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Costa Rica: Restoring fiscal sustainability and setting the basis for a more growth-friendly and inclusive fiscal policy

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COSTA RICA: RESTORING FISCAL SUSTAINABILITY AND SETTING THE BASIS FOR A MORE GROWTH-FRIENDLY AND INCLUSIVE FISCAL POLICY

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By Sonia Araujo and Stéphanie Guichard

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ABSTRACT/RESUME

Costa Rica: Restoring fiscal sustainability and setting the basis for a more growth-friendly and inclusive fiscal policy

Consecutive years of primary deficits have led to mounting public debt of almost 50% of GDP, one of the fastest increases in Latin America over the last decade. Government attempts to restore fiscal health have been undermined by a gridlocked Congress. While only minor reforms have been enacted to contain spending, efforts to curb tax evasion and increase the efficiency of the tax administration are commendable. However, increases in tax revenue have been unable to match mandated increases in spending. As a consequence, sovereign debt ratings have declined to below investment level, and the negative outlook on Costa Rica's debt signals increasing financing costs. Against this backdrop, the risk of a fiscal crisis is increasing, particularly as global financial conditions become less favourable and debt structure has shifted towards increased reliance on floating rates and dollar-denominated bonds. Enacting a three year fiscal consolidation programme of one percentage point of GDP each year, will enable debt to stabilise at current levels by 2032. The current draft bill to strengthen public finances – Ley de Fortalecimiento de las Finanzas Públicas – proposes a comprehensive fiscal reform package, with measures on both the revenue and the spending side, as well as a fiscal rule. It needs to be complemented with additional measures to contain revenue earmarking. In addition, reducing excessive fragmentation of the public sector would allow the Ministry of Finance to regain control of the budget. There is also room to reduce expenditure on remuneration of public sector workers, one of the fastest growing expenditure items and a source of income inequality. The proposed fiscal rule should be strengthened, including introducing a multi-year expenditure framework and a fiscal council. Debt management should be modernised by stepping up communication with markets and reducing the number of benchmark securities. Over time, improving social spending efficiency and quality as well as modifying the tax structure away from social security contributions and enlarging the tax base would allow for a much stronger contribution of fiscal policy to growth and equity.

This Working Paper relates to the *2018 OECD Economic Survey of Costa Rica*.
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JEL classification: H10, H11, H50, H51, H52, H53, H60, H61, H62, H63, H68.
Keywords: Costa Rica, fiscal policy, fiscal framework, fiscal vulnerability, debt sustainability analysis, government spending, taxation, revenue earmarking.

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Costa Rica: Rétablir la viabilité budgétaire et jeter les bases d'une politique budgétaire plus favorable à la croissance et plus inclusive

Des années consécutives de déficits primaires ont conduit à une dette publique croissante à près de 50% du PIB, l'une des augmentations les plus rapides en Amérique latine au cours de la dernière décennie. Les tentatives du gouvernement pour rétablir la santé budgétaire ont été entravées par un Congrès paralysé. Alors que seules des réformes mineures ont été adoptées pour freiner les dépenses, les efforts pour réduire l'évasion fiscale et améliorer l'efficacité de l'administration fiscale sont louables. Cependant, les augmentations des recettes fiscales n'ont pas permis d'égaler les augmentations obligatoires des dépenses. En conséquence, les notations de la dette souveraine ont chuté au-dessous du niveau d'investissement, et les perspectives négatives sur la dette du Costa Rica devraient mener des coûts de financement croissants. Dans ce contexte, le risque de

crise budgétaire augmente, en particulier du fait que les conditions financières mondiales deviennent moins favorables et que la structure de la dette a évolué vers davantage des taux flottants et des obligations libellées en dollars. L'adoption d'un programme triennal d'assainissement budgétaire d'un point de pourcentage du PIB chaque année permettra à la dette de se stabiliser aux niveaux actuels en 2032. L'avant-projet de loi visant à renforcer les finances publiques – Ley de Fortalecimiento de las Finanzas Públicas – propose un ensemble complet de réformes fiscales, avec des mesures sur les revenus et les dépenses, ainsi qu'une règle budgétaire. Il doit être complété par des mesures supplémentaires pour contenir l'affectation préétablie des recettes. En outre, la réduction de la fragmentation excessive du secteur public permettrait au ministère des Finances de reprendre le contrôle du budget. Il est également possible de réduire les dépenses de rémunération des travailleurs du secteur public, l'une des dépenses à la croissance la plus élevée et une source d'inégalité de revenus. La règle budgétaire proposée devrait être renforcée, notamment en incluant un cadre de dépenses pluriannuel et un conseil budgétaire. La gestion de la dette devrait être modernisée en intensifiant la communication avec les marchés et en réduisant le nombre de titres de référence. Au fil du temps, l'amélioration de l'efficacité et de la qualité des dépenses sociales ainsi que la modification de la structure fiscale avec moins de cotisations de sécurité sociale et l'élargissement de l'assiette fiscale permettraient une contribution beaucoup plus forte de la politique budgétaire à la croissance et à l'équité.

Ce Document de travail se rapporte à *l'Étude économique de l'OCDE du Costa Rica, 2018*
Classification JEL: H10, H11, H50, H51, H52, H53, H60, H61, H62, H63, H68.
Mots clefs: Costa Rica, politique budgétaire, cadre budgétaire, vulnérabilité budgétaire, analyse de viabilité de la dette, dépenses publiques, fiscalité, affectation des recettes.

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Restoring fiscal sustainability and setting the basis for a more growth friendly and inclusive fiscal policy

By Sónia Araújo & Stéphanie Guichard[1]

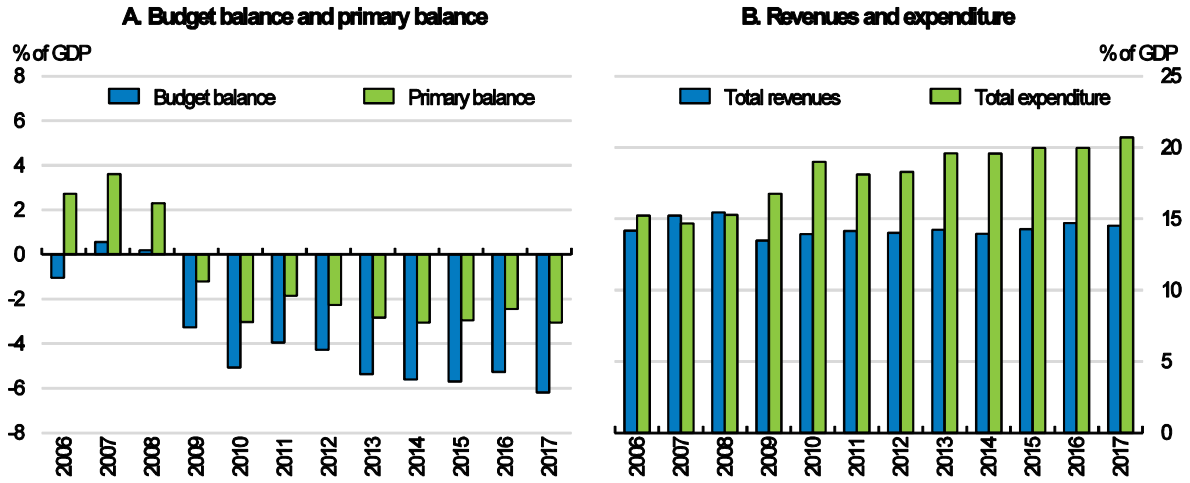
Fiscal performance continues to deteriorate

Consecutive years of primary deficits have worsened debt dynamics

Costa Rica's public finance situation is a growing source of concern. The country has not been able to restore fiscal sustainability after its fiscal position deteriorated sharply in the wake of the global financial crisis. After two years of surpluses, the primary balance swung into deficit in 2008, reflecting both a contraction in revenues as activity weakened and the adoption of what were intended as counter-cyclical measures which have increased expenditure (Figure 1, Panels A and B). Public expenditure growth, driven by public wages and transfers to decentralised public institutions, continued to outpace the growth in revenues. The headline and primary fiscal deficit have remained large and are showing a tendency to deteriorate even more. In the period 2010-16, the headline deficit averaged 5% GDP and the primary balance 2.6% of GDP. In 2017 the headline deficit enlarged to -6.2% of GDP, the worst performance in three decades, and the primary balance to -3.1% of GDP. The 2018 budget projects a deficit of 7% GDP, under the premise that the government will not have to fulfil legal and constitutional obligations regarding mandated expenditures, which is at odds with recent court rulings. If the rulings are accepted and spending is allowed to increase, the deficit will reach 8.1 % of GDP in 2018.

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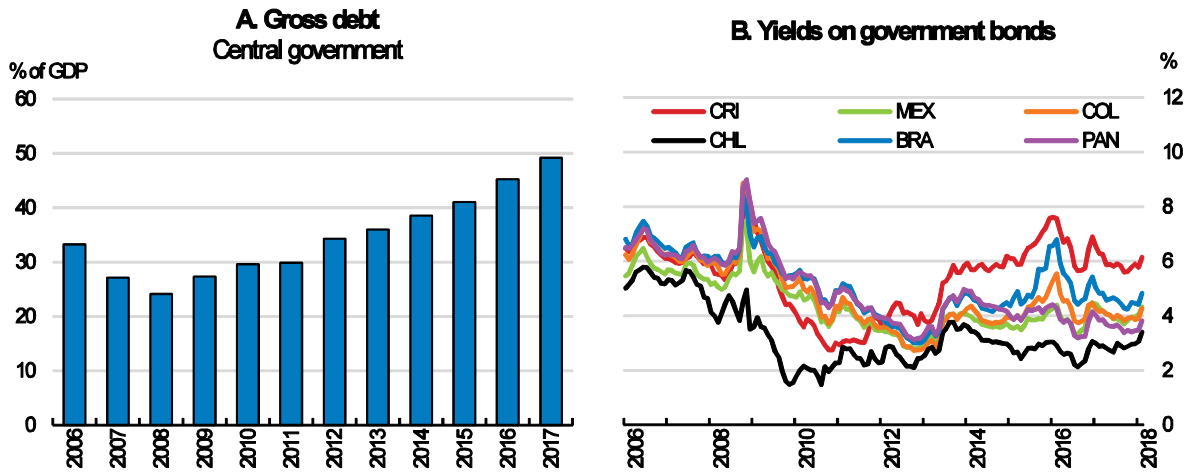
Figure 1. Budgetary imbalances are mounting



Source: Ministerio de Hacienda.

Debt has soared as a consequence of continuous primary deficits. Central government debt increased from about 25% of GDP in 2008 to 49% of GDP in 2017, one of the largest increases in Latin America (Figure 2 Panel A and Figure 3), and amounts to about three years of government revenues. This deterioration of Costa Rica's fiscal situation led to downgrades by rating agencies in 2014, 2016 and 2017 and a surge in bond yields, with bond yields now among the highest in the region (Figure 2, Panel B). In January 2018, one rating agency changed the outlook of Costa Rica's long-term debt from stable to negative, reflecting the country's inability to correct its fiscal imbalance, putting additional upwards pressure on the cost of financing.

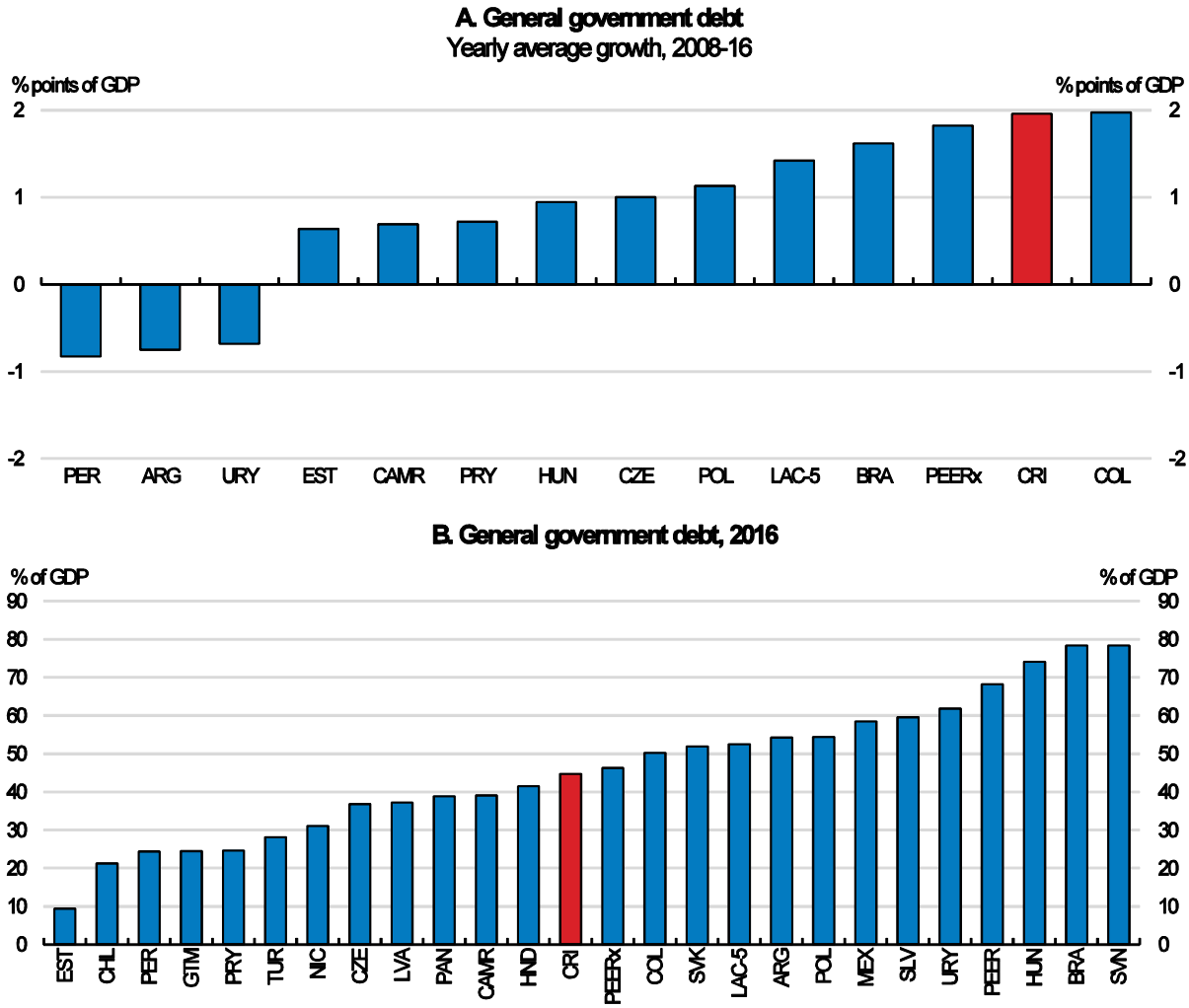
Figure 2. Public debt is rising fast



Source: Ministerio de Hacienda and Thomson Reuters Datastream.

With public debt already very close to 50% of GDP, Costa Rica is dangerously testing the threshold above which excessively high government debt risks undermining economic activity and destabilising the economy. OECD analysis suggests that the threshold above which negative effects on growth may take place could be as low as 30-50% of GDP for emerging economies as they are exposed to capital flow reversals (Fall et al., 2015). Because public debt is mostly held by local rather than international investors, the threshold may be somewhat higher for Costa Rica. But the OECD recommends prudent debt targets that are on average 15 percentage points lower than debt thresholds (Fall et al., 2015). Similarly, the IMF suggests a debt-to-GDP ratio of 50% as the upper-limit safe level for Costa Rica, while the Central Bank estimates such a threshold at 48.6% of GDP (Chaverri Morales, 2016; IMF, 2017a).

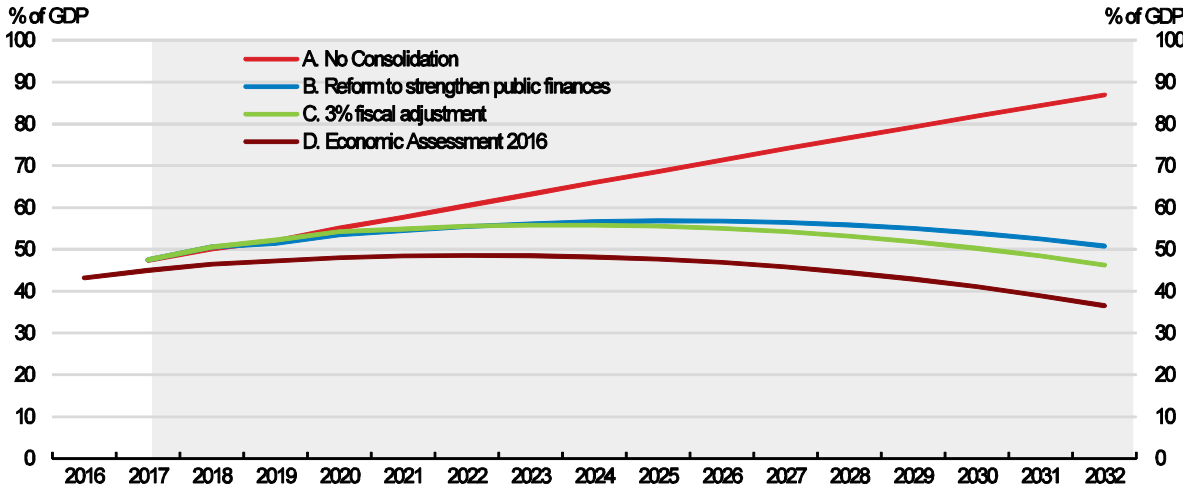
Figure 3. Costa Rica's public debt dynamics has deteriorated faster than those of peers



Note: Includes only central government debt for Costa Rica. For PEER, data refer to Czech Republic, Greece, Estonia, Latvia, Hungary, Slovak Republic, Slovenia, Poland, Portugal and Turkey. For PEERx, data refer to PEER excluding Greece and Portugal. For LAC-5, data refer to Argentina, Brazil, Chile, Colombia and Mexico. For CAMR, data refer to El Salvador, Guatemala, Honduras, Nicaragua and Panama.
Source: IMF, World Economic Outlook database.

Costa Rica's debt dynamics are unsustainable on current trends and policies. In the absence of any reform to correct fiscal imbalances, public debt will reach 70% by 2025, soaring to 90% only seven years after, in 2032 (Figure 4, A. "No consolidation"). The price of inaction is clear: had the policy package recommended by the OECD in its 2016 Economic Assessment been implemented, by 2032 debt would have been projected to be below 40% of GDP (Figure 4, D. "Economic Assessment 2016").

Figure 4. Debt sustainability scenarios



Note: All estimates assume an annual GDP growth rate of 4%, inflation as projected in EO102 for the period 2017-19 and the central bank's 3% inflation target thereafter, and a fiscal multiplier of 0.3 (IMF, 2015). Alternative scenarios for public debt: "No Consolidation" refers to a scenario of projected debt equivalent to no additional fiscal reform, while "Reform to strengthen public finances" projects debt under the assumption that only reforms in the draft bill of Ley de Fortalecimiento de las Finanzas Publicas are enacted, while "3% fiscal adjustment" projects the debt path consistent with a phased 3 year fiscal consolidation of 1 percentage point of GDP each year. "Economic Assessment 2016" projects the debt path consistent with the fiscal adjustment proposed by the OECD in its 2016 Economic Assessment of Costa Rica (see Box 1).
Source: OECD calculations based on data from Ministerio de Hacienda.

Box 1. Debt sustainability analysis

The debt sustainability model builds on Lenain, Hagemann and Carey (2010) and projects Costa Rica's debt path as a function of the evolution of the primary balance and interest payments. Following Batini et al. (2014), GDP growth is assumed to equal potential growth plus a deviation associated with the effect of the previous-year's budget deficit on growth. The long-term interest rate is determined by the expected short-term policy rates over 10 years, and a risk premium relating to the expected fiscal deficit over a 5 year horizon. The model uses Estevão and Samake's (2013) estimate of the short-term fiscal multiplier for Costa Rica (0.3). Debt scenarios assume OECD projections for inflation for the years 2018 and 2019 and the mid-point of the Central Bank's target (3%) thereafter.

Four alternative scenarios for public debt have been considered:

- **"No Consolidation"** projects the central government debt path that is consistent with the absence of fiscal reforms going forward;
- **"OECD 2016 Recommendation"** projects the debt path consistent with the adoption of the fiscal package proposed by the OECD in the 2016 Economic Assessment. This scenario uses historical data for the years of 2016 and 2017.
- **"Reform to strengthen public finances"** projects the debt path consistent with the fiscal consolidation measures listed in the draft bill Ley de Fortalecimiento de las Finanzas Públicas, considering that these are implemented already in 2018..
- **"3% fiscal adjustment"** projects the debt path that is consistent with a three year fiscal consolidation programme, of 1 percentage point of GDP per year, starting in 2018.

All debt scenarios already include the government's estimated savings stemming from current measures to contain spending (e.g. "Ley Caja Única") and projected increases in tax revenues due to measures to curb tax avoidance and evasion (see Box 2).

Recent reforms have not prevented fiscal imbalances from deteriorating

The government is fully aware of the risks associated with the fiscal situation and is committed to restoring fiscal sustainability. Several initiatives to contain spending, raise additional tax revenue and strengthen the fiscal framework have been drafted in the past two years. However, no major reform has been approved as a fragmented Congress prevented a consensus to be reached on the size of the adjustment needed and the split of the fiscal effort between increased tax collection and spending cuts. In the absence of substantial legislative progress on approving a comprehensive fiscal package, the government has implemented a number of measures to contain fiscal imbalances. Actions focused on enlarging the tax base by fighting tax evasion, and on curbing spending by containing the wage bill, reducing pension expenditures and decreasing transfers to decentralised public institutions (Box 2).

Box 2. Measures enacted by the government to contain fiscal imbalances during 2016-18

The government has enacted a number of reforms to contain expenditures, raise tax revenue and strengthen the institutional tax framework and tax administration with a view to improve its efficiency as well as to fight tax avoidance and evasion.

Measures to raise tax revenue:

- **"Electronic invoicing"** is being implemented progressively. As of 2017, large taxpayers could voluntarily implement electronic invoicing. In January 2018, electronic invoicing became compulsory for large firms and the entire health sector. This measure is expected to increase transparency and limit tax avoidance and evasion, improve the tax auditing process, optimise the use of available human resources within the tax administration, and simplify tax compliance.
- **"Tax on corporations" law**: this law was approved in 2017 and re-establishes a tax on legal entities which was declared unconstitutional in 2015. The tax levies any entity registered before the National Registry. As entities registered before the National Registry are not automatically registered before the tax administration, this reform imposes a tax also on inactive companies (those not registered before the tax administration). The rates are determined by total turnover and are set between 15% and 50% of a monthly minimum wage (e.g. 15% applies to entities registered before the National Registry but not registered before the tax administration; entities registered before both (National Registry and Tax Administration) with total turnover under 125 monthly minimum wages pay 25% of a monthly minimum wage, those with total turnover above 280 monthly minimum wages pay 50% of a monthly minimum wage). This law also enables Costa Rica to strike-off companies that fail to comply with the obligation to pay such tax and register with the tax administration for three consecutive years. As of today, Costa Rica has struck-off approximately 260 000 companies (approximately 48% of all companies) from the Registry.
- **"Fight against fiscal fraud" law**: approved in 2016, and effective from 2017 onwards, this reform sets rules that entitle the tax administration to access general information filed by financial institutions about taxpayers, and to identify beneficiary owners. For this purpose, the government created a centralised registry of ultimate beneficiary owners of any legal entity within the country. This law also introduced a provision for foreign trusts administered by a resident trustee to keep ownership and identity information. All of this information is now accessible to the Costa Rican tax administration. This is a major reform and in line with Costa Rica's goal of not being classified as a blacklisted tax haven. It also introduced penalties to tax advisors engaging in tax evasion behaviours and created a special commission within the Ministry of Finance to investigate irregular behaviour of tax auditors and to investigate cases of corruption. To fight

tax evasion, it requires all providers of services (e.g. doctors, attorneys and all individuals rendering services) to accept electronic payments. Finally, it requires a certificate of good standing to any entity/individual entering into a public contract.

Measures to curb spending:

- **Pension reform:** the government was successful in obtaining Congress's approval for a reform of the pension regime in 2016, effective from 2017. Whereas before the reform, children of deceased Deputies would inherit-for-life their parent's pension, now the pension can only be attributed to those under 25 years old. The reform also limited the number of special adjustment mechanisms, taxes pensions exceeding 10 minimum wages and increased the contribution rate applicable to special pension regimes from 7% to 9%.
- **Hiring freeze:** In 2017, the government issued a Directive mandating an across-the-board hiring freeze of public sector workers and a 10% cut in public transfers to decentralised institutions, except those related to social functions. The government plans to extend this Directive into 2018.
- **Ley "Caja Única":** this law, approved in 2016 and effective as of 2018, intends to rationalise transfers to the decentralised sector and enhance spending efficiency. The reform stipulates that autonomous entities have a time limit of up to two years (four years for entities in the education sector) to use the surpluses reported at the end of a year. Surpluses will have to be spent according to the Development National Plan. The Bill also mandates for unspent funds to be transferred back to the central government which will use them to pay for Costa Rica's public debt. Before the reform, autonomous institutions attached to the central government were entitled to accumulate any funds received in a given year that were not spent or executed, thereby not facing any limitation or restriction on the amount of public funds they would receive the following year.

Institutional changes: The Costa Rican government has reinforced the role of the tax administration and taken significant steps to reduce high tax evasion:

- Improved the online tool **"TICA"** and created **"DATAMART"** in 2017 to facilitate compliance and the auditing of customs procedures. These tools are available to customs' users and customs' administration officials.
- **Registro Único Tributário:** During 2017, the tax administration developed a database with all taxpayers which is linked to the electronic invoicing system to monitor compliance.
- The Treasury has improved its **cash management practices**, aligning the transfer of funds during the budget year with actual committed expenditures.

Source: OECD (2017b): OECD Tax Policy Review; OECD (2017d): Public Governance Committee Accession Assessment Report; and Ministerio de Hacienda.

These measures contributed to a reduction of about 0.5 and 0.3 percentage points in the primary and headline deficits in 2016, respectively. Unfortunately, further improvements have been undermined by excessive revenue earmarking and legal requirements to raise social and education expenditures as mandated by the Constitutional Court, pre-election increases of historically low capital spending and soaring debt service. Costa Rica faced liquidity difficulties in the second half of 2017, leading to further increases in bond spreads and downward pressure on the exchange rate, which has constrained authorities' ability to adopt emergency measures to contain expenditure. Despite these measures, total spending did not slow but has actually outpaced revenue growth: in 2017, total expenditures grew by 9.1% while tax revenues grew by 5.3%. Interest payments have risen by 17% between 2016 and 2017. Increases in transfers to the decentralised public sector, and public sector remuneration have also put additional pressure on the budget.

At 6.2% of GDP, the 2017 deficit was among the highest in comparable Latin American and OECD countries. In the absence of substantial progress on fiscal reforms, the 2018 budget is already an emergency budget. To contain the deficit at 7% GDP, the 2018 budget, approved in Congress on November 23 2017, includes a hiring freeze and tighter control over the spending of the independent public sector institutions. Notably, it includes underspending on mandated expenditure (equivalent to 0.84% of GDP), which may be deemed unconstitutional. In this case, the 2018 budget deficit is expected to deteriorate to 8.1% GDP, worsening even more debt dynamics. With these extraordinary measures in place, the budget projects an increase in spending of 3.2% relative to the previous year. However, expected revenue collection will only cover about 56% of projected expenditures, and the remainder will have to be financed through debt. The debt burden is high: 32% of spending is destined to pay interest (1.38 trillion colones) and debt amortisation (1.6 trillion colones).

The high and rising fiscal deficit and mounting debt are the main weaknesses of the Costa Rican economy and represent major risks for Costa Rica's future. In the short term, they undermine confidence and lead to tighter financial conditions as investors ask for a higher risk premium to hold public debt. The impact on local financing conditions is already being felt with higher domestic credit rates, difficulties in finding domestic investors for sovereign debt, potentially reducing private investment and curbing growth.

Prolonged fiscal imbalances also constrain the scope for counter-cyclical policies. Furthermore, Costa Rica's fiscal position also makes the country particularly vulnerable to sudden stops and capital flow reversals. While stronger fiscal positions do not insulate emerging markets from sudden stops (Eichengreen and Gupta, 2016), lower public debt levels tend to reduce exposure to the global financial cycle and global push factors (IMF, 2016a). This is a concern at a time of tightening global financial conditions and increased risks of negative shocks on global financial markets, stemming, for instance, from sudden asset valuation corrections or financial stress in large emerging markets (OECD, 2017a). Even if the degree of Costa Rica's financial integration into global markets is limited and most of its public debt is issued domestically, global financial developments may affect FDI inflows and exchange rates. FDI inflows, which account for a large share of international capital flows to Costa Rica, have been shown to be more sensitive than other inflows to domestic factors (Koepke, 2015; Eichengreen, Gupta and Masetti, 2017). As a result, a further deterioration in Costa Rica's fiscal situation could harm its comparative advantage vis-a-vis other emerging markets in attracting and even keeping FDI. The inability to move ahead with fiscal reform works in the same direction, as it potentially

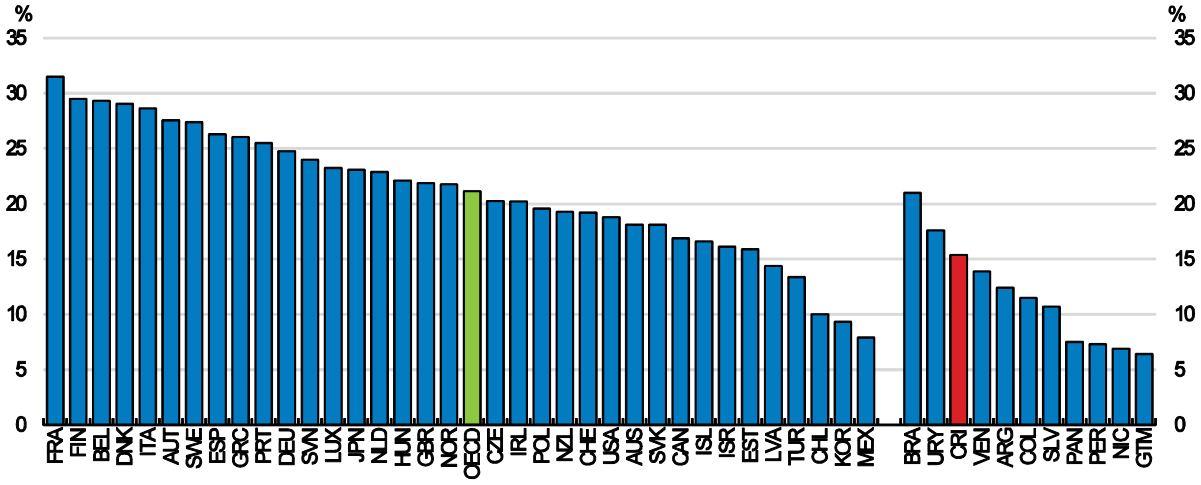
increases the political risks attached to Costa Rica. Additionally, given the high credit dollarization of the Costa Rican economy, and the high share of unhedged borrowers, a depreciation of the exchange rate could lead to financial instability (IMF, 2017a).

Restoring debt sustainability is also essential to ensure the success of Costa Rica's social and economic development strategy. On current trends, Costa Rica will not be able to fulfil its long-term commitments to inclusive growth. Although lower than the OECD average, Costa Rica is one of the countries in Latin America that spends the most on social policies, the main mechanism for poverty alleviation and inequality mitigation (Figure 5, OECD, 2017c). About half of public expenditures are dedicated to social spending, which focus on benefits in kind (about two-thirds, against an OECD average of 40%). Health is the largest in-kind programme, accounting for 43% of total social spending. Education accounts for almost 8% of GDP, which is higher than any OECD country. Cash transfers are mainly channelled towards old-age pensions. Going forward, a debt crisis would force Costa Rica to undertake damaging emergency cuts and freezes to public spending including the downsizing of a welfare system that is a model for the region and for emerging countries more broadly. It would also mean deferring once more the much needed upgrade in public infrastructure.

Past experience shows how long and difficult it can be to recover from dramatic cuts to social spending: the fiscal adjustment episode that followed the economic crisis in the early 1980s drastically cut social spending per capita by 30% in real terms, and only 35 years after, in 2015, did social spending exceeded its real per capita level of 1980. However, even in the absence of negative shocks, there are important public spending needs that will not be met in the current fiscal situation. The Costa Rican population is ageing relatively quickly. According to the UN population projections, by 2050, the share of the population over 60 will have increased to almost a third (from 12.8% in 2015) and those over 80 will reach 8% of the population (less than 2% in 2015). An ageing population raises demand for health care, long-term care and pensions. According to IMF projections, due to its quasi-universal welfare system, Costa Rica is one of the Latin American countries with the highest foreseen increases in health care and pension spending: age-related pressures could push up public health spending from about 8% of GDP to over 20% in 2065 and public spending under the pay-as-you-go pillar of the pension system from less than 3% to 13% of GDP (IMF, 2017b; IMF, 2017c). Also, enhancing growth and well-being requires additional public spending – notably on infrastructure, which has been notoriously low relative to identified needs for upgrading and modernisation, and also R&D, which currently Costa Rica cannot afford (see Meehan, 2018).

Figure 5. Social spending is relatively high in Costa Rica

Social expenditure as a percentage of GDP, 2015



Source: OECD (2017c): OECD Reviews of Labour Market and Social Policies: Costa Rica 2017.

Therefore, it is urgent to overcome the political gridlock that has hampered fiscal reforms in the past few years, before the fiscal situation deteriorates further and degenerates into an open crisis. Unfortunately, cross-country evidence on fiscal consolidation episodes reveals that consolidation is more likely to take place when a country is already in deep fiscal trouble (Price, 2010). This may be because crises increase public awareness of fiscal problems, hence helping overcome resistance to reforms and making opposition to consolidation unsustainable. However, larger fiscal deficits do not only lead to larger and more painful adjustments, they tend to limit the ability to implement much needed reforms as they require emergency measures to first bring the fiscal situation under control. Only well planned and designed spending as well as structural tax reforms can put debt on a sustainable path, while preserving or even enhancing long term growth and inclusiveness. There is still time for Costa Rica to take such a path, but time is quickly running out.

A comprehensive package of fiscal reforms is needed to restore healthy public finances

The deterioration of public finances results from a combination of structural weaknesses

It is clear that the government cannot rely on extending emergency measures indefinitely. Against this backdrop, a policy priority for Costa Rica is to design a comprehensive reform package that credibly addresses structural public sector and budgetary weaknesses, thereby repairing fiscal imbalances in a long-lasting way. Costa Rica's inability to balance its fiscal situation after the global crisis reveals the flaws in its public finance management and tax systems. These weaknesses have been clearly identified, including in the 2016 OECD Economic Assessment of Costa Rica (OECD, 2016) and in OECD tax and public governance reviews (OECD, 2017b; OECD, 2017d), as well as by the World Bank (Oviedo et al., 2015) and the IMF (2013; 2016b).

In 2008, as counter-cyclical fiscal policy measures, the government opted to increase the remuneration of public sectors workers and step up current transfers to decentralised institutions. Both measures have proven impossible to revert due to their structural nature. Costa Rica's public administration is highly fragmented into deconcentrated and decentralised institutions (e.g. semi-autonomous and autonomous bodies) and public corporations (Table 1). While such a situation is not exceptional, and is found in many OECD countries with large sub-national sectors, it is an issue in Costa Rica. This is because the government is unable to align spending and budget lines to these different institutions, according with the country's medium-term strategic priorities as defined by the National Development Plan, which sets the overall economic strategy and objectives. As such, fragmentation of public administration reduces the government's ability to reallocate funds to priority areas and ensure accountability to central government institutions. Fragmentation has also increased recently: of the 330 different public sector institutions, around a third has been created since the 1990s (Table 1).

The existence of a large decentralised sector is also not associated with strong cooperation mechanisms neither between the different institutions of the decentralised sector, nor with the relevant ministries. Concurring with this outcome is that fact that the Centre of Government, formed by the Presidency, the Ministry of Planning and Economic Policy (*Ministerio de Planificación Nacional y Política Económica* - MIDEPLAN) and the Ministry of Finance, currently lacks a strong enough strategic and steering role to overcome fragmentation and ensure effective policy coordination (OECD 2017d). These weaknesses affect decision making in many areas, from social policies to debt management, and significantly dampen the effectiveness and quality of public services. A good example is the case of early childhood education and care, where the absence of leadership resulting from excessive fragmentation of responsibilities across several public institutions prevents real improvements in access and quality (OECD, 2017e). Another is the governance around decisions on investment in infrastructure. Multiple government bodies responsible for infrastructure services do not coordinate on infrastructure investment prioritisation while there are areas where there is neither a clear assignment of responsibilities (e.g. municipal roads) nor a dedicated budget line (e.g. public transportation).

Moreover, fragmentation has impeded the control of expenditure in line with fiscal sustainability constraints, changing economic conditions or policy priorities. While excessive budget flexibility can lead to a misuse of public resources, in Costa Rica, only half of the general government budget is under the budget process headed by the Ministry of Finance (OECD/IDB, 2014; Figure 6). Spending by deconcentrated and decentralised institutions and public corporations is approved by the Office of the Comptroller General of the Republic, but mostly from a legal standpoint. The responsibility of verifying that these entities comply with the National Development Plan is undertaken by the MIDEPLAN, but without any instruments to enforce compliance. In addition, decentralised institutions' funding schemes are extremely rigid and funds cannot be reallocated between spending areas according to emerging priorities. As a result, while the decentralised/deconcentrated bodies generally have a balanced budget or even financial surpluses, they contribute to the overall deficit by absorbing a higher share of revenues than they need. Fragmentation also reduces budget transparency because of the inconsistencies in the institutional classifications used by the different ministries, and the different datasets available.

Table 1. Evolution of the public sector in Costa Rica

Number of entities created

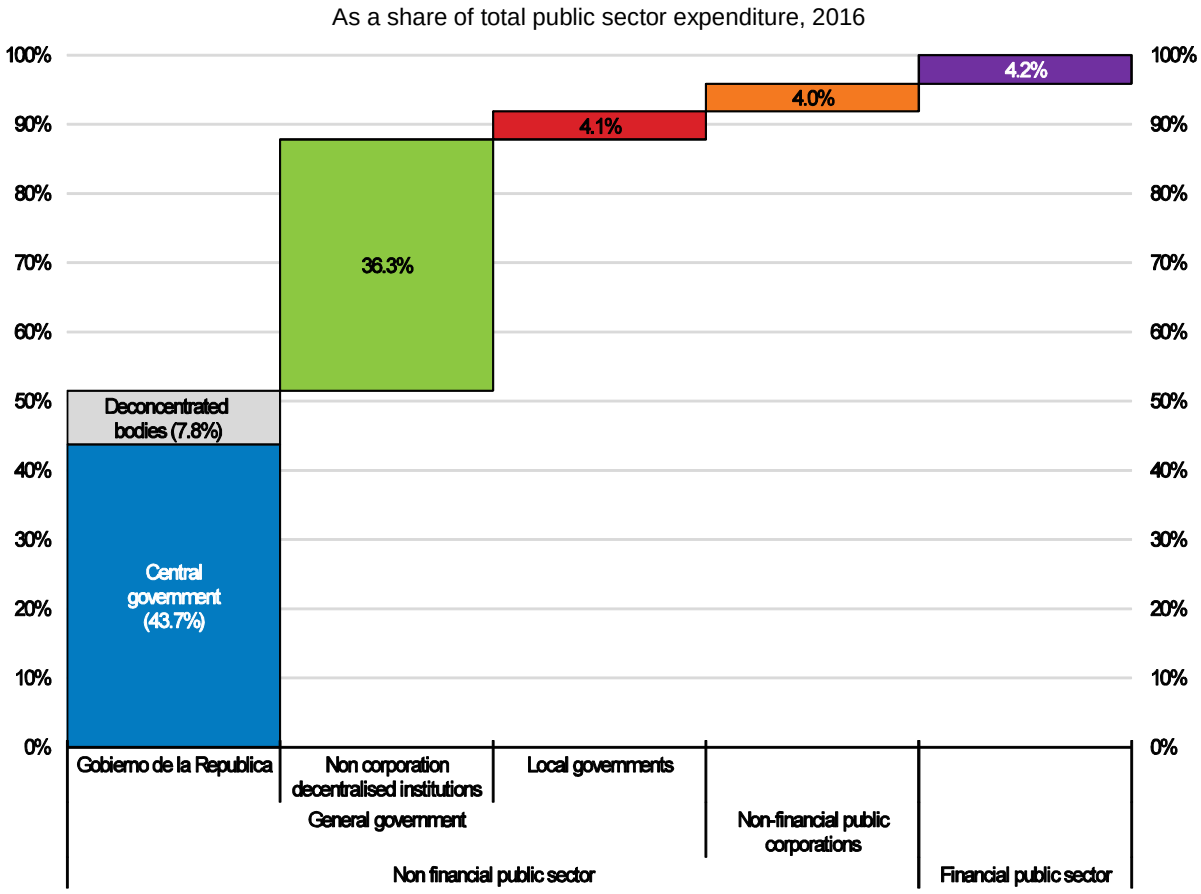
Entity	Before 1900	1900-1939	1940-1949	1950-1959	1960-1969	1970-1979	1980-1989	1990-1999	2000-2009	2010-2016	Total
Ministries	3	1	0	1	2	5	3	3	0	0	18
Subsidiary bodies of the Ministries	2	0	2	0	4	14	8	24	19	7	80
Autonomous institutions	2	4	5	6	6	6	2	3	1	0	35
Subsidiary bodies of the autonomous institutions	0	0	0	0	0	0	2	6	4	1	13
Semi-autonomous institutions	0	0	0	0	1	3	1	3	0	0	8
Municipalities	32	29	4	0	7	8	1	0	0	0	81
Municipal District Councils	0	0	0	0	1	3	2	0	2	0	8
State public enterprises	0	0	1	1	1	4	0	8	6	0	21
Non-state public enterprises	0	0	0	0	0	1	0	1	4	0	6
Non-state public entities	0	0	6	3	12	8	5	11	2	3	50
Others including the branches of government and the bodies attached to them	0	0	5	1	0	0	0	3	1	0	10
Total	**39**	**34**	**23**	**12**	**34**	**52**	**24**	**62**	**39**	**11**	**330**

Source: OECD (2017d): Public Governance Committee Accession Assessment Report: Costa Rica 2017.

To regain control of public finances, the government should develop a strategy allowing the gradual rationalisation of the institutionally decentralised sector and the development of a clear set of steering, co-ordination and control mechanisms at the level of the Centre of Government. To this end, in 2017, a study was carried out by MIDEPLAN to identify non-functional institutions and progressively abolish them as part of the endeavour to develop a strategy to gradually rationalise the institutionally decentralised sector in order to work towards a sound structure of government. The study revealed that 22 institutions (18 subsidiaries bodies of ministries and four non-state public institutions) could potentially be abolished. Based on the results of the study, a draft law to eliminate non-

functional institutions and a draft decree to close non-functional commissions have been prepared. These should be approved swiftly but efforts should proceed to identify non-functional institutions, clearly identify responsibilities for each government body, avoid loopholes and duplication of responsibilities, and enhance accountability, coordination and steering.

Figure 6. Only half of the government budget is under the budgetary process headed by the Ministry of Finance



Source: Ministerio de Hacienda.

The government's ability to allocate budget spending according to changing needs and priorities is further undermined by excessive revenue earmarking and mandated spending, some of which is enshrined in the Constitution. The most important are the constitutionally mandated spending of 8% of GDP on education, 6% of ordinary revenues allocated to the judicial sector, and 7% of income tax revenues received by PANI (National Child Welfare Agency). After allocating funds for earmarked and mandated spending, debt servicing (amounting to about one third of the budget) and remunerations outside of education and justice, only 4.5% of the central government's budget can be used for discretionary spending (Table 2). A worrying trend is that the share of discretionary spending has been declining over time.

Budget earmarking is defined as pre-assigned funding not stemming from operational expenditures such as debt servicing. Earmarks set aside a percentage of government funds, which can be estimated as a share of GDP for specific sectors such as health, education or defence, and are established by the constitution, or by primary or secondary legislation. Their purpose is to pre-commit a percentage of government spending to specific sectors. Costa Rica and Brazil are the countries in Latin America that use earmarking the most (OECD/IDB, 2014). The earmarking of tax revenues can guarantee a stable source of funding to public programmes and independent public institutions, as well as improve transparency and trust in the government, ultimately encouraging tax compliance. However, it severely constrains the allocation of public funds and does not allow spending to adjust to society's changing needs. Notably, public expenditure in infrastructure has not kept up with needed investments (Oviedo et al, 2015). This level of spending combined with poor prioritisation and management (discussed below) has resulted in the Costa Rica's deficient quality infrastructure stock, limiting the country's competitiveness and development plans (Estado de la Nación, 2016; OECD, 2016b; IMF 2017a). Clearly, earmarking and mandated spending have become dysfunctional, severely hindering the government's capacity to allocate the budget according to changing needs and priorities, thereby reducing the role of the budget as an instrument to support government policy, also threatening fiscal sustainability in the long term.

Table 2. Costa Rica's budget is excessively rigid

As a % of total budgetary spending, 2010-18

Budgetary Categories	2010	2011	2012	2013	2014	2015	2016	2017	2018
Constitutional Destinations	31.8	31.2	31.4	32.2	34.4	32.8	34.8	33.9	33.9
Unavoidable Obligations	21.2	20.7	21.1	20.6	21.4	19.4	20.5	19.2	19.6
Debt servicing	31.7	33.7	33.9	32.9	29.1	33.7	31.2	32.7	32
Amortisation	*20.8*	*25.0*	*24.9*	*23.0*	*17.4*	*22.1*	*19.4*	*20.5*	*17.2*
Interest payments	*10.3*	*8.7*	*9.0*	*9.9*	*11.6*	*11.6*	*11.7*	*12.2*	*14.8*
Specific Destinations	9.0	8.4	8.1	9.2	9.7	8.9	8.5	9.0	10.1
Discretionary Spending	6.9	6.0	5.5	5.1	5.4	5.3	5.0	5.2	4.5

Note: Spending categories as defined by the Costa Rican government. "Unavoidable Obligations" consist of salaries and social security contributions related to public sector workers, pensions and contributions to the Caja Costaricence de Seguro Social; "Constitutional Destinations" and "Specific Destinations" are predefined budgetary allocations either by the Constitution or by other laws that allocate total or partially some tax revenues or mandate spending as a share of GDP, nominal revenues, base salaries, etc.
Source: Ministerio de Hacienda (2017): Ley 9514 Presupuesto Ordinario y Extraordinario De La República Para El Ejercicio Económico 2018.

Combined with the lack of performance-based budgeting, earmarking also results in an emphasis on spending as a measure of policy focus and prioritisation rather than the

definition of specific targets and outcomes or on spending effectiveness. The education system illustrates this fragility: access to education for all has been a cornerstone of Costa Rica's successful social model and for this reason constitutional revisions have raised mandated spending to 8% GDP. There is no underlying reason for this specific target that acts as a major obstacle to spending restraint while not being efficient in raising educational outcomes. Specifying the education spending target in such a way also implies that any increase in nominal GDP growth will automatically inflate education spending even in the absence of a strategy to raise educational outcomes. A draft bill submitted to Congress in the summer of 2017, stipulating that each new budgetary line needs to be accompanied by a specification of its funding source, as a measure that would enhance fiscal responsibility and contribute to rigorous public finances, gives evidence of the difficulty around the debate on earmarking in Costa Rica.

The excessive use of earmarking in Costa Rica is also at odds with the OECD Recommendation on Budgetary Governance, which states that "Special-purpose funds and earmarking of revenues for particular purposes should be kept to a minimum" (Recommendation of the Council on Budgetary Governance, Principle 7, OECD 2015a). Moreover, the specific characteristics of earmarking in Costa Rica are a major source of distortion as increased revenues resulting from efforts to curb tax evasion and tax reforms inevitably lead to proportional increases in earmarked spending based on tax revenues (e.g. to the judicial sector) when overall spending should be cut to reduce the deficit.

Largely as a result of fragmentation and rigidity, the increase in public spending since the crisis has not been accompanied by an increase in the quality of spending nor a stronger contribution to economic growth and equity. There is a growing dissatisfaction among Costa Ricans regarding the quality of delivery of public services (Estado de la Nación, 2016; 2017). Also, as already highlighted in the 2016 OECD Economic Survey of Costa Rica, inequalities have risen, educational outcomes have stalled, and bottlenecks associated with the lack of infrastructure have persisted. As high spending growth has made a limited contribution to growth and equity, debt will be more difficult to repay in the medium term.

Ensuring fiscal sustainability

Against this background, restoring Costa Rica's fiscal sustainability requires in-depth reforms and a comprehensive approach that addresses, in parallel, the flaws in the budgetary framework, expenditure control and the tax system. Cross-country analysis of consolidation episodes shows that large consolidation efforts typically require action on both sides of the budget (Price, 2010). It also shows that measures on the spending side play a major role in ensuring consolidation success (Guichard et al., 2007; Price, 2010; Molnár, 2013). Ensuring successful consolidation via containing expenditures is even more relevant in Costa Rica's context as any tax reform alone is bound to fail due to strong earmarking. This has already been the case in 2017, when a large share of the additional revenue stemming from fighting tax evasion was absorbed by mandated expenditure. Domestic debates on tax reform also suggest that combining measures on both sides could also be easier to promote from a political economy standpoint. Reforms on both spending and revenue sides would also need to be complemented by a modernisation of fiscal management tools, including the fiscal rule, which have been shown to make fiscal consolidation results more durable. Going forward, Costa Rica could also improve debt management that could potentially result in savings in interest payments via lower spreads.

The Executive's attempts to balance the budget have moved in the right direction. While initially consolidation efforts focused on the approval of a tax reform to raise extra revenue, they now include a broader package of reforms to improve expenditure control. The most important pending reforms have been bundled in a bill to strengthen public finances (*Ley de Fortalecimiento de las Finanzas Públicas*). This comprises: i) a bill to transform the current sales tax into a fully-fledged VAT tax, also including the enlargement of the tax base by scrapping a number of exemptions, including in services, which now account for more than half of GDP; ii) an increase in the taxation of capital gains to 15%; iii) several bills to reform the remuneration schemes of public sector workers and iv) a fiscal rule bill, which imposes increasingly tighter spending limits as central government debt increases (see below). The packaging of reforms to restore fiscal sustainability is welcome as it formalises the understanding that the restoration of fiscal sustainability in Costa Rica requires a comprehensive approach. However, the proposed fiscal consolidation plan does not suffice as any plan to stabilise debt should be complemented by a plan to reduce government fragmentation and excessive earmarking. Otherwise, any additional tax revenue would be washed away.

Assuming that all gains in expenditure revenues resulting from the implementation of the *Ley de Fortalecimiento de las Finanzas Públicas* are no longer earmarked to spending destinations, the implementation of this bill already in 2018 would lead to an increase in central government debt until 2028, when it would reach 56% of GDP, and a slow decrease thereafter (Figure 4, B. "Reform to strengthen public finances"). The government estimates that the total fiscal impact of this bill amounts to 1.92% of GDP (Table 3). Its implementation in 2018 is still feasible as the Legislative Assembly has approved by the end of February 2018 a fast-track approval procedure for the *Ley de Fortalecimiento de las Finanzas Públicas.*

An additional consolidation effort of one percentage point of GDP in a third consecutive year could stabilise debt four years earlier (Figure 4, C. "3% fiscal adjustment"). This strategy seems more appropriate to Costa Rica in the current risky environment of rapidly deteriorating debt dynamics and sovereign ratings and increasing interest rates in global markets. Although there is considerable uncertainty regarding the size of the fiscal multiplier, it appears to be substantially less than unity, and low in international comparisons (Estevão and Samake, 2013). This suggests that the short-term costs of fiscal consolidation, measured by output losses, would be low and that the long-term benefits of putting the fiscal accounts back on track, thereby creating the conditions for sustainable growth, would largely outweigh those short-term costs. By enacting fiscal consolidation measures already in 2018, Costa Rica would regain market confidence, which would in turn reduce spreads and the debt burden, also lightening the burden of future fiscal consolidation efforts to bring debt to a prudent level. Over time, Costa Rica could also regain its recently lost investment grade status of sovereign debt. Lower interest rates would also ease financial conditions for the private sector, therefore improving the investment climate. Going forward, reducing the debt-to-GDP ratio to a prudent level will require additional consolidation measures in the medium term (OECD, 2015a).

Table 3. Fiscal consolidation package

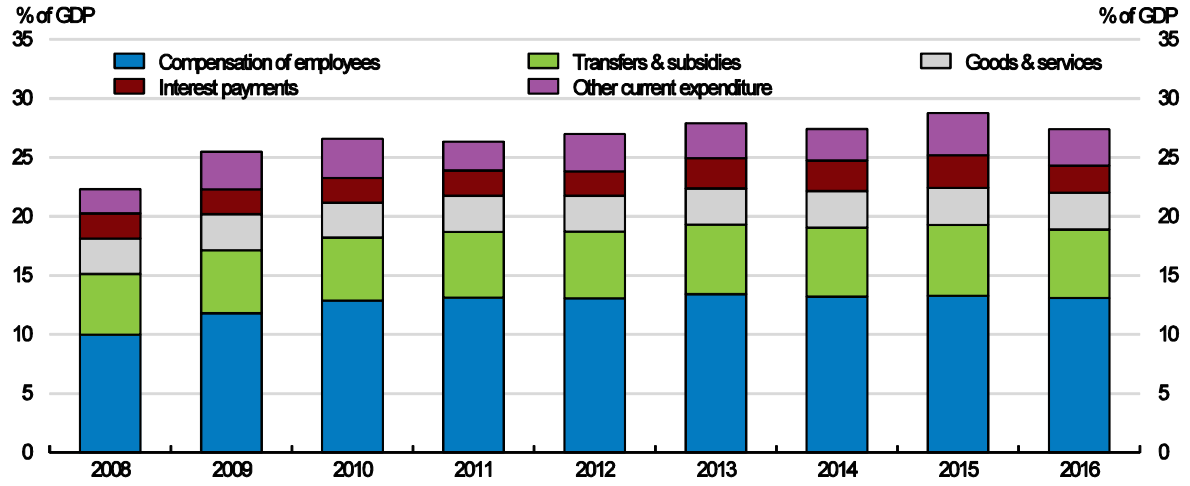
Fiscal Consolidation Measures	Estimated impact of the *Ley de Fortalecimiento de las Finanzas Públicas* (% of GDP)	OECD Recommendation (% of GDP)
Revenue Increase	**1.40**	**1.40**
VAT	0.90	0.90
Income Tax	0.50	0.50
Spending Cuts	**0.52**	**1.08**
Compensation of public sector workers	0.02	0.02
Fiscal Rule	0.50	0.50
Cut mandated spending	**-**	**0.56**
Total	**1.92**	**3.00**

Improving the efficiency and quality of public spending to better support growth and equity

Even though public spending as a share of GDP is relatively low by international standards, at slightly over 30%, it has been on an increasing trend since 2008, driven by current transfers and public sector workers' remunerations, while the share of capital investment is small, despite major infrastructure needs (Figure 7; Meehan, 2018). Expenditure restraint in 2016-17 has mostly resulted from temporary freezes and underspending on mandated expenditure, even though the constitutional court has ruled that revenue earmarking demanded by the constitution (notably in education) should be enforced.

Figure 7. Compensation of public-sector employees accounts for an increasing share of spending

General government; decomposition of current expenditure



Source: IMF Government Finance Statistics database.

A broad strategy to durably curb expenditure growth while enhancing its contribution to economic and social development requires a set of complementary measures to:

- Reduce the role of earmarking and mandated spending in the budget and better align spending with the country's development strategy and priorities.
- Increase the budgetary control of the Ministry of Finance and devise a strategy to reduce fragmentation over time.
- Reform public sector wage formation.
- Further improve spending efficiency.
- Address pension sustainability issues.

Addressing budgetary fragmentation and rigidity

Budget fragmentation, excessive earmarking and the lack of flexibility has contributed to the drift in public spending and prevented compliance with the formal, legal balanced budget rule that is enshrined in Articles 176 and 179 of the Constitution. The success of consolidation efforts will depend on the ability of Costa Rica to address these weaknesses in managing public finances.

The 2015 and 2017 OECD public governance reviews have already made several recommendations in this direction including (OECD, 2015b; OECD 2017d):

- Ensure fiscal flexibility and create fiscal space by reviewing the formulas of budgetary earmarks; strengthening the planning system; carrying out spending reviews and envisaging time limits ('sunset' clauses) for new programmes.

- Better align the institutionally decentralised sector with government priorities through strengthened accountability, monitoring and evaluation mechanisms; consider associating conditions with budgetary transfers.
- Build on the recent progress achieved in the preparation of the National Development Plan to further broaden the use of performance-informed budgeting practices, including in the decentralised public sector.
- Consider a general revision of the mandated finance schemes and institutional framework of the decentralised sector's agencies, evaluating whether their mandate still fits government priorities, and whether their funding is in line with their needs.

Several proposals in line with these recommendations are currently under discussion and it is essential that they are approved and implemented. In particular, a bill of law presented to the Legislative Assembly by the General Comptroller, aims at including the deconcentrated agencies in the national central budget (Bill 20.203). The enactment of this law is now pending. This is a step in the right direction even though it only concerns less than 8% of public expenditure (Figure 6). In November 2017, the Executive has also submitted to the Legislative Assembly a bill of law which would reduce the extent of earmarking, by proposing to delink some spending categories from revenues (Bill 20.595). This bill is welcome as it is a first step to reduce earmarking. However, this initiative is difficult to reconcile with another bill that has been submitted to the Legislative Assembly, proposing that all new expenditures need to be obligatorily accompanied by their funding sources.

The authorities have tasked the World Bank with preparing a Public Spending Review with the aim of providing analysis, reform options and measures in selected areas of the general government budget to put the debt on a sustainable path, while taking into account equity and medium-term growth concerns.

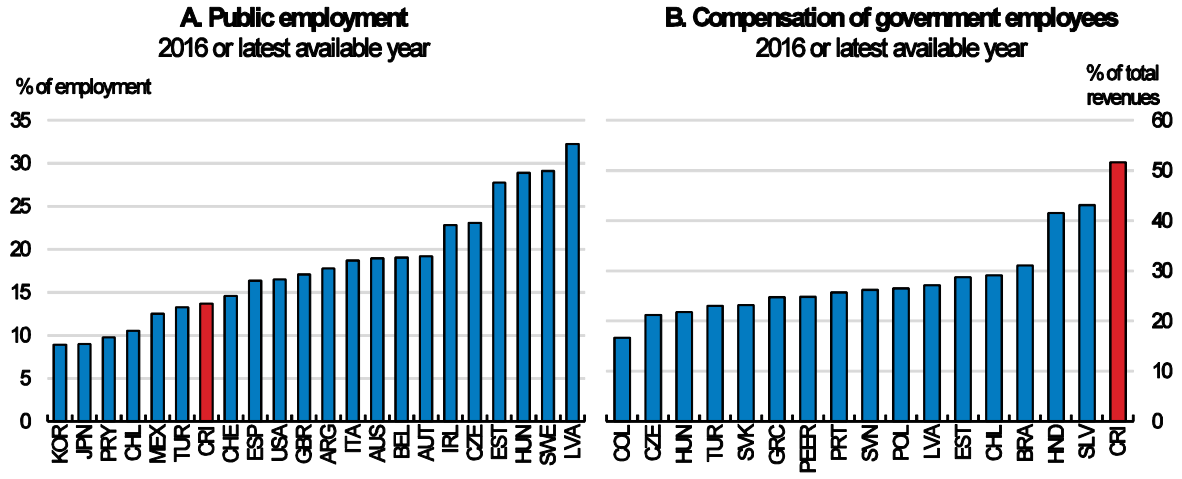
An interesting example of a successful fiscal consolidation episode that could be useful for Costa Rica is the one enacted in Sweden after the financial crisis of 1990-91. While Sweden's level of development and the economic circumstances in which public debt became unsustainable are very different, excessive fragmentation and budget rigidity played a key role in the drift of Swedish public spending (Blöndal, 2001a). As part of the fiscal consolidation programme, all the open-ended permanent budget appropriations (i.e. permanent earmarking) were abolished and appropriations were subject to annual scrutiny and authorisation, and off-budget entities were included back in the budget process under the scrutiny of the Ministry of Finance. A top-down approach was adopted by which the general size of the budget was approved first before deciding on its allocation (Blöndal, 2001a; Wehner, 2007; Downes, Moretti and Shaw, 2017). Canada and the Netherlands offer other examples of successful consolidation efforts in the 1990s that largely owed their success to a complete reform of the budgeting framework (Blöndal, 2001b; Blöndal and Kroman Kristensen, 2002).

Reforming the remuneration of public employees

A priority area for expenditure reform is public sector employment compensation, which, as a share of GDP, is higher than in OECD countries, even though public employment is much lower than in OECD countries (Figure 8). Costa Rica is also the Latin American country that spends the most on public wages after Paraguay, which amount to 40% of public expenditures (OECD, 2017f). Growing at a faster pace than productivity, public

sector compensation has had a negative impact on the economy by contributing to income inequality, creating distortions in the labour market and reducing workers' mobility (Baddock, Lang and Srivastava, 2015; González Pandiella and Gabriel, 2017).

Figure 8. Public employment is low but accounts for a large share of public expenditure



Note: Data compiled on the basis of the guidelines of IMF's Government Finance Statistics Manual 2014.
Source: ILOSTAT; IMF Government Finance Statistics database.

High public employee compensation results from the combination of numerous allowances that vary from one employee to the next and a multiplicity of interrelated collective agreements and legislations that tie increases in salary of one group to another (OECD, 2015b). For instance, the base salary of employees that depend on the Civil Service regime can be complemented by over 20 different types of incentives, including seniority pay and bonuses (OECD, 2017d). This makes public employee remuneration overly complex, opaque, inequitable and difficult to control, especially in the absence of an integrated database on public employment and a fiscal ceiling in the overall public wage bill. In other cases, increases in compensation have been extended to groups other than the one originally intended. For example, in 2014, the public sector wage bill was inflated by a reform to the compensation of professionals working in the central administration. The reform, which had been supported by the OECD, was designed to improve the attraction and retention of staff who were paid much less than their peers carrying out similar jobs in the various autonomous public agencies. However, the new benefits were also extended to teachers, resulting in much higher fiscal costs than those planned (OECD, 2017d).

To curb public expenditure and create room for other spending priorities, it is essential to reduce the overall public sector wage bill and put in place mechanisms that prevent it from bouncing back and absorbing the bulk of new revenue in the future. The solution is not, however, to implement across-the-board wage cuts and hiring freezes. Although sometimes these shortcuts are the only way to reduce or contain the deficit in emergency situations, as is the case of the 2018 budget, when not accompanied by deeper reforms these types of emergency measures do not suffice to improve fiscal sustainability. The solution is, rather, in long lasting reforms of wage settings in the public sector, tailored to Costa Rica's level of development and institutional capacity.

To deflate the public sector wage bill while reducing the complexity of the remuneration system, the focus should be on streamlining allowances, accompanied by a mechanism ensuring regular reviews of these allowances and aggregate institutional caps to avoid proliferation going forward. It is therefore unfortunate that the bill aimed at making the bonus system more equitable and transparent was abandoned following trade unions' threat of a general strike.

In addition, to keep public wages under control, public wage settings need to be reviewed and better aligned with the productivity of public services. There are two main recommended options for setting public wages: (i) centralisation in the Ministry of Finance or (ii) decentralisation accompanied by a strong framework including performance/merit based remuneration (IMF 2016c). Both would be challenging: the fragmentation of the public administration limits the feasibility of the first option, while the need to upgrade Costa Rica's performance-based remuneration to make it more transparent, efficient and equitable makes the second option difficult to operationalise. Best practices to effectively manage the wage bill, as identified by the IMF, also include: improving medium-term wage forecasting, strengthening links between wage determination processes and fiscal frameworks, and developing position-based employment systems that provide more flexibility to adjust employment levels to ensure efficient service delivery (Forni and Novta, 2014; IMF, 2016c). These reforms need to be coordinated with reforms in other areas of public spending, especially in the health and education sectors, which account for a large share of public employment (IMF, 2014a).

Ongoing reform efforts are led by the National Employment Commission, which gathers high level representatives from the Ministry of Labour and Social Affairs, MIDEPLAN, the Ministry of Finance, the Civil Service and the Ministry of the Presidency. The Commission has drafted bills that promote equal pay scales for the same functions and establish a single salary scale for senior officials, alongside an information system and a performance evaluation system based on the achievement of institutional goals. In particular, the fiscal package to strengthen public finances includes measures to cap base salaries, establish a single salary scale for senior officials, limit bonuses related to prohibition and exclusive dedication, and review performance-based bonuses.[2]

Improving the efficiency and the quality of public spending

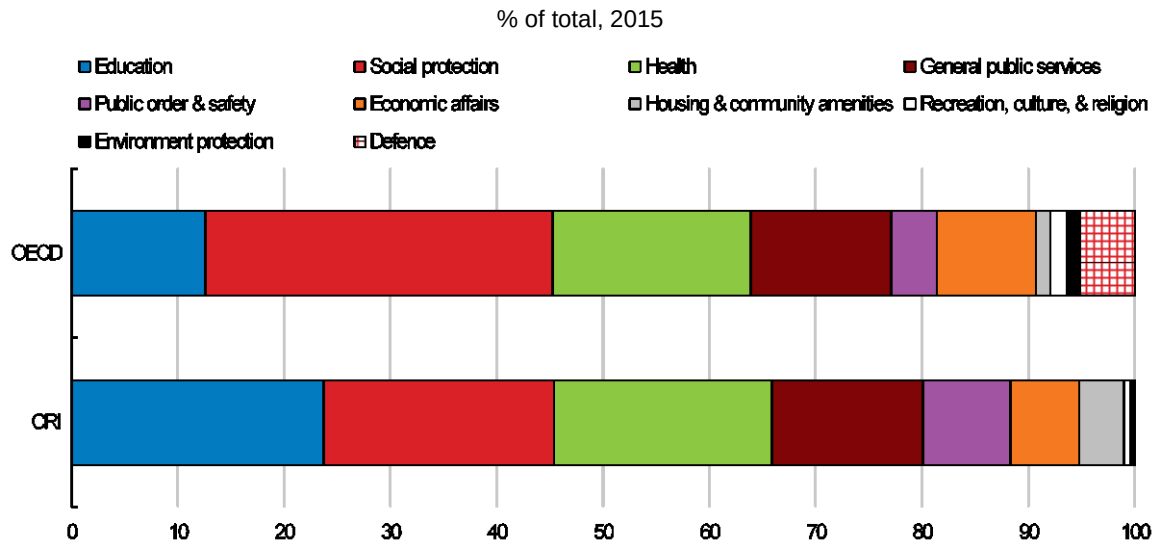
Another priority area for action on the expenditure side is the efficiency of spending, especially social spending (i.e. on social security, education, health), which accounts for over two-thirds of the general government budget (Figure 9) and is relatively high compared with other Latin American countries. While it has supported Costa Rica's exceptional social achievements over the past decades, the quality of spending has not kept pace with the quantity of spending, nor with the requirements of a fast-changing global economy. There is, therefore, room to improve social outcomes while spending less.

The priority for Costa Rica is to switch from a focus on the volume of social spending to a focus on how to improve its quality and efficiency, including through stronger accountability mechanisms, transparency and impact evaluation. This is all the more

2 Prohibition bonuses are financial compensation derived from the prohibition for some officials from practicing a profession due to potential conflict of interest, while exclusive dedication bonuses are paid as a counterpart of civil servants' agreement not to undertake any private activity.

necessary given that Costa Rica's development ambitions and ageing population will put further pressure on social spending.

Figure 9. General government expenditure by function



Source: IMF Government Finance Statistics database; and OECD Government at a Glance 2017.

Improving the quality of public spending is also a way to reduce informality and tax evasion at a time when there is growing discontent in this regard. While all sectors are different, they are all affected by fragmentation of decision and policy making, complexity and low coordination (as mentioned above).

Social programmes: improving targeting and efficiency

As already pointed out in the 2016 OECD Economic Survey of Costa Rica, 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, suggesting inadequate targeting. This limits their contribution to inequality reduction, also weighing on public finances (OECD, 2017c). In addition, institutional fragmentation and a lack of coordination translate into a duplication of efforts and spending inefficiencies as different institutions offer similar schemes using different eligibility criteria and different registries of beneficiaries.

Against this background, the 2016 OECD Economic Survey of Costa Rica recommended the adoption of a unified framework, based on a single list of beneficiaries. It also stressed the need to evaluate social programmes, and focus resources on those that are effective while scaling down the others. Since then, processes have been brought into line with these recommendations (see Meehan, 2018). A common database has been created to identify households in need, and these households are being targeted to receive joined-up social assistance services. The database is also being used to improve the consistency and quality of programme delivery.

Health care: containing expenditure while reducing inequality of access

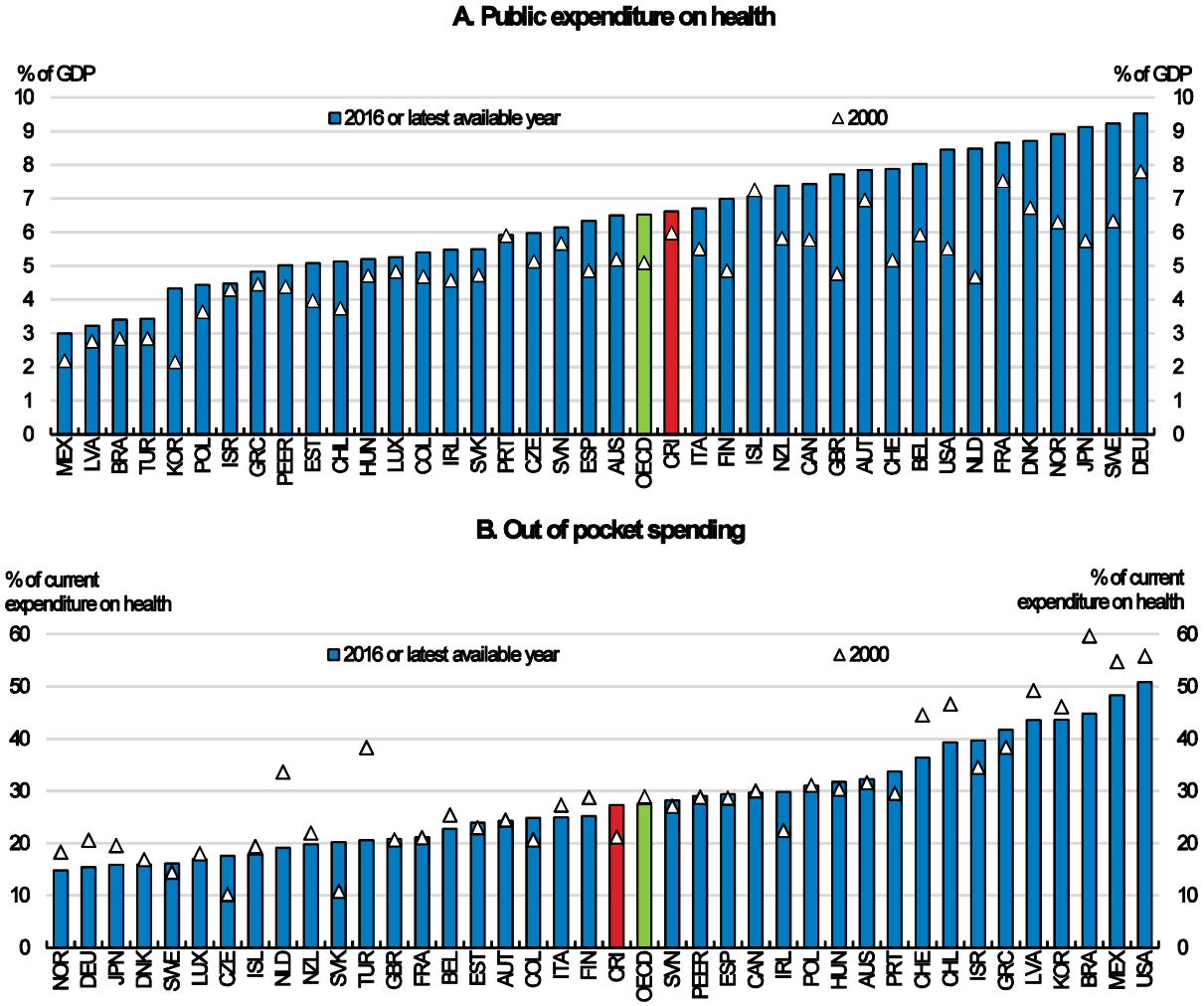
The Costa Rican health system has been considered a model among emerging market economies (World Bank, 2015). Virtually universal health care has reduced infant mortality and increased life expectancy (to close to 80 years) well beyond achievements in other Latin American countries. Costa Rica ranks close to the OECD average in the health dimension of the OECD well-being indicators. Virtually universal health care also contributes to reducing inequalities.

However, recent spending increases have been driven mostly by increases in medical salaries and have not benefited patients through a higher provision of health care (OECD 2017fg; World Bank, 2015). While public health spending as a percentage of GDP is now above the OECD average and continues to increase, the average daily hospital production or the number of outpatient visits per professional have declined, with users facing excessively long waiting times (Figure 10). While the waiting time for surgery has improved somewhat since 2014, patients still need to wait on average 452 days for general surgery and child surgery has a waiting line of up to two years. Users also pay more out of pocket than the OECD average (even though this is still much less than in many other Latin American countries). The increase in out-of-pocket payments suggests that a two-tier health system may be building up, where those who can afford it avoid lengthy waits (or perceived poor quality) by turning to the private sector (OECD, 2017g). Overall the universal access achievements of Costa Rica are being *de facto* eroded.

The challenge for Costa Rica is then to make more of its already high spending on health care by improving efficiency while restoring *de facto* universal access. Several weaknesses of the health care system therefore need to be addressed, including its excessive fragmentation, its lack of effective information systems, poor cost containment mechanisms, excessive reliance on historical budgeting and a remuneration system that does not take performance into account. While these issues are common to the whole Costa Rican public sector, they imply the adoption of specific measures for the health care sector.

The first priority is to improve the collection of performance indicators, such as unitary costs and waiting times. This is already underway with the single digital medical file, which will provide real time statistics and performance indicators. The second, as recommended in the 2016 OECD Economic Survey of Costa Rica, is that the allocation of resources needs to be modernised to better reflect changing demographic patterns and disease trends; diagnosis-related funding schemes should be introduced, which have been shown by the OECD as being effective in containing costs without harming the quality of services (Pisu, 2014).

Figure 10. Public expenditure on health



Source: OECD, Global Health Expenditure database.

Keeping expenditure under control while reducing waiting times is a challenge. A way forward, once a Diagnosis-Related-Group-type provider payment system and an accurate and timely national database of hospital waiting times for specific procedures is established, would be to allow patients a choice of hospital, including private sector providers. A successful example is the implementation of the Integrated Management System of the Waiting List for Surgery in Portugal, which combines a waiting time and waiting list information management system with vouchers allowing free choice of provider issued to patients when they reach 75% of guaranteed maximum waiting times. This system has been particularly effective in decreasing waiting times while earlier efforts that focused on providing additional funds for additional activity had failed (see Siciliani, Borowitz and Moran, 2013).

The authorities are aware of these challenges. Although plans are in the early stages, the creation of a health council is under consideration with the view to providing institutional oversight and promoting better use of evidence (including epidemiological and

demographic information) in health funding and delivery. Improvements are also being made in procurement through a joint initiative with other Central American countries.

Education: focusing on improving outcomes

Education has a central role in economic development through its impact on both productivity growth and inequality reduction. Consequently, it has been a key priority for Costa Rica, resulting in almost universal literacy and enrolment. The priority given to education in Costa Rica's development strategy is reflected in the constitutional requirement to allocate 8% of GDP to the education sector. As a result, spending per student has almost doubled in the past decade (Figure 11).

However, here too, outcomes have not kept pace with spending increases. While Costa Rica now spends more on education as a share of GDP than the OECD average (8.3% of GDP, most of it public, versus 5.2% of GDP on average in the OECD) and absorbs about a fifth of total public expenditure (double the OECD average), average levels of schooling remain low even for younger generations: only half of the 25-34 year olds have completed secondary education versus over 80% in OECD countries; many students repeat grades in lower secondary school and end up dropping out. By the end of basic education, 30% of Costa Rican students have already dropped out of school (OECD 2017e) and one third of those who remain in school lack core competencies. Costa Rican students score low in OECD PISA tests, pointing to quality issues. Moreover, the inequality of access has increased with children from disadvantaged background less likely to complete secondary education (Estado de la Nación, 2016 and 2017; OECD, 2017e) despite the success of *Yo me Apunto* and *Avancemos* in reducing drop outs and increasing enrolment of children from low-income families.

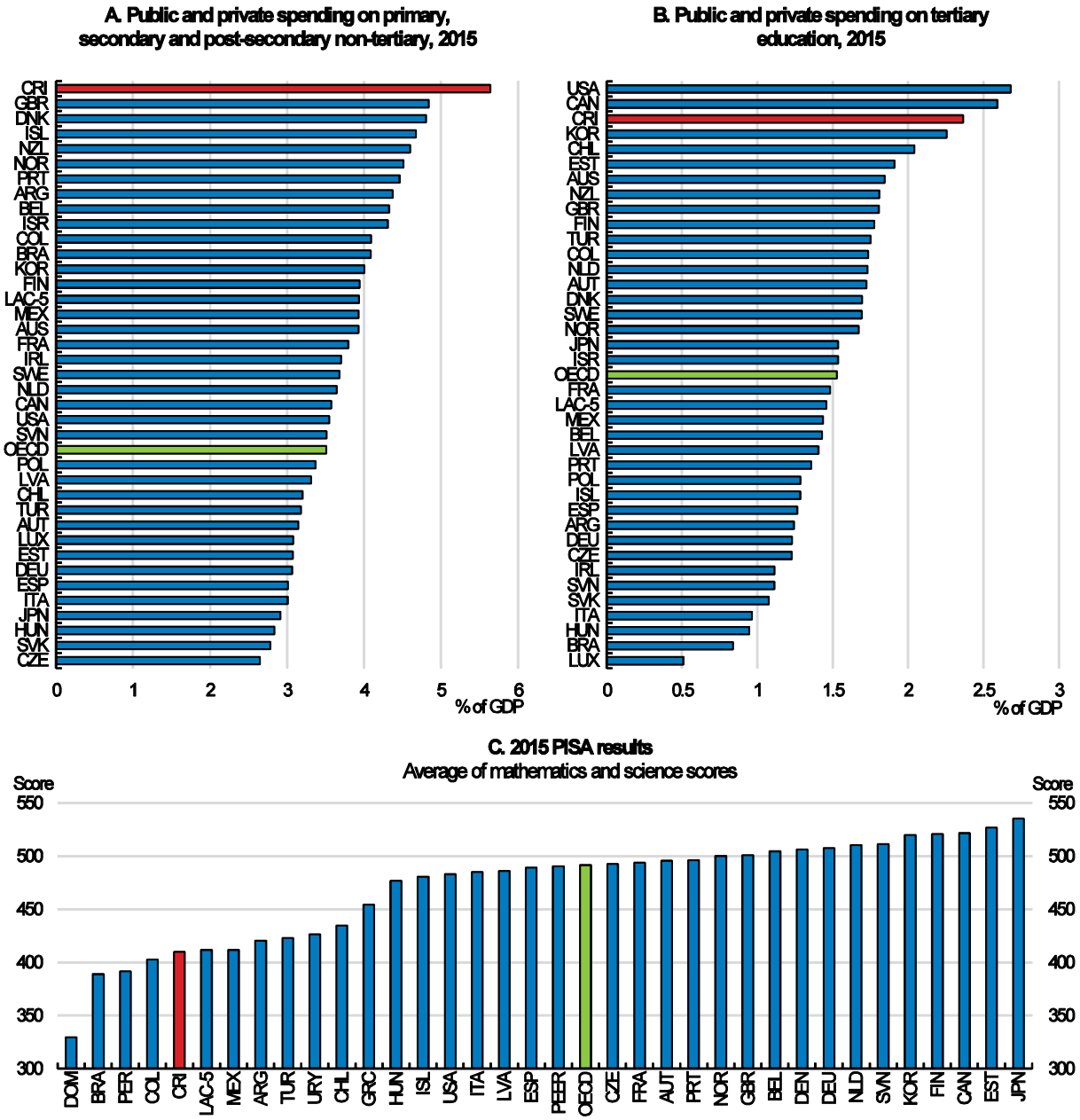
While public spending on education of 8% of GDP is unwarranted in the current fiscal context, access to good quality education not only enhances growth and well-being in the long-run, it also ensures that all citizens are able to fulfil their potential. Also, there seems to be a consensus in society that education is an integral part of Costa Rica's social pact. To ensure that this level of investment indeed generates inclusive growth, the quality and equity of educational outcomes need to be improved. To enhance the effectiveness of spending and education policies' results, Costa Rica needs to refocus on results which necessitates establishing evaluation and monitoring mechanisms to measure performance and outcomes, correcting weaknesses in delivery, and sustaining quality improvements (OECD 2017e).

Costa Rica has already taken steps in these directions with the ongoing implementation of a result-oriented strategy for schools that includes concrete goals in terms of management and academic outcomes. A bill now in parliament focuses on requiring the accreditation of teacher training programmes delivered by private universities while a new curriculum is being implemented which better emphases critical thinking skills. In addition, new rules have been established to reduce the high degree of grade repetition. There are also initial discussions on the need to reform the *Bachillerato* which currently prevents many students from obtaining their upper secondary diploma. Moreover, a dual education pilot project aims to provide students with job-relevant technical training in addition to academic education.

Building on these efforts will require prioritising educational spending in three main areas:

- Expanding early childhood and pre-school education for low income groups and improving its quality is key to increasing educational outcomes. It would also contribute to inequality reduction and support female labour force participation. However, only 63% of children attend two years of pre-school (OECD 2017e). Early childhood care services tend to focus more on health and nutrition than cognitive, linguistic, emotional and social skills that children need to develop in the early years (OECD 2017e). Overall, early and pre-school education services require a stronger focus on learning and should be fully integrated in the education budget and policy.
- Resources need to be reallocated to secondary education, which is a weak link in Costa Rica's education system, especially as the high drop-out rate makes the financing of tertiary studies very regressive. It should particularly ensure that upper secondary education (*Educación Diversificada*) provides opportunities to all, including those who wish to enter the job market, rather than focusing on preparing a small elite for university (OECD 2017e). This requires improving the quality of basic schooling, with a particular focus on the most disadvantaged students and communities. Earlier and more focused, targeted support could also be granted to students with a higher risk of dropping out rather than reliance on grades and repetition, which is a costly and ineffective way to overcome learning difficulties so commonly used in Costa Rica. Although repetition has declined from over 40% in 2009 to 31% in 2015, following education reforms undertaken in the past 10 years, this rate is still well above the OECD average of 10% (OECD, 2017e). Another measure to reduce high secondary school drop-out rates is to proceed with the authorities' plans to develop vocational education and training (see Meehan, 2018).
- More resources need to be devoted to initial and on-the-job training of teachers and the provision of education material. According to PISA results, 38% of students are enrolled in schools where principals identify that a shortage of education materials (e.g. textbooks, IT equipment, library or laboratory materials) are hindering student achievement. This strategy should be complemented with setting higher standards for teachers and schools, backed by more strategic leadership from the central government to set the commitment and the direction of change. All actors in the system need to be accountable for improvement.
- On the other hand, resources can be freed by taking advantage of the smaller cohorts entering primary education where the average number of students per class (14) is already below the OECD average (21, see OECD 2017e). Financing of tertiary education, which is highly regressive, should be reviewed. However, reform progress has stalled in this area.

Figure 11. Educational spending is high but outcomes are low



Note: Educational spending data refer to 2015 or latest available year; Costa Rica data is from 2013. PEER refers to the 10 non-Latin American OECD countries with the lowest GDP per capita: Czech Republic, Estonia, Greece, Hungary, Latvia, Poland, Portugal, Slovak Republic, Slovenia and Turkey. LAC-5 refers to the unweighted average of Argentina, Brazil, Chile, Colombia and Mexico.
Source: OECD Educational finance indicators; and PISA 2015 databases.

Addressing pension sustainability issues

The wide coverage of its multi-pillar pension system is another great achievement of Costa Rica: with two-thirds of Costa Rican workers contributing to, or affiliated with, a pension scheme in 2014 and 75% of people over 65 receiving a pension (OECD, 2017c), it is one of the largest coverages in Latin America and Caribbean countries. Costa Rica's pension system is structured in three tiers. The first tier consists of a social insurance pay-as-you-go (PAYGO) system; the second tier is a mandatory savings scheme with individual accounts and the third tier consists of a voluntary retirement savings. There is also a means-tested old-age safety net which targets the elderly poor.

The main pension scheme facing sustainability issues is the pay-as-you-go state pension with a defined benefits pillar administered by the Costa Rican Social Security Agency (*Caja Costarricense de Seguro*, CCSS). Other sources of vulnerability stem from the pensions of teachers and the judiciary system, which are actuarially imbalanced. Despite a reform in 2005 to progressively increase contributions, and recent progress in reducing early retirement, the system will fall into deficit in the medium term. According to the most recent estimates, this will happen between 2020 and 2030 depending on economic growth, wages and coverage of the system; reserves will be exhausted between 2027 and 2035 (see Arias López et al., 2016). As the CCSS is guaranteed by the government, this represents an implicit government liability.

Even if ongoing reforms to tackle informality can help broaden coverage, the pension system needs to undergo major reforms to ensure medium-term sustainability. While contributions increased by 1% in June 2017, broader proposals to address the sustainability of the pension system are still needed and are currently under discussion, following the findings and recommendations of the actuarial study of the sustainability of the pension system by Arias López et al. (2016). Reform efforts should focus on indexing pension entitlement parameters, such as benefits or the statutory retirement age, to changes in life expectancy, rather than increasing contributions further, as this may increase informality.

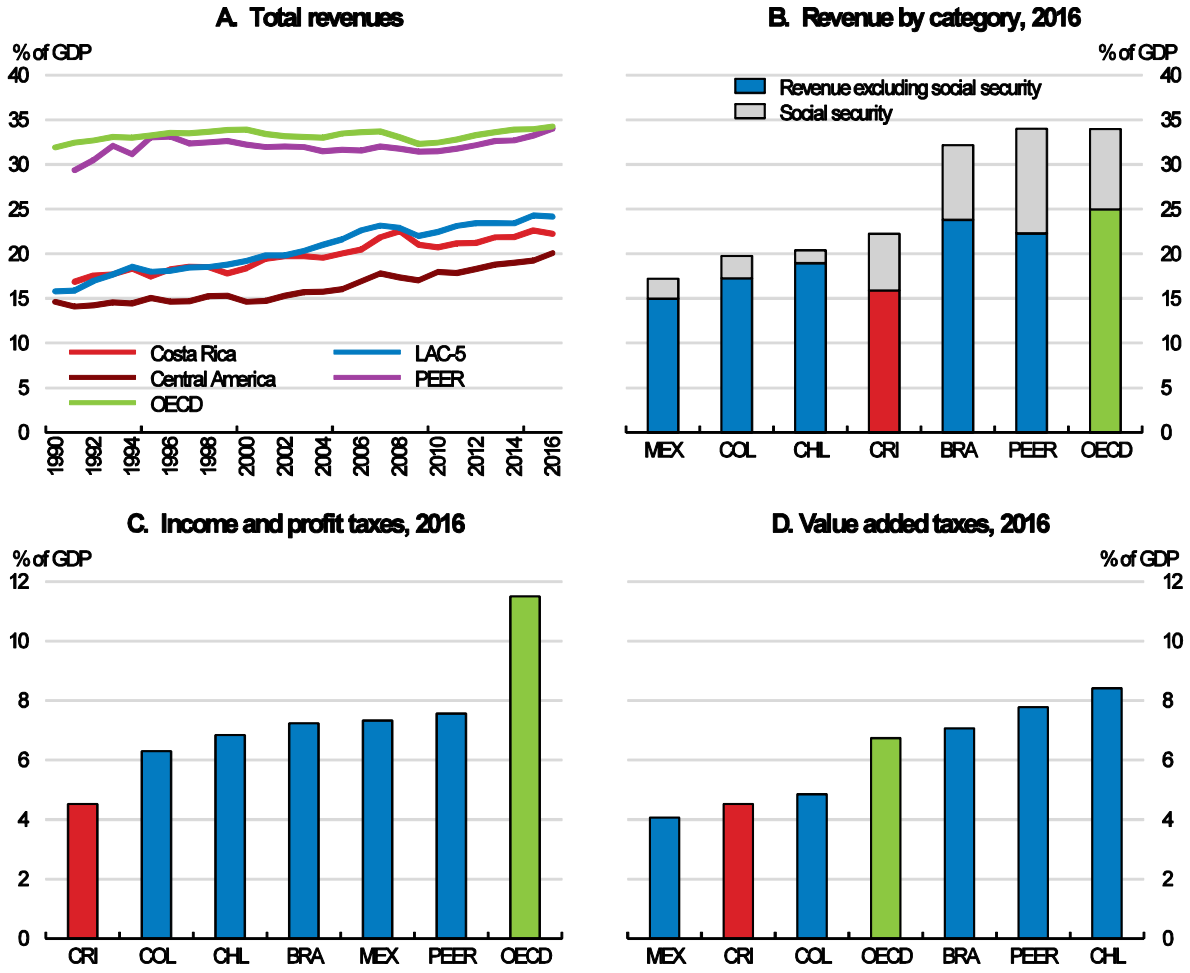
In addition, the management of pension assets needs to be modernised to achieve higher and more stable returns. The majority of the assets are concentrated in Costa Rican sovereign debt, which makes them very sensitive to changes in the country's credit rating and debt sustainability. A downgrade in the credit rating of Costa Rica, for example, would have a severe impact on the system's sustainability, with potential negative feedback effects on Costa Rica's credit rating. To reduce the risks of such a negative feedback loop, it is important that pension funds adopt a more diversified financing strategy.

Raising tax revenues and enhancing the redistributive power of tax policy

At just over 20% of GDP, tax revenues are much lower than most comparable countries (Figure 12). High tax evasion, narrow tax bases and a multiplicity of tax expenditures mean that there is room to increase revenues in a way that supports growth and reduces inequality. Authorities estimate that tax evasion and avoidance represented 8.22% of GDP in 2013. Tax exemptions, which amount to 5% of GDP, continue to be granted, further lowering tax revenue collection (Estado de la Nación, 2017). They reduce the redistributive ability of the tax system and also generate distortions in resource allocation. Given the urgency of balancing the budget, and that spending efficiency reforms will take time to deliver, a key priority for Costa Rica remains to continue increasing public

revenue with further progress in decreasing tax evasion, reducing exemptions and approving a tax reform.

Figure 12. There is room to further increase revenues, especially VAT and income taxes

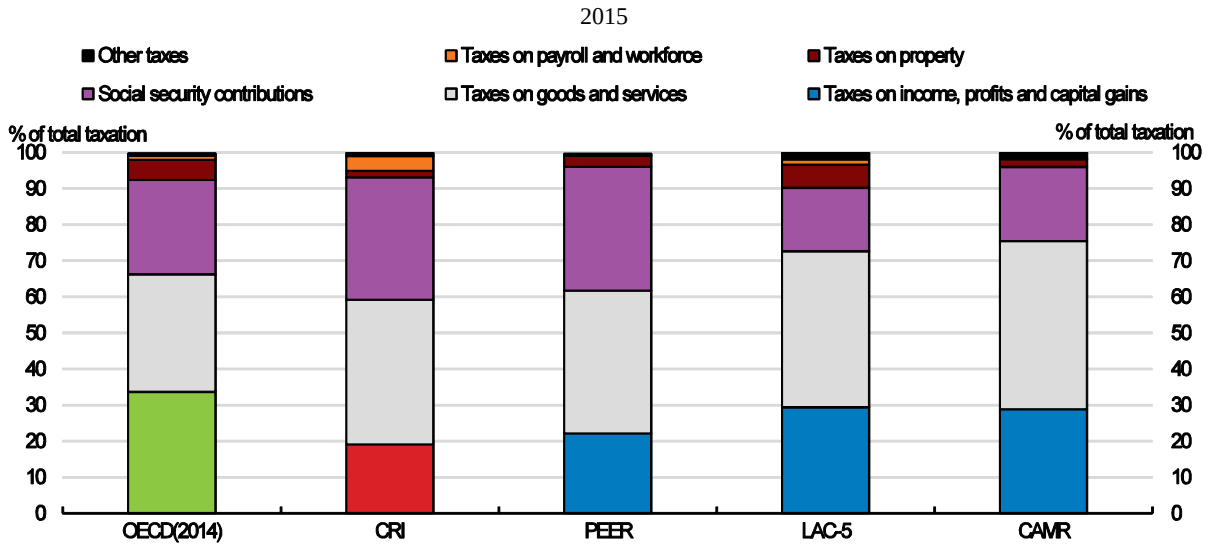


Note: Data are expressed in percent of GDP at market prices for the general government. LAC-5 is an unweighted average of: Argentina, Brazil, Chile, Colombia and Mexico. Central America is an unweighted average of Belize, Guatemala, Honduras, Nicaragua, Panama, El Salvador. PEER is an unweighted average of the 10 non-Latin American OECD countries with the lowest GDP per capita and available information: Czech Republic, Estonia, Greece, Hungary, Latvia, Poland, Portugal, Slovak Republic, Slovenia and Turkey. For Panels B, C and D, OECD is an unweighted average of 2015 data.
Source: OECD Revenue Statistics; OECD/IDB/CIAT Revenue Statistics in Latin America (2018).

Costa Rica's tax mix differs markedly from either the OECD or the LAC regional averages (Figure 13). The tax system overly reliant on social security contributions (SSCs), which account for more than one-third of total revenues, compared with the OECD average of 26% or the LAC-5 average of less than 20%. High SSCs generate labour market distortions and provide incentives for workers, in particular low-income workers, to remain in the informal sector and for employers to hire informal workers, thereby lowering the tax base and generating inequalities. In addition, SSCs are levied at

flat rates but with a minimum base contribution, resulting in a tax wedge which is highly regressive at the bottom of the income distribution (OECD, 2017b; Figure 15).[3]

Figure 13. Costa Rica's tax structure relies heavily on social security contributions



Note: PEER includes the 10 OECD non-Latin American OECD countries with the lowest GDP per capita: Czech Republic, Estonia, Greece, Hungary, Latvia, Poland, Portugal, Slovak Republic, Slovenia and Turkey. LAC-5 is an unweighted average of: Argentina, Brazil, Chile, Colombia and Mexico. CAMR is an unweighted average of Guatemala, Honduras, Nicaragua, Panama, El Salvador. OECD is an unweighted average of 2014 data.
Source: OECD, Revenue Statistics - Latin American Countries and OECD members.

Furthermore, limited revenue is raised from personal income tax (PIT), which also does not contribute to reducing high inequality. Taxes on income, profits and capital gains account for less than 20% of total taxes, contrasting with over a third among OECD countries. Additional revenue collection could also come from taxes on property, which account for around 6% of total revenues in the OECD and LAC-5 countries but less than 2% in Costa Rica.

Further improving tax collection

Not only are tax evasion and avoidance denting tax revenues by close to a third, but they undermine the integrity and fairness of the tax system and ultimately negatively affect tax morale. Tax evasion and avoidance take multiple forms and affect all types of tax revenues in Costa Rica. It especially impacts on the sales tax: according to the OECD (2017b), sales tax revenue losses from non-compliance are estimated at about 30%, and income tax avoidance by liberal professions is especially high with 55% of the physical and legal persons having profitable professional service activities declaring zero income tax (OECD, 2017b). This form of evasion reduces the overall progressivity of the tax

[3] For workers earning below CRC 228 530 a month (about 50% of the average wage in 2016), SSCs are calculated on the basis of a CRC 228 530 income threshold, regardless of actual earnings (OECD, 2017b).

system as these professionals tend to earn high incomes. Brockmeyer and Marco (2016) have estimated that in 2014 a quarter of corporations and almost a fifth of self-employed professionals did not fill out their income taxes, while respectively 14.4% and a fifth did not file sales taxes.

Tax administration and collection reforms are critical. The authorities have already taken important steps, especially with use of new technologies in tax collection. In particular, the "Modelo predictivo" introduced in 2016 uses electronic fiscal data to identify inconsistencies and uncommon taxpayer behaviours and hence possible non-compliance and fiscal fraud, such as the use of false providers with the aim of obtaining a fiscal benefit, under-declaration of total net income by professionals and as well as under-invoicing. The first results of this new detection system will be evaluated by the end of 2017. Other new technological tools to cross-check tax declaration and fight tax evasion include an online system of Virtual Tax Administration to promote online declarations; the TICA system devoted to online import customs procedures; DENUNCIEYA that facilitates denunciation from the web page or from mobile devices; COLMENA that uses data mining to detect tax evaders; the Tax Geographic Information System (SIGT) that helps to locate properties liable for the Solidarity Tax; and the AMPO System aimed at strengthening control of large taxpayers. The progressive roll out of electronic invoicing, which started with the largest taxpayers in 2017, is also a major step.

Other proposals currently under discussion as part of the fiscal reform include tax refunds of up to 1% of VAT to companies using electronic invoices, tighter filing and disclosure requirements for companies and measures to fight corruption in the tax.

- These efforts go in the right direction and have already resulted in higher tax collection in 2016 and 2017. But further reforms could strengthen tax administration and collection capacities as pointed out in OECD (2017b), including:
- Requiring inactive companies, often used as vehicles to hide assets both for tax (and non-tax) purposes, to register before the tax administration, file income tax returns and comply with the general tax system.
- Integrating the tax and social security contribution administrations so that firms cannot understate their labour costs to the social security system and overstate them to the tax administration.
- Further modernising the tax administration through computerisation, risk-based compliance assessments, and by increasing the number and the training of staff employed in the tax administration.
- Strengthening tax auditing capacities.
- Establishing rules requiring all professionals to maintain accounting records and issue receipts, adopting a stricter definition of deductible expenses and focusing audits on riskier professions.

In addition, measures to make the tax system fairer such as the simplification and reduction of tax exemptions (see below) could also help improve tax compliance.

Moving ahead with the tax reform

To raise additional revenue, the Executive had drafted a bill which would introduce two new top brackets to PIT, with rates of 20% and 25%, at 5 and 10 times the average

income, thereby also raising its progressivity. The Executive has also submitted a VAT reform, intending to increase the tax rate from 13% to 15% and enlarge the tax base by extending VAT collection to all services sectors. These VAT and PIT reforms were in line with previous OECD recommendations to broaden the tax base, increase progressivity and simplify the tax system. Moreover, not only is the introduction of a fully-fledged VAT system welcome, but the proposed VAT refund system is well designed to avoid negative impacts on poorer households and is consistent with the view that zero or reduce VAT rates are not the best way to address poverty issues. IMF estimates based on household survey data suggest that overall the tax reform package could have increased the progressivity of the tax system and contributed to reducing income inequality (IMF 2017b). It would have allowed for significant increases in revenue collection: authorities estimate that the VAT and PIT reforms would have brought additional revenues worth 1.24% of GDP and 0.79% of GDP, respectively. Political gridlock in Congress led the Executive to withdraw these planned reforms.

As part of the comprehensive fiscal sustainability package (*Ley de Fortalecimiento de las Finanzas Públicas*), the current tax reform proposal has been modified from the original proposal, but still contemplates transforming the current sales tax into a fully-fledged VAT tax, extended to services, thereby increasing tax neutrality; it also increases the taxation of capital gains to 15%. These reforms will allow for an increase in tax revenue collection of 1.4% of GDP (Table 3) instead of the originally planned 2.03% of GDP.

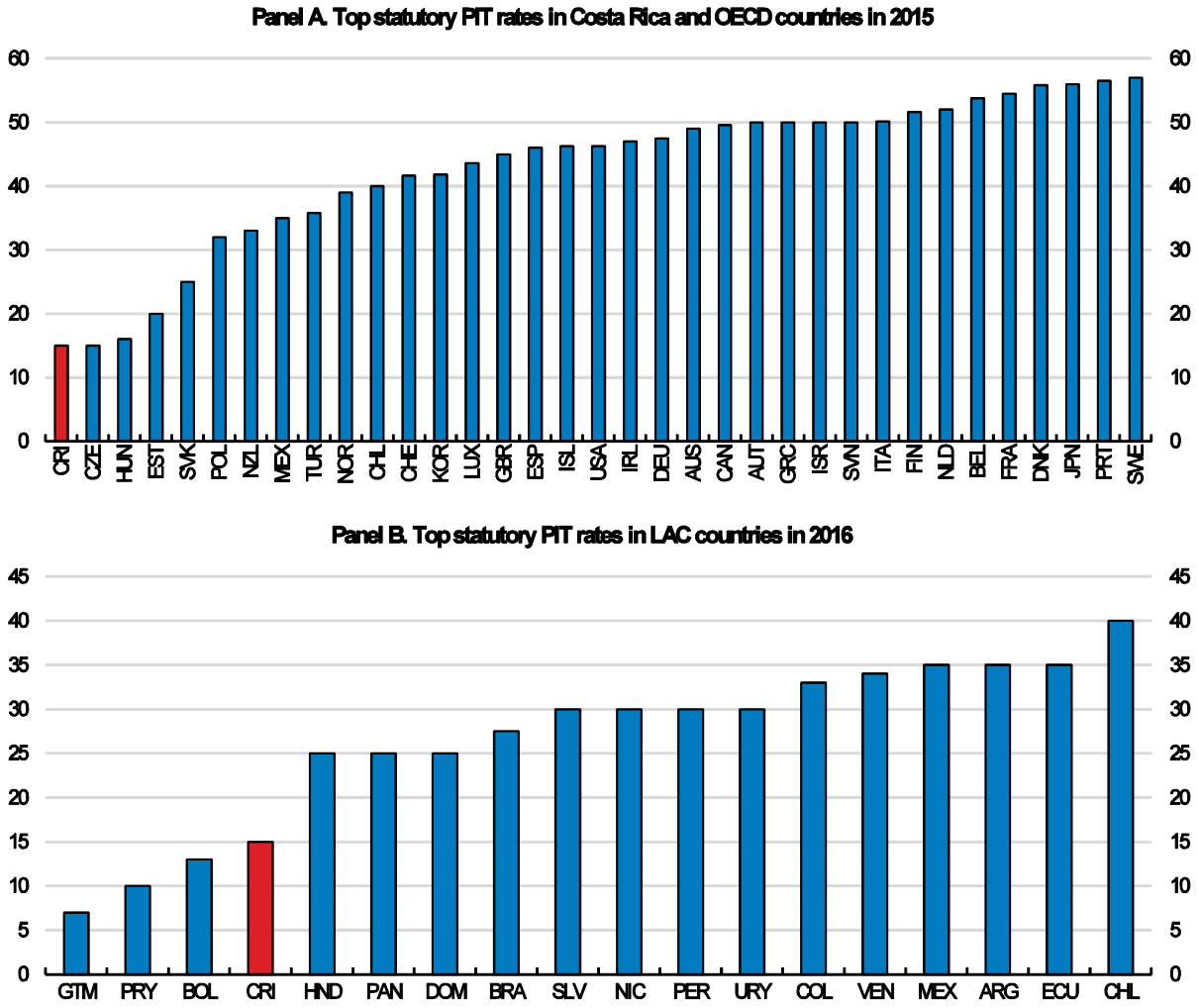
Current plans are only a first step and still fall short of the need for a broader and more comprehensive approach that would improve the contribution of the tax system to inclusive growth while increasing revenues. Tax expenditures remain too numerous and the different taxes faced by different types of income are a source of unfairness. The proposed reforms leave many of them untouched. In particular:

- The VAT reform still leaves many exemptions. Exempt goods include the 250 goods in the basic consumption basket (*canasta básica*); essential goods for education; medicines, agricultural inputs; a number of cultural goods; kerosene; and the monthly consumption of electric energy when it does not exceed 250 kW/h (OECD, 2017b).
- The multiplicity of reduced rates for SMEs goes against findings by the OECD that they tend to limit SME growth, while eliminating or reducing them could free resources for cuts in the statutory corporate tax rates (OECD, 2017b).
- In PIT, the reforms do not reduce the high income threshold at which single taxpayers start paying income tax. Costa Rican employees only start paying PIT on earnings exceeding more than 150% of the average wage. This tax-free threshold is high when compared to current practice among OECD and Latin American countries alike. Overall only 14% of Costa Rican wage earners pay any income tax. Moreover, personal income tax rates are low (Figure 14). The 2017 PIT rate schedule consists of only three brackets. The tax rates on employment income range from 0% up to a monthly income of CRC 793 000 (EUR 1320), 10% and 15% on monthly employment income exceeding CRC 1 190 000 (EUR 1980).

A more ambitious reform that reduces tax expenditures would make the tax system fairer and less complex and would also contribute to reducing tax avoidance. Moreover, it would create some room to reduce the tax rates going forward and help rebalance the tax away from social security contributions. Social security contributions represent a much

higher share of fiscal revenues than in Latin American countries or OECD countries. However, these taxes are regressive; they increase labour costs and harm employment, especially for the low skilled, and feed informality (Figure 15). Moreover, the strong reliance on social security contributions, that are by definition employment-linked, to finance the health system and poverty reduction programmes is unsustainable in the long term. Following the increase in informality and the ageing of the population, already, only 53% of the population are formal contributors to the CCSS, compared to 70% ten years ago.

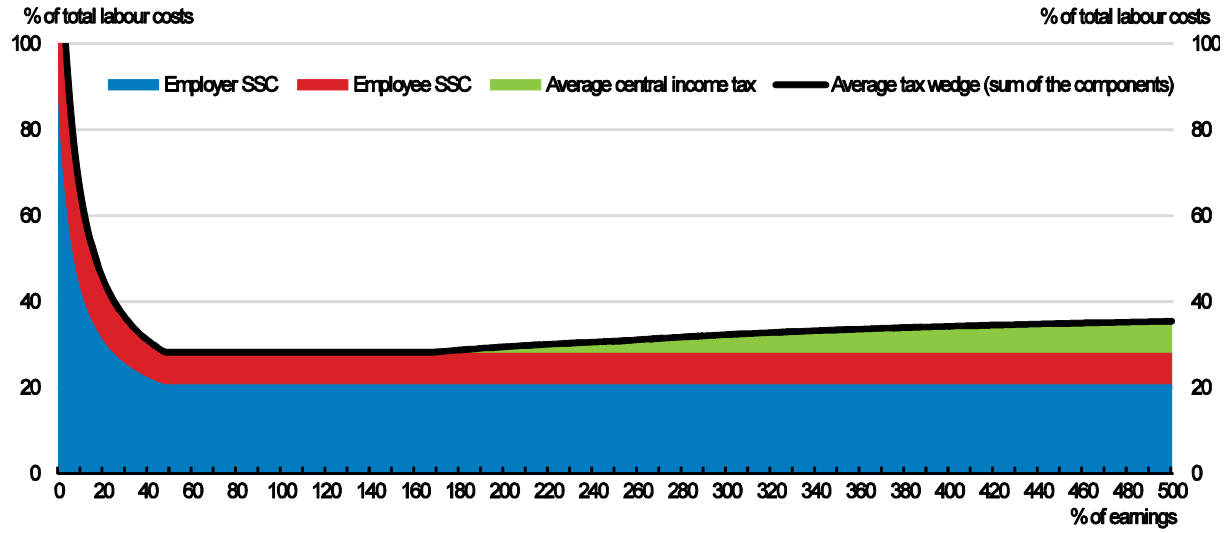
Figure 14. There is space to raise additional revenues from PIT



Source: OECD, Tax Policy Reviews: Costa Rica 2017.

Figure 15. Low-income workers face a large tax wedge

Average tax wedge across earnings levels expressed as a % of the average wage in 2016



Source: OECD, Tax Policy Reviews: Costa Rica 2017.

Modernising the fiscal framework

To support consolidation efforts and ensure medium-term fiscal sustainability, Costa Rica should consider modernising its fiscal framework by upgrading its fiscal rule, as currently planned, and introducing a fully-fledged multi-year expenditure framework and a fiscal council. In particular, there is evidence that fiscal consolidation is more likely to succeed and lead to medium-term debt sustainability when the country has a well-designed fiscal rule (Guichard et al. 2007; Molnár, 2012). However, the positive role of fiscal rules in supporting fiscal sustainability found by empirical literature may also reflect that more disciplined countries are more likely to adopt fiscal rules. Fiscal rules should not be seen as the magic solution to solve fiscal sustainability issues and do not lead to long-term improvement if they are not associated with strong political commitment. There are nonetheless a few tools that can help compliance with the rules, such as expenditure frameworks and fiscal councils (Fall et al., 2015).

In addition, the "Medium-term fiscal and budgetary framework" (*Marco Fiscal Presupuestario de Mediano Plazo*) published every year by the Ministry of Finance detailing baseline expenditure forecast and underlying assumptions, falls short of being an effective operative medium-term expenditure framework (MTEF), as defined under the OECD Recommendation of the Council on Budgetary Governance, Principle 2 (OECD, 2015a). Indeed, in the absence of a clear fiscal target, this document does not set boundaries for the main categories of expenditures.

Upgrading the new fiscal rule

The new fiscal reform package foresees the introduction of an expenditure fiscal rule to complement the existing budget-balanced rule embedded in the Constitution and the 2001

Ley de Administración Financiera de la República y de Presupuestos Públicos. The existing rule works as a golden rule since it states that borrowing can be used only to finance investment spending (Lledó et al., 2017).[4] However, it has not been complied with in recent years. The introduction of a fiscal expenditure rule would be a welcome step, and a clear signal of the authorities renewed political commitment to fiscal sustainability. The resulting combination of a budget balanced rule and an expenditure rule is particularly appropriate in Costa Rica where public spending has kept increasing since the global financial crisis and would be in line with recent trends in other countries.

The proposed expenditure rule constrains current spending by central government when the debt-to-GDP ratio is too high and lets them grow at the same rate as nominal GDP when the debt level is considered as sustainable. More precisely:

- When the debt at the end of the previous fiscal year is under 30% of GDP or the current expenditure-to-GDP ratio is below 17%, the annual growth of current expenditure should not exceed the average nominal GDP growth in the past four years.
- When the debt at the end of previous fiscal year is between 30% and 45% of GDP, the annual growth of current expenditure should not exceed 85% of the average nominal GDP growth in the past four years.
- When the debt at the end of previous fiscal year is between 45% and 60% of GDP, the annual growth of current expenditure should not exceed 75% of the average nominal GDP growth in the past four years.
- When the debt at the end of previous fiscal year is above 60% of GDP, the annual growth of total expenditure should not exceed 65% of the average nominal GDP growth in the past four years.
- The rule is to be implemented gradually in order to avoid drastic cuts. It only affects current spending, hence sparing public investment from consolidation efforts, unless debt is over 60% of GDP.

The new rule addresses some of the factors that have hindered compliance with the existing rule following the recession associated with the global financial crisis: the lack of flexibility and well-specified escape clauses. According to the envisaged escape clause, in exceptional circumstances such as an economic recession or a national emergency that requires an increase of current expenditure of 0.3% of GDP or more, the rule can be suspended temporarily. This is very important given the high likelihood of natural disasters in Costa Rica. When real GDP growth exceeds 6% for two consecutive years, current expenditure growth could be capped by the Ministry of Finance. In addition, regular evaluation of tax exemption and sunset clauses would be introduced, in line with past OECD recommendations.

Some other features of the foreseen rule are more questionable. First, the rule foresees that all new proposed bills will have to be assessed against fiscal sustainability objectives. This is welcome but, unless the excessive reliance of earmarking is addressed, there is a risk that this feature of the rule could lead to new earmarking and rigidities, especially considering the draft bill submitted to Congress in August 2017 that stipulates that all

4 Articles 176 and 179 of the Political Constitution of Costa Rica state that public finances should be balanced and sustainable. The Golden Rule is reflected in Article 6 of the FML Financial Management and Public Budget Law.

new public spending projects should have to designate the respective financing source. More importantly, recognising the difficulty of establishing a single unit responsible for compliance with the fiscal rule given the high fragmentation of the budget, the new law envisages shared responsibility for compliance with the rule between the Ministry of Finance and the Comptroller General of the Republic. This is clearly a complex process and a second best to first fixing the fragmentation and increasing the share of total public expenditure under the oversight of the Ministry of Finance.

Overall, it is still difficult to see how compliance with the fiscal rule can be ensured in a way that is in line with Costa Rica's strategic priorities, if the importance of earmarking and mandated spending and the weak control of the Ministry of Finance on the budget process are not addressed together with the establishment of the rule. While the establishment of the new rule foresees some strengthening of enforcement mechanisms, it still lacks a clear commitment and strategy to replace these unwarranted features by more modern and efficient budget management and expenditure control frameworks.

Over time, Costa Rican authorities could also consider establishing a rainy day fund as the probability of tail events is high. Rainy day funds can also help prevent pro-cyclical policies in good times, by ensuring unexpected surpluses are saved, hence supporting compliance to rules. Rainy day funds could instead be used later to finance unexpected deficits resulting from unforeseen events, or even short-term stabilisation policies. Costa Rica already has a disaster fund, the National Emergency Fund, partially financed with surpluses to deal with unforeseen events such as natural disasters and wars (IMF, 2013). The fund is made up of 3% of the earnings of public corporations and the budgetary surplus of revenues not allocated to specific expenditures. But as stressed in IMF (2013), this fund does not cover other contingencies like those arising from macroeconomic effects on budgetary revenues or events of a legal nature such as judgments against the State. Moreover, in practice the funding has been very volatile, almost all of the funds have been used each year and they have not sufficed to respond to the needs associated with disasters.

Strengthening the budgetary process

Adopting multi-year expenditure agreement

Multi-year expenditure frameworks (MTEFs) have proven to be an effective tool to control public expenditure over the medium term and ensure support to government strategic priorities. It would be an essential complementary tool to an expenditure rule. Moreover, it would support consolidation efforts in the short term. Indeed, successful fiscal consolidations in the 1990s in the Netherlands, with the 1994 Coalition agreement on multi-year targets, and Sweden, which introduced three-year nominal ceilings for total outlays in 1996, relied on such frameworks (Blöndal and Kristensen, 2002; Bosworth, 2010). An interesting feature in the case of Sweden is the requirement to offset cost overruns by reductions in the same programme area, or cost savings in the following two years.

Today almost all OECD Members have established an MTEF. In most cases, it is approved in the Cabinet (52% countries) or in the legislature (34% countries) (see OECD, 2014a). An MTEF can be enshrined in law or established in a policy or strategy decided by the government through other arrangements. Costa Rica should build on its medium-term framework to establish a full-fledged MTEF. To be effective, it should have the

following characteristics (Recommendation of the Council on Budgetary Governance, Principle 2, OECD 2015a):

- Have real force in setting boundaries for the main categories of expenditure, for each year of the medium-term horizon.
- Be fully aligned with the top-down budgetary constraints agreed by government.
- Be grounded upon realistic forecasts for baseline expenditure (i.e. using existing policies), including a clear outline of the key assumptions used.
- Show the correspondence with expenditure objectives and deliverables from national strategic plans.
- Include sufficient institutional incentives and flexibility to ensure that expenditure boundaries are respected.

Accounting for contingent liabilities

Contingent liability realisations are a major source of fiscal distress. International experience reveals that a lack of transparency in disclosing and preparing for the materialisation of contingent liabilities has led to large increases in public debt, triggering fiscal crises (IMF, 2012). Therefore, determining a country's fiscal position needs to include an assessment of these sources of fiscal risk. In Costa Rica, they mainly stem from the unlimited state guarantee of deposits in state-owned banks (including deposits denominated in foreign currency) and increased exposure of state-owned enterprises and institutions to sovereign debt. In particular, the exposure of CCSS (which administers the contributory pension fund) and state-owned insurance company (where insurances also benefit from a state guarantee) hold large amounts of public debt in their portfolio. As part of the process of strengthening Costa Rica's budgetary process framework, authorities should identify all sources of exposure to fiscal risks and assess their potential future implications.

An independent fiscal institution could help to achieve compliance with the fiscal rules

Independent fiscal institutions (IFIs) are considered among the most important recent innovations in public financial management (Von Trapp, Lienert and Wehner, 2016) and are increasingly seen as a necessary complement to fiscal rules in promoting sound fiscal policy and sustainable public finances. In particular their role is to ensure that fiscal targets are realistic, monitor the fiscal situation and assess whether the fiscal rules are met. By making their analysis public, they also increase the reputation costs of breaching rules (Lledó et al., 2017; Von Trapp et al., 2016). Beetsma and Debrun (2016) have notably shown that the IFIs improve the public's understanding of the quality of fiscal policy, that this contributes to a better alignment of voters and policymakers' incentives and helps reduce the deficit bias. They can also guide the government on when it is sensible to depart from these rules (see Calmfors and Wren-Lewis, 2011).

The creation of a fiscal council in Costa Rica would be a useful complement to the new fiscal rule, especially given the limited compliance with the existing rule. It would confirm the commitment of the authorities to sound fiscal policy. The IFI would also act as a watchdog to alert the public if the government was attempting to misuse the escape clauses or was relying on erroneous forecasts. Beside this role, the fiscal council could have a coordinating role in the fiscal consolidation strategy and lead the reforms to

improve the budget framework. Once fiscal sustainability is restored, it would also play a key role in assessing fiscal risks.

There are many different types of IFIs and each IFI needs to reflect the specific institutional settings and situation of individual countries. However, effective IFIs all share a few key features: independence, non-partisanship, transparency and accountability. Learning from past and current IFIs, the OECD has defined 22 Principles for Independent Fiscal Institutions in order to guide countries in improving existing IFIs performance, and support countries that are considering the creation of an IFI (OECD, 2014b). These principles should guide the design of a future Costa Rican council to ensure its relevance and survival of the political cycle.

Improving debt management

Debt management has a key role to play in containing the cost of debt servicing as well as in reducing risks in the current situation of high and rising public debt. The government relies heavily on local capital markets to meets its financing needs: three-quarters of Costa Rica debt is domestically issued debt. Rising budget deficits and a small capital market have put upward pressure on interest rates over the past two years.

However, there are several issues associated with the debt management framework in Costa Rica. As in many other areas of public administration, debt management is characterised by segmentation and a lack of medium-term strategy. Both the Ministry of Finance and the Central Bank of Costa Rica issue and manage debt, with the first one responsible for maturities over three years (about 85% of total debt), and the Central Bank for maturities under three years. However, in recent years both organisations have issued debt outside their remit (Mendis, 2016). Moreover, following Law 8131, within the Ministry of Finance, two departments are involved in debt management: the National Treasury is responsible for local debt while the Public Credit Department is responsible for external debt. This structure creates overlaps and inefficiencies, as the existing coordination and communication between these entities does not suffice to ensure clarity about the sharing of responsibility for overall debt management and a unified medium-term debt and fiscal framework.

According to best practices as defined by the IMF (IMF, 2014b; Awadzi, 2015) the centralisation of all debt functions in one single unit or agency reduces fragmentation and promotes effective risk management of the overall debt portfolio. There has been an international trend towards such a consolidation of debt management under a single agency, the so-called Debt Management Offices (DMO). The benefits of DMOs range from minimising explicit and implicit fiscal and borrowing costs; increasing financial intermediation and efficiency through the elimination of duplicating and competing organisations; improving transparency and communication with markets and deepening capital markets (see Blommestein and Hubig, 2012). In many OECD countries, DMOs have not only helped reduce funding costs and kept markets accessible during crises, but also they have helped balance funding needs with the public's risk preferences through Asset and Liability Approaches (ALM) to debt management and the integration of contingent liabilities into medium-term fiscal planning (Mendis 2016).

However, the creation of an independent DMO requires a sophisticated institutional set-up with highly experienced managers. Current institutional and capacity constraints would limit the effectiveness of a DMO in Costa Rica. Hence, in the short term, the current structure of two agencies could be maintained, with responsibilities for day-to-day debt management of all securities (issuance, servicing, accounting, monitoring)

concentrated in the National Treasury, while the Public Credit Department could focus on analysis, forecasting and communication with investors. IMF best practices recognise indeed that where consolidation of debt management functions is not feasible, the legal framework should help to promote coordination among the various departments or entities with day-to-day responsibly for debt management operations. In spite of recent improvements, especially after the introduction of a bidding council where the Public Credit Unit and the National Treasury actively participate, this coordination mechanism has not ensured the adoption of best practices in terms of debt management such as achieving a reduction in the large volume of issuances not sufficiently spaced out in time, achieving a modern communication strategy with investors and rating agencies

Another issue is the reliance on direct sales of debt to local non-financial public entities which has contributed to higher borrowing costs, a lack of transparency, uneven playing field vis-à-vis private sector investors and little liquidity and trading activity in the secondary market (Estado de la Nación 2016). While this has the advantage of providing a stable investor base, it tends to increase the costs of debt. Moreover, as public financing needs continue to grow they will exceed the absorption capacity of these entities and bring new challenges. Moving away from this practice would require the development of local debt markets, including through a reduction in the number of benchmark securities to allow for a properly benchmarked and liquid government yield curve, and better communication with markets. Unfortunately, reforms in these areas have stalled.

Box 3. Fiscal policy recommendations

Restore fiscal sustainability:

- Implement immediate measures to reduce the budget deficit by 3 percentage points of GDP during 2018-20 to stabilise the debt-to-GDP ratio, through a comprehensive package of measures to raise revenue, curb spending, and strengthen the fiscal rule. In the medium term take actions to reduce the debt-to-GDP ratio to prudent levels while building fiscal space to address contingencies.
- Reduce budget rigidities stemming from mandated spending and earmarking of government revenues.
- Reduce public sector fragmentation. Approve the draft law to close non-functional institutions and the draft decree to close non-functional commissions.

Improve the efficiency and quality of public spending to better support growth and equity:

- Streamline public sector employment to better control payroll costs.
- Assess recent initiatives to integrate fragmented social programmes on their ability to avoid programme duplication and improve targeting.
- Continue to develop technical capacity to monitor and evaluate results of targeted programmes with a view to rationalise spending.
- Reduce rigidity and earmarking of budget allocation into social programmes.
- Ensure sustainability of the pension system by indexing pension entitlement parameters. Maintain recent efforts to tame benefits associated with special pension regimes. Once fiscal sustainability is ensured, extend coverage of non-contributory pension using means-testing approaches.
- Improve monitoring of quality and outcomes of healthcare services, by collecting performance indicators in a standardised way. Audit compliance with established standards of health care provision.
- Improve cost-containment mechanisms by establishing expenditure ceilings, introducing early warning systems to alert the central government to the risk of overspending to allow for corrective measures to be adopted. Accelerate ongoing efforts to adopt the OECD's System of Health Accounts to help manage spending growth.
- Reallocate spending towards earlier phases of education and secondary education, in particular, to schools with high drop-out rates.

Raise tax revenue and enhance the redistributive power of tax policy:

- Approve the Ley de Fortalecimiento de las Finanzas Públicas, which converts the current sales tax into a modern VAT with a broadened tax

base that includes services and taxes capital income.

- Once the debt ratio is stabilised, gradually shift the tax mix away from SSCs towards greater reliance on VAT, income tax and environmental-related taxes. Consider raising additional revenue by lifting the standard VAT rate form 13% to 15%, complemented with target measures to compensate the poor for its regressive impact. Broaden the PIT base by lowering the PIT threshold under which no PIT has to be paid and raise the top PIT rates.

Measures to improve the fiscal framework:

- Create a fiscal council and introduce a multi-year expenditure framework.
- Modernise debt management by reducing the number of benchmark securities and improving communication with the markets.
- Assess contingent liabilities.
- Consolidate debt management into one single unit to reduce fragmentation, and promote effective risk management.

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