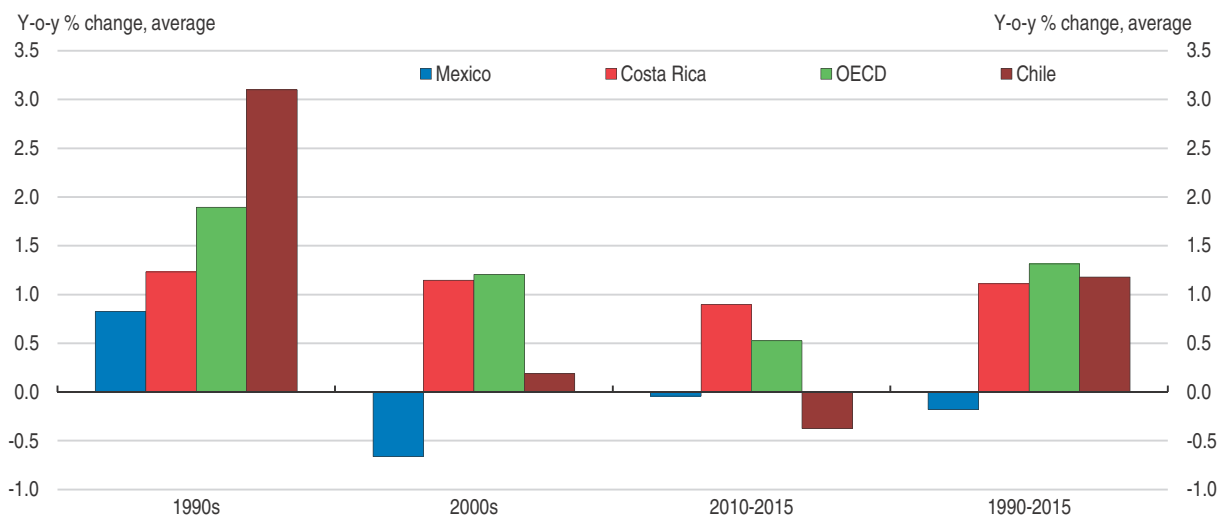
Sewage treatment and solid-waste management are other challenges originating from urbanisation. Seventy-five percent of the residential wastewater is diverted to septic tanks. Sewers are used by only 20% of the population, and only 4% of that fraction receives remedial treatment (Estado de la Nación, 2014). This is well below OECD standards and also below standards in other neighbouring countries. Of all urban wastewater collected in Costa Rica, 96% of is discharged into rivers and receiving water bodies without any treatment, generating public health risks and water contamination. To respond to these challenges, the first ever collection system in the Metropolitan Area of San José is being built. The government should aim at building additional waste-treatment plants in other regions with the aim of gradually covering 100% of water discharges.

Improving productivity will require a whole-of-government approach

Costa Rica's rising living standards over the latest decades have largely depended on rising employment while productivity has made a decreasing contribution (Figures 2 and 26). Since early 2000s, potential output growth has declined by nearly one percentage point to about 4% as employment growth has fallen (Figure 27). The slow-down in employment trend growth can be ascribed, as discussed above, to structural issues besetting the labour market and resulting in an increasing structural unemployment rate and informality, and falling participation among low-skilled workers.

Raising productivity growth so as to sustain output growth will require measures spanning innovation, competition and transport infrastructure, in addition to improving education, as discussed above. Given this wide range of policies, it is important they are well aligned. In this respect, it is useful to develop a national strategy actively involving all stakeholders, including businesses, academia and social partners (OECD, 2015k). The government is aware of this challenge and in 2010 it established the Presidential Council on Competitiveness and Innovation (CPCI), to co-ordinate policies across institutions. It is composed of three sub-councils – Council on Competitiveness, Council on Innovation and

Figure 26. **Productivity growth is decreasing**

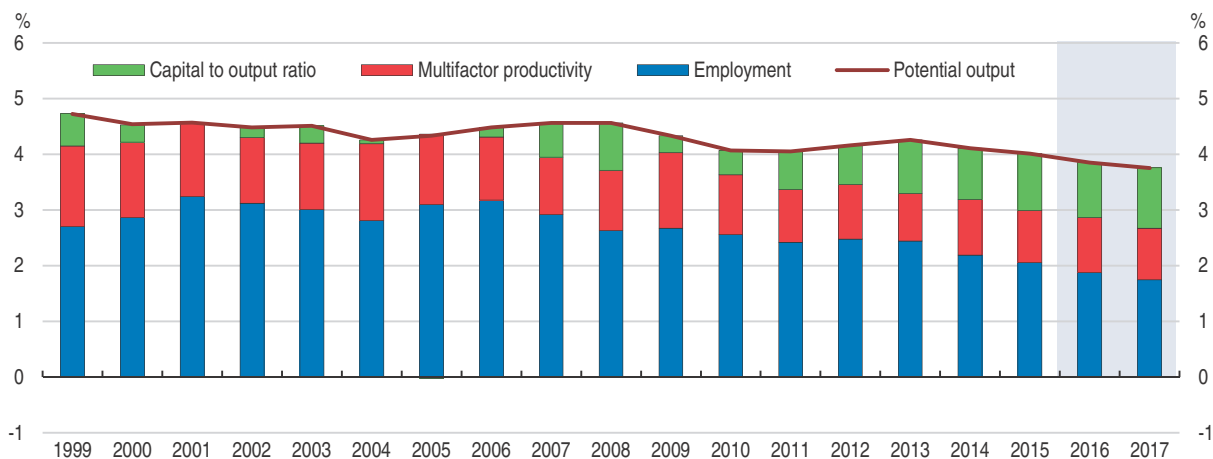


Note: Data for Mexico is available since 1996 and for Costa Rica since 1992. OECD corresponds to the arithmetic average of the percentage annual growth of member countries whose data is available at each year.

Source: OECD (2015a), OECD Economic Outlook 98 Database.

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Figure 27. **Employment and productivity have contributed to lower potential output growth**



Source: OECD (2015a), OECD Economic Outlook 98 Database.

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Human Talent, and Alliance for Employment and Development – with representatives from ministries and the private sector; it has the support of a small technical unit.

The establishment of the CPCI is a good development and is in line with similar initiatives in OECD countries, such as Australia, Chile, Mexico and New Zealand, which have created productivity commissions. The CPCI has managed to improve accountability and break down policy silos but so far has mainly worked as a coordinating agency. To become more effective in identifying obstacles to productivity growth and propose policy options to overcome them, CPCI should be streamlined, by

merging the three sub-councils into one, and assume a more strategic role. The technical unit should be strengthened and staffed with experts in the different areas coming from academia, the private sector and think tanks. It could be tasked to prepare and update at regular intervals long-term strategic plans to be submitted to the government and parliament for discussions and potentially approval. Other efforts to improve the coordination and implementation of policies to improve productivity are also underway and should be pursued. These include a draft law to create an agency (Agencia Costarricense de Fomento Productivo, Innovación y Valor Agregado, FOMPRODUCE) with a public-private governance structure, which will centralise funds and functions currently dispersed across several agencies, to facilitate the establishment of businesses and promote innovation.

Enhancing links between foreign and domestic firms and encouraging innovation

Costa Rica is an attractive FDI destination because of its friendly FDI regime and it ranks rather well in the OECD FDI Regulatory Restrictiveness Index (Figure 28). However there is scope to lower FDI restrictions in some sectors, such as mining and quarrying, electricity distribution, surface and maritime transport, and insurance.

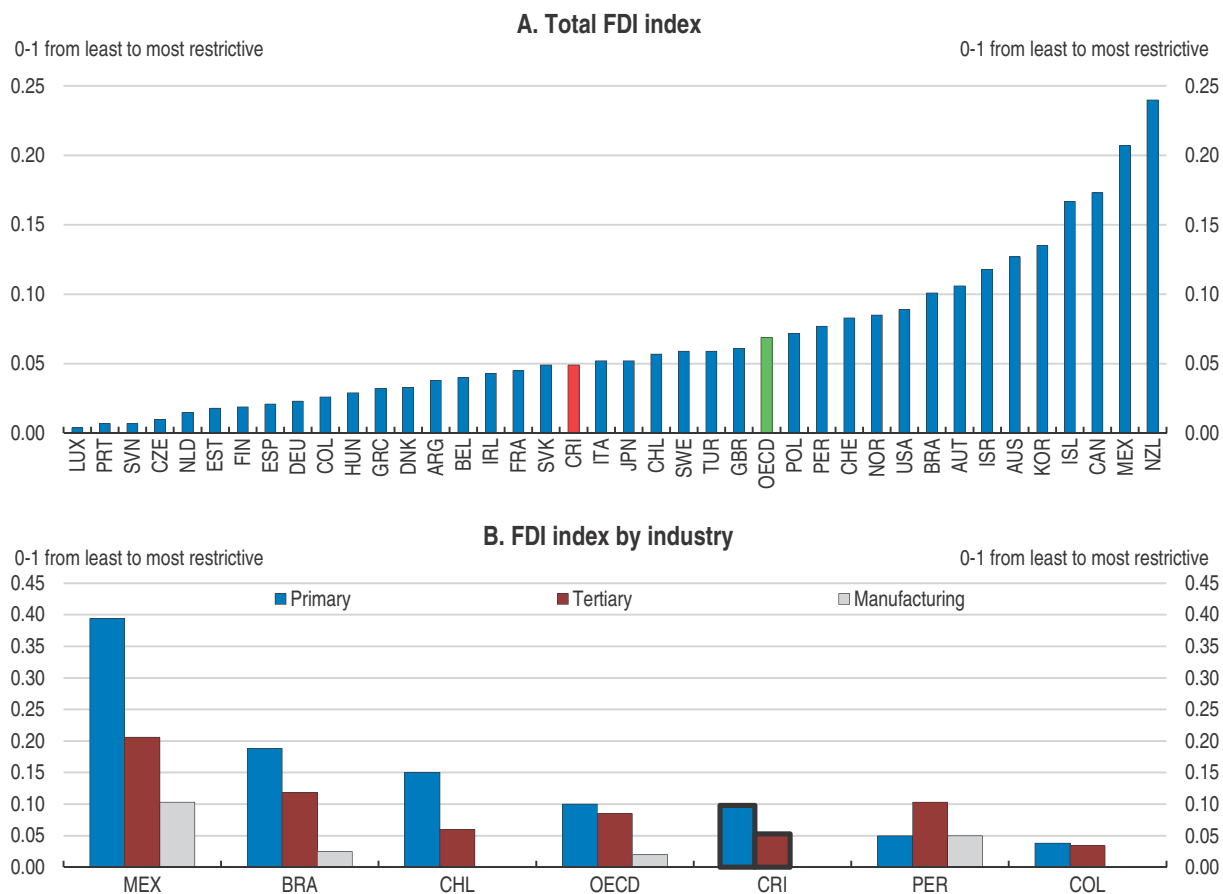
Despite large FDI inflows, links between foreign and domestic firms have remained elusive. Foreign affiliates limit their purchases from local suppliers to unsophisticated products and services, such as packaging materials, office supplies, security and food. Wages differences are also large, hampering labour mobility from foreign to domestic companies and the transfers of technologies and know-how.

Strengthening linkages between domestic and foreign firms will hinge on improving the technology, quality of products and productivity of the domestic sector. In this respect, R&D activities play a crucial role as not only they stimulate innovation but also favour technology transfers (Griffith et al., 2004; Adalet McGowan et al., 2015). Gross expenditure in R&D and the numbers of employees involved in R&D activities are substantially lower in Costa Rica than in most OECD countries (Figure 29). Business R&D spending is exceedingly low and mostly performed by foreign affiliates in free trade zones. Public research is nearly equally split between government and higher education institutions (Figure 29).

The government should focus a larger share of public R&D spending on higher education institutions as this could enhance collaboration between firms and universities, through for instance joint public-private research projects and enhancing student and faculty mobility. In many OECD countries universities have already replaced public research institutes as the main recipient of public research funds (OECD, 2014a). Close collaboration between universities and firms allows firms, especially small ones, to access universities' advanced knowledge capital, laboratories and skills, which they would not be able to afford otherwise (Adalet McGowan et al., 2015); it is also associated with more diffusion of foreign technologies (OECD, 2015k) and enhances the career prospects for graduates of technical and scientific disciplines, ultimately increasing their number and reducing skill mismatches in the labour market. To take full advantage of the knowledge being generated in universities it will be important to consolidate and scale up the Ministry of Science, Technology and Telecommunication's current efforts to work collaboratively with universities so as to connect researchers with private sector firms and fund research-based innovation projects. Given the small size of local companies, R&D tax credits would


Figure 28. **Costa Rica has an attractive FDI regime but could do even better**

2014



Note: Index ranges from zero (least restrictive regime) to one (most restrictive). The higher the value of the index, the more obstacles for inward FDI.

Source: OECD FDI Regulatory Restrictiveness Index Database.

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be a less effective way to promote innovation in Costa Rica than direct and transparent support measures – e.g. contracts, grants and awards.

Policy evaluations of current programmes to boost innovation in local SMEs (*Programa de Apoyo a la Pequeña y Mediana Empresa*, PROPYME) and establish local suppliers' links with foreign affiliates (*Proyecto de Desarrollo de Proveedores para Empresas Multinacionales de Alta Tecnología*, Costa Rica Provee) have shown encouraging results (Monge González and Rodríguez-Álvarez, 2013). The government should scale up these programmes by increasing their budget and enhancing their coordination. The effort the Ministry of Science, Technology and Telecommunications to increase funding to this sort of programmes through IADB loans is welcome. As the outcomes of aiming at boosting innovation in local companies and deepening their links with foreign affiliates are tightly intertwined, establishing a one-stop agency to better coordinate them is likely to improve their effectiveness. The establishment of the agency FOMPRODUCE, as envisaged by a draft law proposed by the government (as described above), to concentrate funds and responsibilities, of programmes concerning firms' innovation and development, in a single entity is welcome. However, programmes will need to be carefully evaluated and the

government should then commission policy evaluations on a regular basis to assess their cost effectiveness and inform future policy changes.

Strengthening competition and improving access to finance

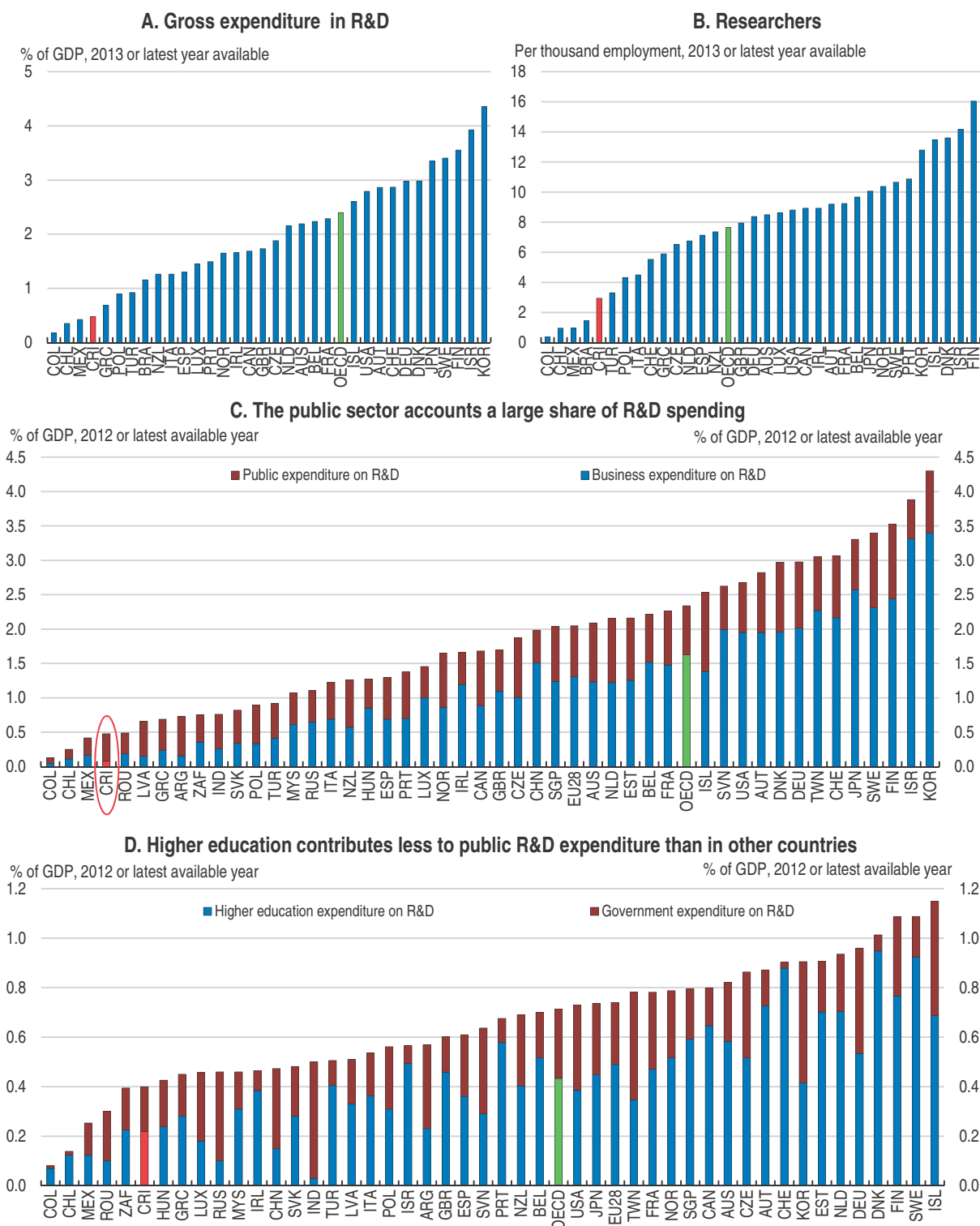
According to OECD's Product Market Regulation (PMR) indicator (Koske et al. 2015), regulation in Costa Rican product markets is stringent (Figure 30). Restrictions in the form of state controls and barriers to entrepreneurship are especially high (Figure 31). State controls are particularly binding because of government involvement in network sector, poor governance of state owned enterprises and extensive price controls. High barriers to entrepreneurship are attributable to the license and permits system, administrative burdens for sole proprietors of firms, antitrust exemptions and barriers in network sectors.

Markedly reducing barriers to entrepreneurship will improve the business environment and enhance competitive pressures, in addition to reducing labour market informality. More specifically, among barriers directly hampering entrepreneurship, the license and permits system and administrative burdens for sole proprietor firms are significantly higher than the OECD average. OECD best practices indicate that establishing one-stop agencies and adopting the "silence is consent" rule can significantly lower these barriers. Over the past five years, most OECD countries have made progress in this area by, for instance, modernising license and permits systems, streamlining administrative procedures for start-ups, simplifying rules and procedures and improving access to information about regulation (Koske et al., 2015). Costa Rica has ample scope for making similar improvements and move towards OECD standards.

Eliminating anti-trust exemptions, without creating private monopolies, is key to exposing a larger share of the economy to competitive forces, as underlined in previous OECD reports (OECD 2014c; 2015m). Currently, the sectors exempt from the competition law include all public services requiring state concessions by law, these are all sectors under the purview of Public Services Regulatory Authority (*Autoridad Reguladora de los Servicios Públicos*, ARESEP), with the exception of airports. Other important markets outside the scope of the competition laws include: imports, refinery and distribution of wholesale petroleum and its derivatives; the manufacture of alcohol for beverages; maritime transport; the production and commercialisation of sugar and rice; professional services. The recent experience of the telecommunications sector, which was opened up to competition in 2009 is positive as it was accompanied by a large expansion of the sector and use of telecommunication services, closing the gap with peer countries, and lower prices (Figure 32).

The government should grant the competition authority (COPROCOM) more decisional and administrative independence and raise its human and financial resources. Unlike the Superintendence for Telecommunications (Superintendencia de Telecomunicaciones, SUTEL) and ARESEP COPROCOM does not have administrative independence or a separate budget from the Ministry of Economic Affairs. COPROCOM human and financial resources should also be increased as they fall well short of what is needed (OECD, 2015m). Installing full-time commissioners instead of the current part-time system, as the government plans to do, will reduce the likelihood of conflicts of interests. Besides this, COPROCOM's should be granted the power to conduct market studies, and its investigative powers should be enhanced by establishing a leniency programme for whistle-blowers and increasing penalties on those involved in illegal practices and those who do not provide requested information (OECD, 2014c).

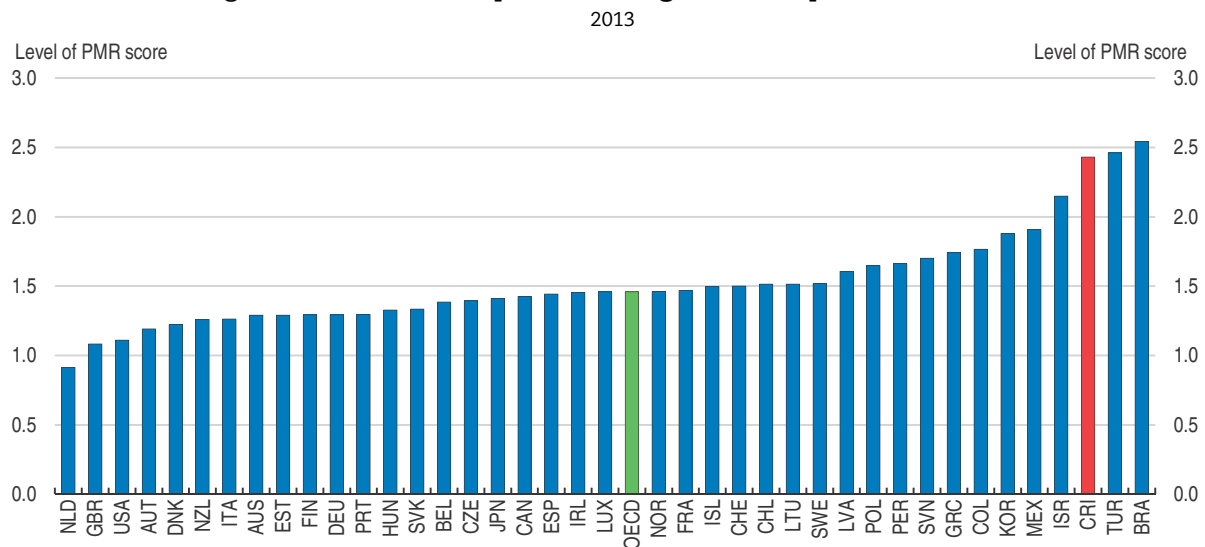
Figure 29. Research and development (R&D) activities are low



Note: Panel A: Gross expenditure on R&D as a percentage of GDP for 2013 or latest year available. Panel B: Researchers per thousand employment for 2013 or latest year available. Panel C: Total R&D expenditure (public and business) as a percentage of GDP, 2012 or latest available year. Panel D: Public R&D expenditure by type of research system.


Source: OECD (2014e), *Main Science and Technology Indicators 2014*; Eurostat; UNESCO Institute for Statistics (UIS), June 2014.

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Figure 30. **There is scope to ease regulation in product markets**

Note: OECD is a simple average of OECD countries, 2013 data. USA latest data is 2008.

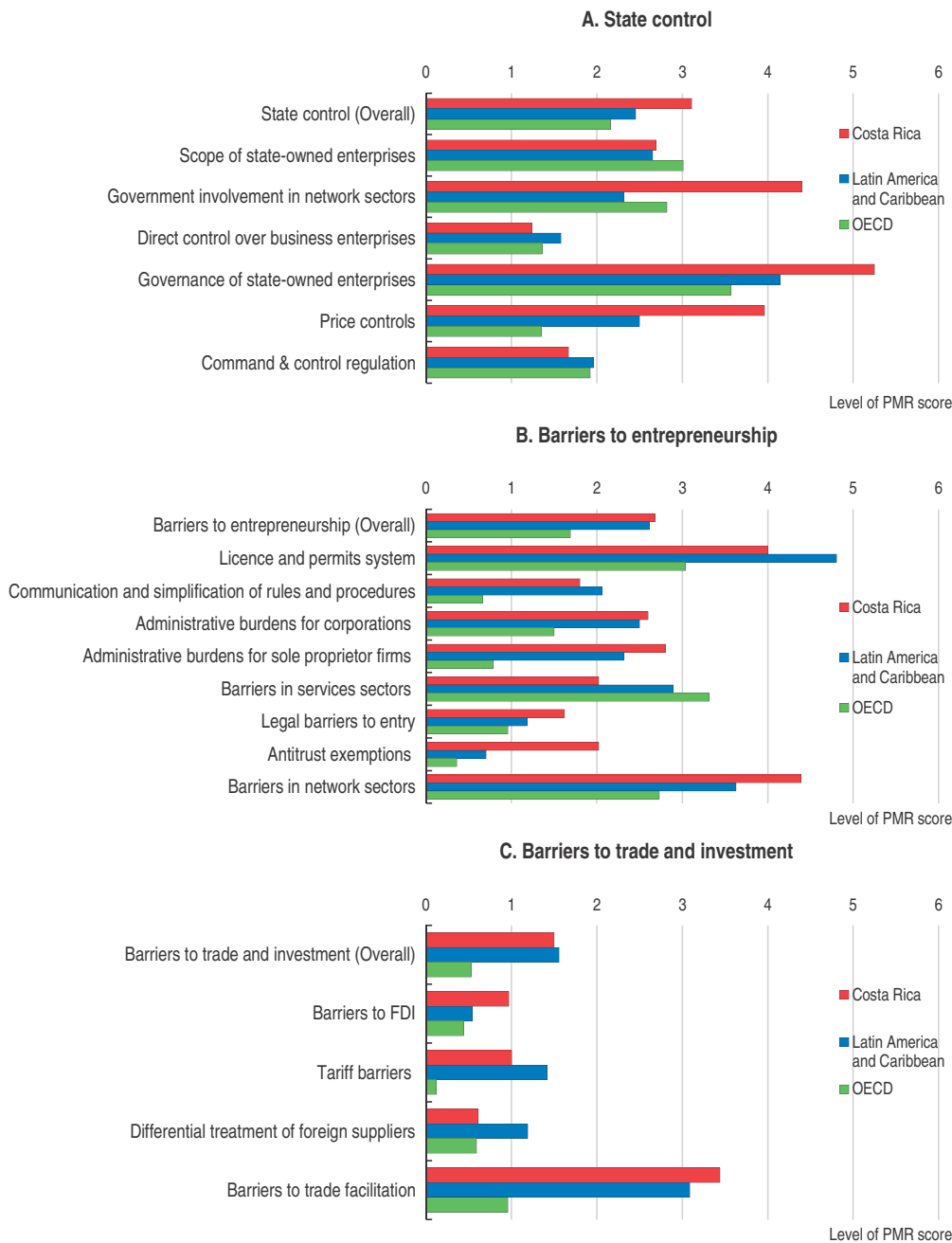
Source: OECD Product Market Regulation Database for OECD countries and Brazil; OECD-World Bank Group Product Market Regulation Database for Colombia, Peru and Costa Rica.

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State-owned enterprises play a dominant role in many key sectors of the economy, such as electricity, transport infrastructure (excluding airlines), banking, insurance and petroleum products. A preliminary count of SOEs by the government following OECD criteria reaches about 40. Most of these SOEs have been created by specific laws determining their internal regulations and procedures for reporting to the central government. Setting a more uniform set of operational regulations and procedures for reporting to the central government would be a start to rationalise their operations. Furthermore, corporatising state-owned enterprises will yield large efficiency gains (Aivazian, Ge and Qiu, 2005; Bilodeau, Laurin and Vining, 2007; Nelson and Nikolakis, 2012). Adherence to the *OECD Guidelines on Corporate Governance of State-owned Enterprises* (OECD, 2015i) can help in addressing governance challenges usually faced by state-owned enterprises attributable to political interference, lack of incentives to improve performance and complex institutional arrangements.

In the banking sector, significant regulatory asymmetries favour state-owned banks, hindering full competition between public and private banks. State-owned banks enjoy a government guarantee on bank deposits (amounting to more than 20% of GDP) that private banks do not. In addition, all public institutions are obliged by law to deposit their cash with one of the state-owned banks. Although the three state-owned banks (Banco Nacional de Costa Rica, Banco de Costa Rica, Banco and Crédito Agrícola de Cartago) are less efficient than private banks (Figure 33), they continue to play a dominant role as in mid-2015, they accounted for around 55% of assets and liabilities. Inefficiencies and lack of competition in the banking sector contribute to high interest rate spreads between loans and deposits in local currency (Castro Arias and Serrano López, 2013) and hamper credit provision (Figure 34). In the absence of strong market pressures, in November 2015 the government issued a directive instructing state-owned banks to increase their efficiency, mainly by cutting administrative expenses, so as to reduce their intermediation margin by at least one percentage point by 2018 (La Gaceta, 2015).

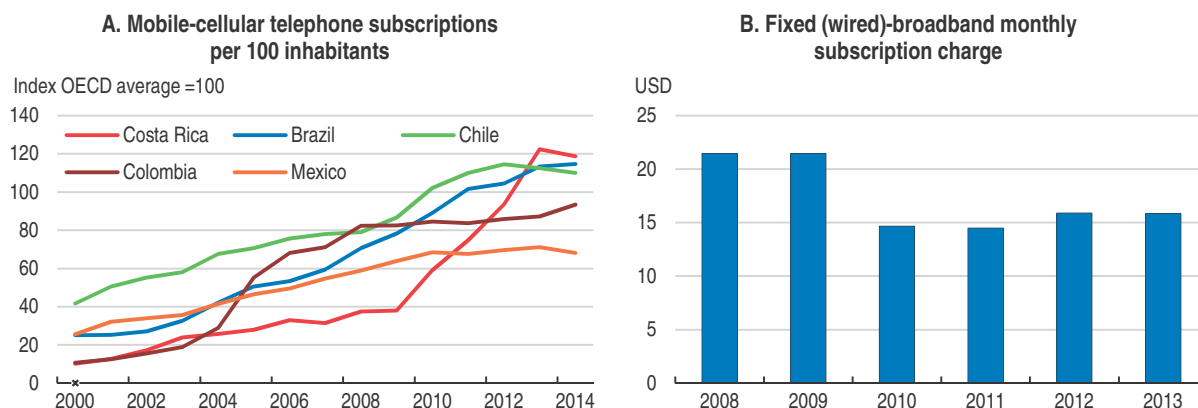
Figure 31. **State control and barriers to entrepreneurship are especially high**
2013



Note: Simple average of OECD and 12 Latin America countries, 2013 data. USA latest data is 2008.

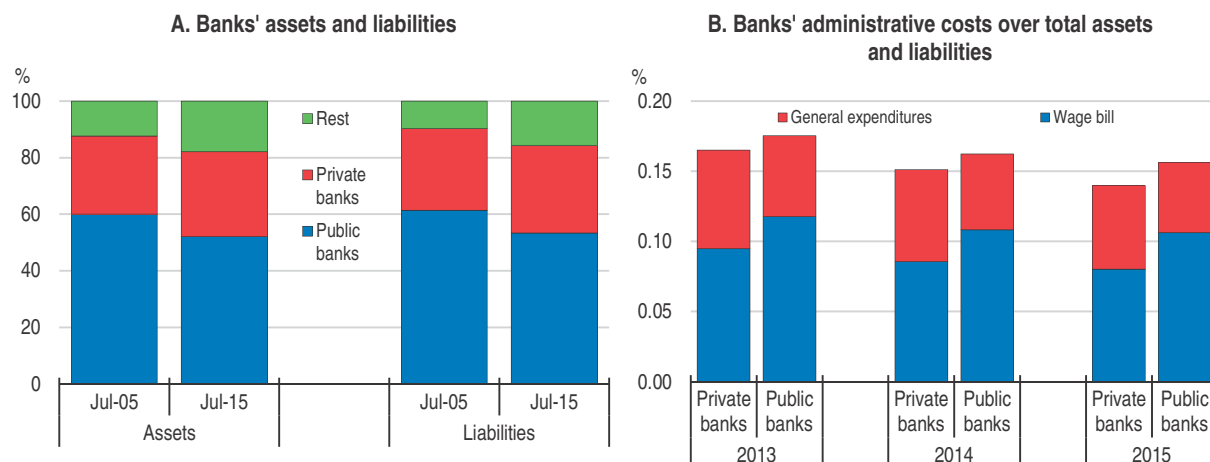
Source: OECD Product Market Regulation Database for OECD countries and Brazil. OECD-World Bank Group Product Market Regulation Database for Latin American and Caribbean countries except Chile, Mexico and Brazil.

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Figure 32. **The telecommunications sector has expanded since opening up to competition**

Source: International Telecommunications Union, *World Telecommunication/ICT Indicators Database 2015*.

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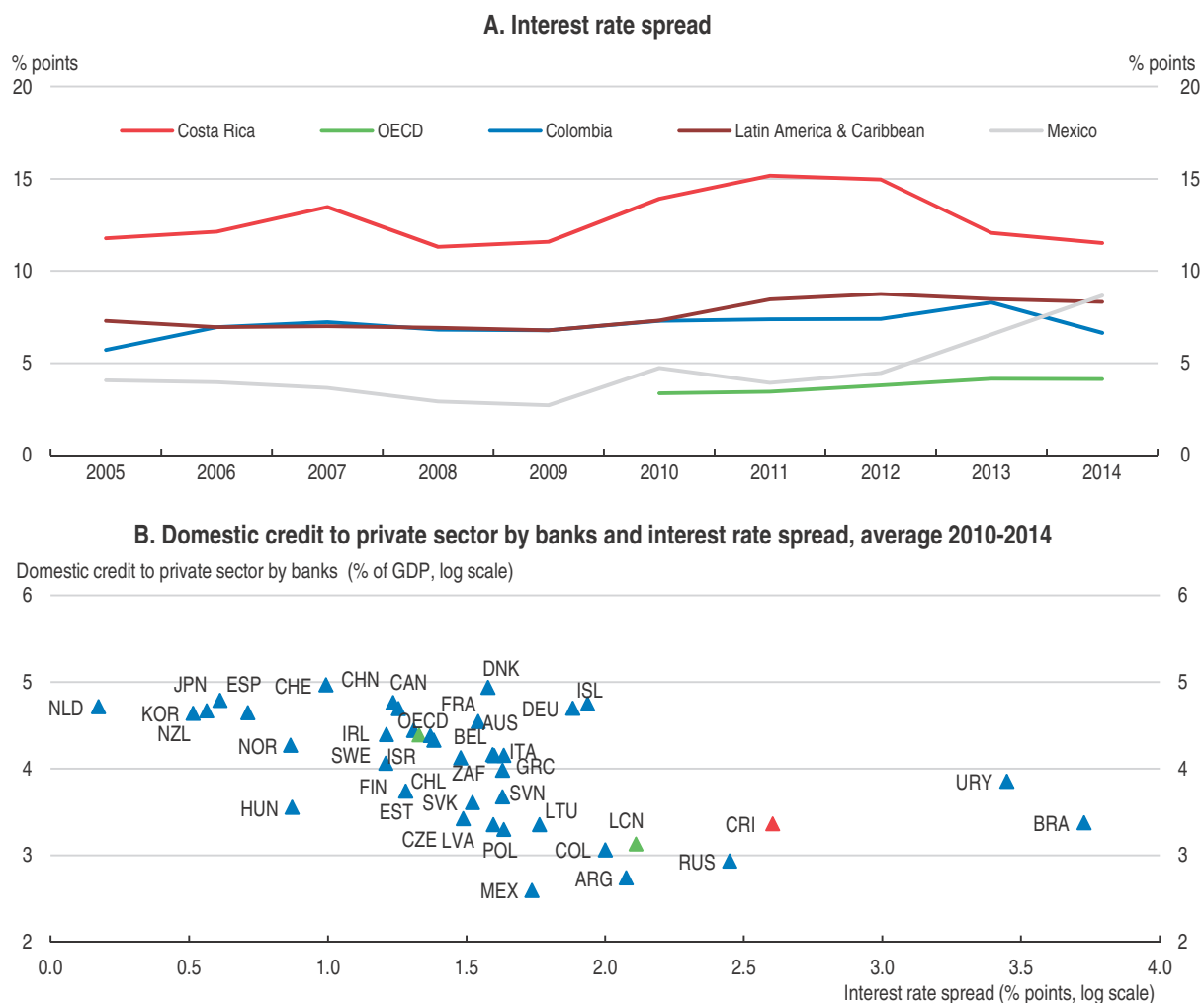
Figure 33. **State-owned banks have a dominant role and have higher costs than private banks**

Note: Panel B: The bars show the median of private and public banks' monthly administrative costs (general costs and personnel expenditures) expressed as percentage of the sum of total assets and liabilities; the ratio of the monthly administrative costs to the sum of total assets and liabilities are averaged over the year; data for 2015 are from January to September.

Source: Superintendencia de Financial Institutions (SUGEF).

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In addition to improving the corporate governance of state-owned banks, the government should create a more even level-playing field in the banking sector by introducing a deposit insurance scheme covering all banks and eliminating all other regulatory asymmetries favouring state-owned banks. Only few OECD or Latin America countries do not have an explicit deposit insurance scheme, such as Israel, New Zealand and Bolivia (Demirguc-Kunt et al., 2014). Eventually, once public banks are operating according to higher standards of governance and corporate performance, the authorities should assess whether or not maintaining public ownership of a large share of the banking industry is justified on economic, social and financial stability grounds. Reducing the

Figure 34. **High banking interest rate spreads curtail credit availability**

Note: Interest rate spread is calculated as the lending rate minus the deposit rate; LCN stands for Latin America and Caribbean (all income levels) as defined by the World Bank.

Source: World Bank World Development Indicators.

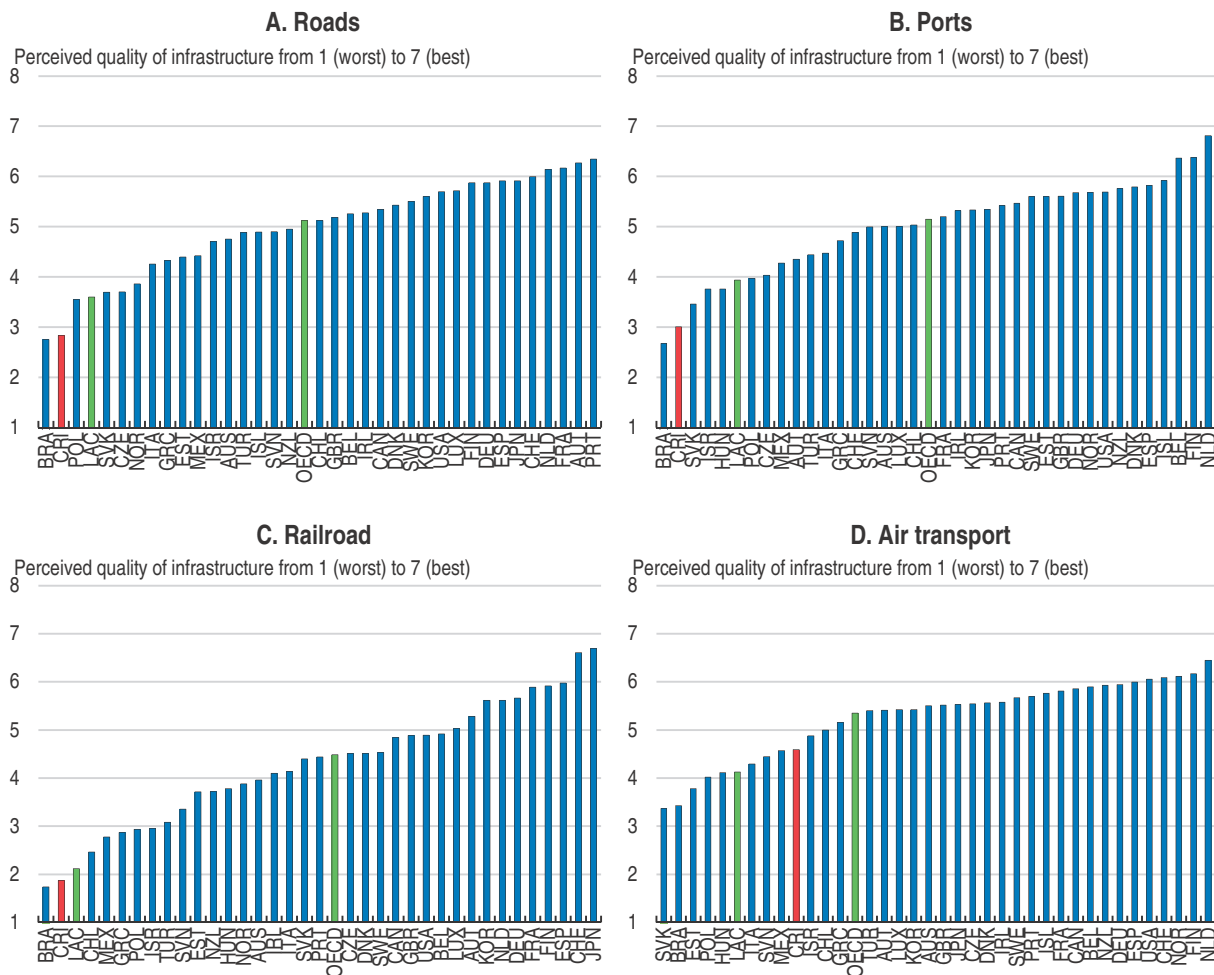
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State's equity stake in reformed state-owned banks could free resources that could be used more effectively to pursue economic and social objectives.

Improving transport infrastructure


Survey data on the perceived quality of infrastructure rank Costa Rica 103rd worldwide, well below Latin America average for roads, ports and railroads, although above it for airports (Figure 35). Better transport infrastructure can contribute to higher GDP growth and productivity through boosting the productivity of private inputs, which in turn will raise private investment (Agénor and Moreno-Dodson, 2006). Better transport infrastructure can support more environmentally sustainable growth and mobility patterns.

The low quality of Costa Rica's transport infrastructure is attributable to chronic underspending compounded by deficient strategic planning and lack of a long-term vision

Figure 35. **There is scope to improve the quality of transport infrastructure**

Note: Figures refer to the following question: How would you assess general infrastructure in your country (from 1 = extremely underdeveloped – among the worst in the world to 7 = extensive and efficient – among the best in the world)? The OECD and Latin America & Caribbean (LAC) aggregate are calculated as an unweighted average.

Source: World Economic Forum, The Global Competitiveness Index Historical Dataset © 2005-15.

StatLink  <http://dx.doi.org/10.1787/888933318734>

for the sector. From 2002 to 2013, transport infrastructure spending averaged 0.8% of GDP less than the OECD average. In addition, spending has been irregular as in the absence of a multiyear budgeting process, public investment in transport infrastructure is negotiated every year and subject to cuts (MOPT, 2011).

The government is aware of the transport infrastructure spending shortfall. The National Transport Plan 2011-35 (MOPT, 2011) calls for annual infrastructure spending of 3.99% of GDP to 2035. According to the Plan, one third of the estimated spending should be financed by the public budget with the remaining part coming from the private sector.

Improving the efficiency of public investment in transport infrastructure

The transport infrastructure planning and decision making processes are highly fragmented among different ministries and government agencies. The Ministry of Public Works (MOPT) is the institution that has historically been in charge of planning, building, maintaining and operating transport infrastructure. However, in the 1990s, many of these

responsibilities were transferred to new autonomous or semi-autonomous agencies (Pisu and Villalobos, forthcoming). As a result of this fragmentation, infrastructure projects are often the result of individual institutional efforts, do not follow common approaches and suffer from inadequate preparation (CGR, 2012). The current administration is aware of the problem and is trying to recover MOPT's sector stewardship, through better planning, management, coordination, monitoring and control and evaluation of sector agencies.

This complex institutional framework would be simplified by articulating the policy mandate of the different ministries and agencies on transport policies and better integrating the development and execution of policies. To remedy policy fragmentation and reinforce planning capacity, some OECD countries have created dedicated agencies to develop long-term strategies and plans, such as Australia (Infrastructure Australia) and the United Kingdom (Infrastructure UK), with good results. In the current institutional setting, a reformed Presidential Council on Competitiveness and Innovation (CPCI) with a more strategic role could be tasked with the Ministry of Public Works to design long-term transport infrastructure strategies and policies, consistent with other long term economic and social objectives, and track progresses towards them.

Additionally, the role of SOEs should be reconsidered. In this respect, as discussed above, the priority should be to corporatise the state-owned enterprises, especially those responsible for maritime transport and railways, and enhance their corporate governance in line with the *OECD Guidelines on Corporate Governance of State-Owned Enterprises*. Also, a clear functional separation of SOEs' activities – between the regulation and the provision of infrastructure services and between the management of and access to the infrastructure network – can better prepare them for and encourage increased private-sector participation (OECD 2015h).

Reforming the institutional setting to attract more private investment

In the nearly 20 years since General Concession Law has been into force, only four projects involving private participation have materialised. The weak performance of the National Concession Council in promoting concessions and PPPs is partly attributable to its institutional setting as an agency within the Ministry of Public Works. This does not conform with OECD practice as PPP units mostly depend on the Ministry of Finance (OECD, 2010a). The current arrangement in Costa Rica may create a bias against private participation in infrastructure because the Ministry of Public Works also promotes public-funded infrastructure projects that can be in direct competition with privately funded ones. In addition to promoting private participation in transport infrastructure, CNC should be directly involved in project preparation and selection, and perform cost-benefit analyses. Moving CNC within the Ministry of Finance could improve performance and would facilitate the accounting of implicit liabilities arising from private-sector participation, which currently Costa Rica does not undertake (Irwin, 2007; Posner et al., 2009).

Finally, a transparent and credible infrastructure project pipeline will manifest the government commitment to attract private capital and lower perceived policy uncertainty. A credible project pipeline can help de-politicise project selection and execution and instead base them on purely technical and economic considerations. The United Kingdom is a recent example of creating an infrastructure project pipeline, which has helped to revive private investors' interest in infrastructure (Pisu, Pels and Bottini, 2015).

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Thematic chapters

Chapter 1

All together: Making growth more inclusive in Costa Rica

In the past 30 years Costa Rica has grown steadily and social indicators have improved markedly. Well-being indicators are comparable or even above the OECD average in several dimensions, such as health, environment or life-satisfaction. This chapter reviews the social progress that Costa Rica has achieved and identifies reducing inequality and poverty as the main challenges. To tackle those challenges, the chapter argues that there is a need to upgrade existing social assistance programmes to maximise their impact. Social policies should put more emphasis on getting more people into formal work, including by raising their skill levels. This is the most effective way to get people out of poverty. Education is the area where the largest gap with respect to OECD countries is observed. Policy efforts are also warranted to tackle informality, which is increasing rapidly, and to close the gender gap in the labour market. The health and pension systems play a fundamental role in maintaining social cohesion in Costa Rica and it is crucial to modernise them and to make them sustainable in the face of demographic challenges. Costa Rica exemplifies the benefits of preserving natural resources in generating growth and employment opportunities, thereby providing a way out of poverty. Building on its achievements in this area, Costa Rica should reinforce environmental protection efforts, such as reducing emissions from the transport sector and improving wastewater treatment.

Chapter 2

Boosting productivity to sustain income convergence

In the latest 30 years, Costa Rica's real GDP per capita has more than doubled, driven by increasing labour utilisation. Labour productivity has instead stagnated at around 30% of the more advanced OECD countries. Productivity growth has been lacklustre despite the opening up of markets to international competition and large FDI inflows. Several obstacles continue to hamper the development of domestic firms and markets. They have fostered a dual speed economy characterised, on the one hand, by an innovative, productive and export oriented FDI sector – increasingly focussing on high value added sectors – and, on the other hand, a domestic sector – dominated by small firms and focused on traditional industries – that is neither innovative nor very productive. Boosting national productivity to sustain the convergence process towards OECD countries living standards will hinge on creating the right conditions for domestic firms to thrive and become more innovative and productive, while maintaining the long-standing commitment to open international markets and investment. To make this happens the government should: 1) encourage innovation and improving links between domestic and foreign firms by better enforcing and implementing intellectual property rights, shifting public R&D spending towards tertiary education institutions, and improving the coordination of public programmes promoting innovation of local firms and linkages with foreign affiliates; 2) strengthen competition in product markets and ease access to finance for SMEs by eliminating anti-trust exemptions, empowering the competition commission and giving it more independence, reducing barriers to entrepreneurship, ameliorating the corporate governance of state-owned enterprises and creating a level-playing fields between state-owned and private banks; 3) enhance the institutional and legal framework of the transport and other infrastructure sectors by reducing the number of agencies involved in policy development and project executions, and establishing an institutional framework to reduce policy uncertainty and attract more private investment.

This Economic Assessment is published on the responsibility of the Economic and Development Review Committee of the OECD, which is charged with the examination of the economic situation of member countries.

The Economic situation and policies of Costa Rica were reviewed by the Committee on 10 December 2015. The draft was then revised in the light of the discussions.

The Secretariat's draft report was prepared for the Committee by Mauro Pisu, Alberto Gonzalez Pandiella, Adolfo Rodriguez-Vargas under the supervision of Patrick Lenain. Mabel Gabriel provided the statistical research assistance, and Brigitte Beyeler provided the administrative support. The Economic Assessment also benefitted from contributions by Bert Brys, Daniel Blume, Antonio Capobianco, Mabel Gabriel, Isabell Koske, Chandima Mendis, Ryan Parmenter, Dirk Pilat, Horacio Levy, Shruti Singh and Federico Villalobos.

This is the first Economic Assessment of Costa Rica

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