OECD Economic Surveys
COSTA RICA

APRIL 2018

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OECD Economic Surveys: Costa Rica 2018

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Please cite this publication as:
OECD (2018), *OECD Economic Surveys: Costa Rica 2018*, OECD Publishing, Paris.
http://dx.doi.org/10.1787/eco_surveys-cri-2018-en

ISBN 978-92-64-08522-0 (print)
ISBN 978-92-64-08540-4 (PDF)
ISBN 978-92-64-29803-3 (HTML)
ISBN 978-92-64-08542-8 (epub)

Series: OECD Economic Surveys
ISSN 0376-6438 (print)
ISSN 1609-7513 (online)

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This Survey was prepared in the Economics Department by Sónia Araújo and Lisa Meehan under the supervision of Patrick Lenain. Damien Azzopardi, Pedro Herrera Gimenez, Alex Linares and Adrien Moutel provided statistical assistance and editorial assistance was provided by Stephanie Henry. The Survey also benefited from contributions by Eva Beuselinck, Bert Brys, Daniel Blume, Sara Calligaris, Thomas Dannequin, Manuela Fitzpatrick, Stephanie Guichard, Gernot Hutschenreiter, Andrea Marin Odio, Iota Nassr, Dirk Pilat and Anna Pons.

The Survey was discussed at a meeting of the Economic and Development Review Committee on 1 March 2018 and is published under the responsibility of the Secretary General of the OECD.

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Basic statistics of Costa Rica

(Data refer to 2016 or latest available. Numbers in parentheses refer to the OECD average)*

LAND, PEOPLE AND ELECTORAL CYCLE

Population (million)	4.86		Population density per km^2	95.1	(37.5)
Under 15 (%)	21.9	(18.0)	Life expectancy (years)	79.6	(80.7)
Over 65 (%)	9.2	(16.5)	Men	77.2	(78.1)
Foreign-born (%)	8.4		Women	82.1	(83.3)
Latest 5-year average growth (%)	1.1	(0.7)	Latest general election	February 2018	

ECONOMY

Gross domestic product (GDP)			Value added shares (%)		
In current prices (billion USD)	57.1		Primary sector	5.4	(2.4)
In current prices (billion CRC)	31 044.1		Industry including construction	21.2	(26.7)
Latest 5-year average real growth (%)	3.7	(1.9)	Services	73.4	(70.9)
Per capita (000 USD PPP)	16.4	(42.1)			

GENERAL GOVERNMENT

Per cent of GDP

Expenditure	29.0	(41.2)	Gross financial debt	45.7	(108.1)
Revenue	24.7	(38.3)	Net financial debt	NA	(69.8)

EXTERNAL ACCOUNTS

Exchange rate CRC per USD	544.0		Main exports (% of total merchandise exports)	
PPP exchange rate (USA = 1)	387.7		Food, animals + beverages, tobacco	42.9
In per cent of GDP			Miscellaneous manufactured articles	28.7
Exports of goods and services	32.8	(28.1)	Goods classified chiefly by material	9.5
Imports of goods and services	31.9	(27.7)	Main imports (% of total merchandise imports)	
Current account balance	-2.61	(0.20)	Machinery and transport equipment	30.0
Net international investment position	-49.6		Chemicals	17.7
			Goods classified chiefly by material	16.8

LABOUR MARKET, SKILLS AND INNOVATION

Employment rate for 15-64 year-olds (%)	58.7	(67.0)	Unemployment rate, Labour Force Survey (age 15 and over) (%)	9.7	(6.5)
Men	72.8	(74.8)	Youth (age 15-24, %)	23.1	(12.9)
Women	44.3	(59.4)	Long-term unemployed (1 year and over, %)	1.6	(2.0)
Participation rate for 15-64 year-olds (%)	65.0	(71.7)	Tertiary educational attainment 25-64 year-olds (%)	23.0	(35.7)
Average hours worked per year	2 212	(1 763)	Gross domestic expenditure on R&D (% of GDP)	0.6	(2.4)

ENVIRONMENT

Total primary energy supply per capita (toe)	1.0	(4.1)	CO_2 emissions from fuel combustion per capita (tonnes)	1.4	(9.2)
Renewables (%)	52.7	(9.6)	Water abstractions per capita (m^3)	348	(812)
Fine particulate matter concentration ($PM_{2.5}$, µg/m^3)	20.1	(15.2)	Municipal waste per capita (kilogrammes)	390	(520)

SOCIETY

Income inequality (Gini coefficient)	0.48	(0.32)	Education outcomes (PISA score, 2015)		
Relative poverty rate (%)	20.9	(11.6)	Reading	427	(493)
Median disposable household income (000 USD PPP)	9.3	(23.0)	Mathematics	420	(490)
Public and private spending (% of GDP)			Science	400	(493)
Health care, current expenditure	9.1	(9.1)	Share of women in parliament (%)	33.3	(28.7)
Pensions	5.8	(9.1)	Net official development assistance (% of GNI)	0.20	(0.39)
Education (primary, secondary, post sec. non tertiary)	5.6	(3.7)			

Better life index: *www.oecdbetterlifeindex.org*

* Where the OECD aggregate is not provided in the source database, a simple OECD average of latest available data is calculated where data exist for at least 29 member countries.

Source: Calculations based on data extracted from the databases of the following organisations: OECD, International Energy Agency, World Bank, International Monetary Fund, Inter-Parliamentary Union, UN Comtrade, INEC, Costa Rican Ministry of Finance and the Central Bank of Costa Rica.

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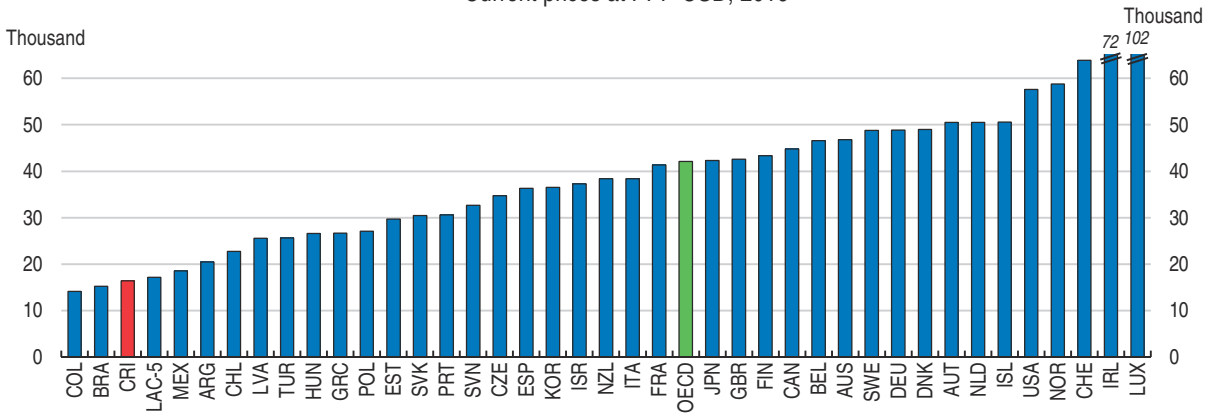
Costa Rica at a glance

- *General economic and demographic indicators*
- *Inequality and poverty indicators*
- *Labour market inclusion indicators*
- *Education indicators*
- *Health indicators*
- *OECD regulatory indicators*
- *World Bank Doing Business indicators*

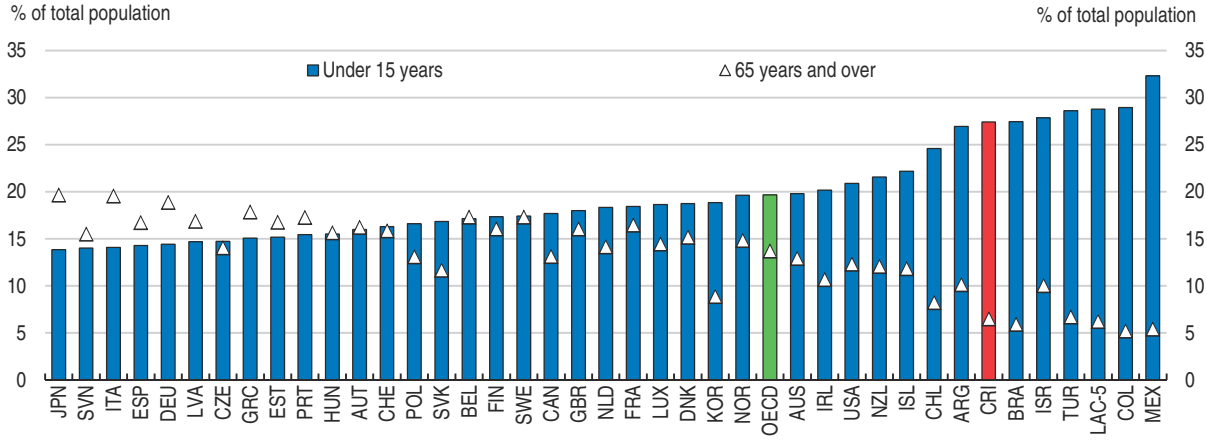
General economic and demographic indicators

A. GDP per capita

Current prices at PPP USD, 2016



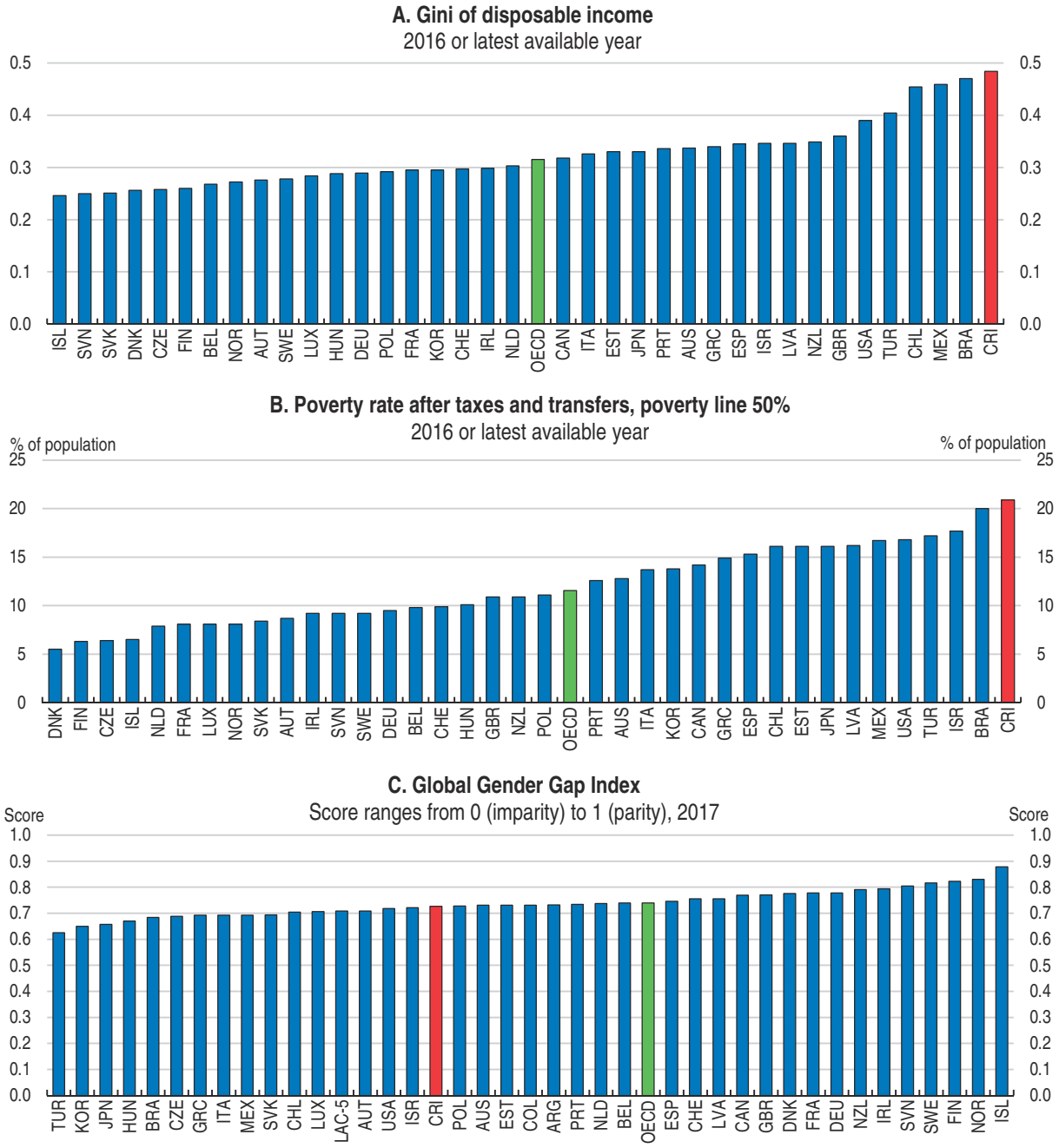
B. Population by age group



Note: LAC-5 is a weighted average of Argentina, Brazil, Chile, Colombia and Mexico.
Source: *OECD Analytical Database*; World Bank Development Indicators.

StatLink http://dx.doi.org/10.1787/888933701281

Inequality and poverty indicators



Note: LAC-5 is a simple average of Argentina, Brazil, Chile, Colombia and Mexico.

Source: *OECD Income Distribution Database*; the Global Gender Gap Report 2017 Dataset © 2017 World Economic Forum.

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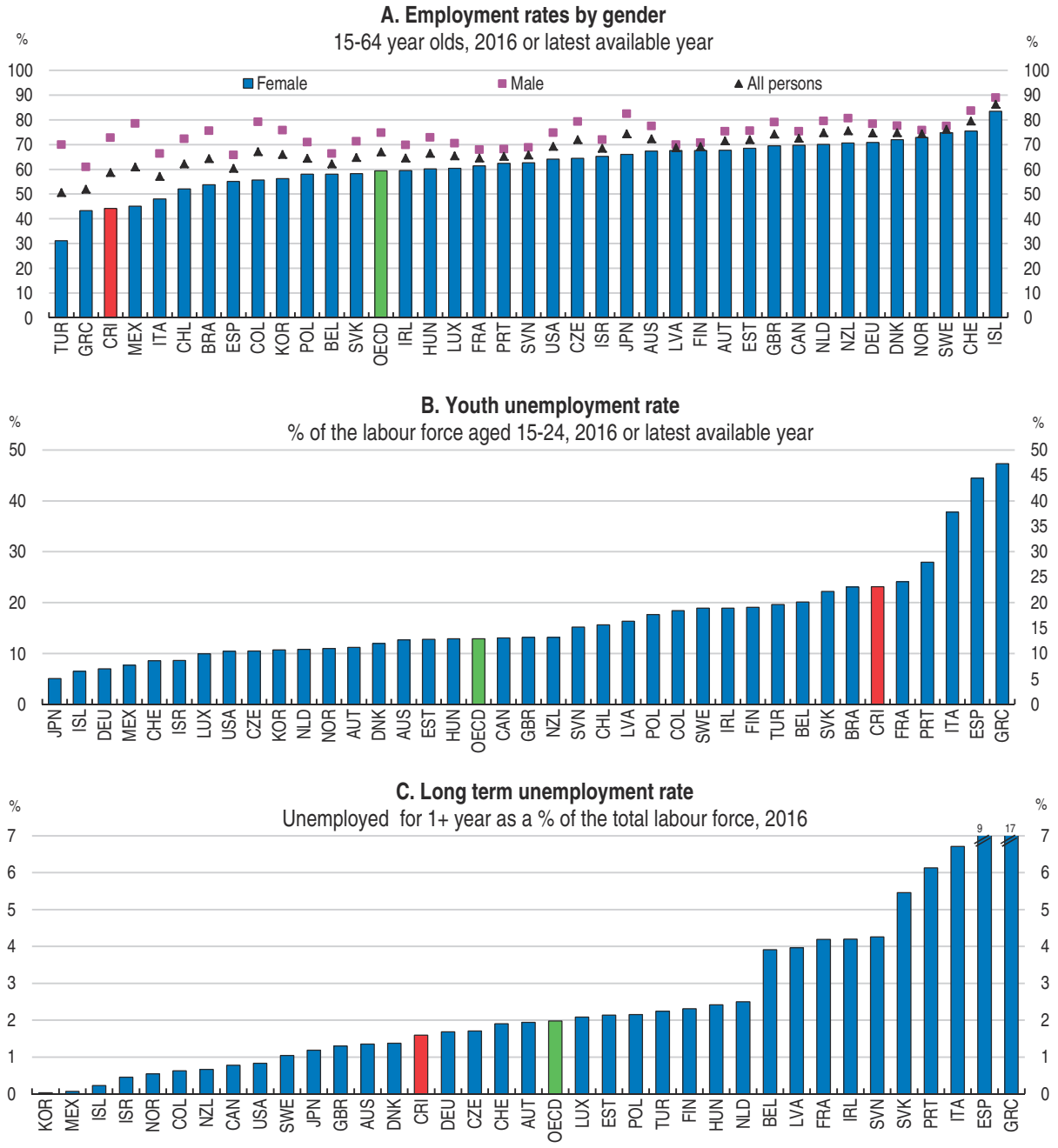
Labour market inclusion indicators

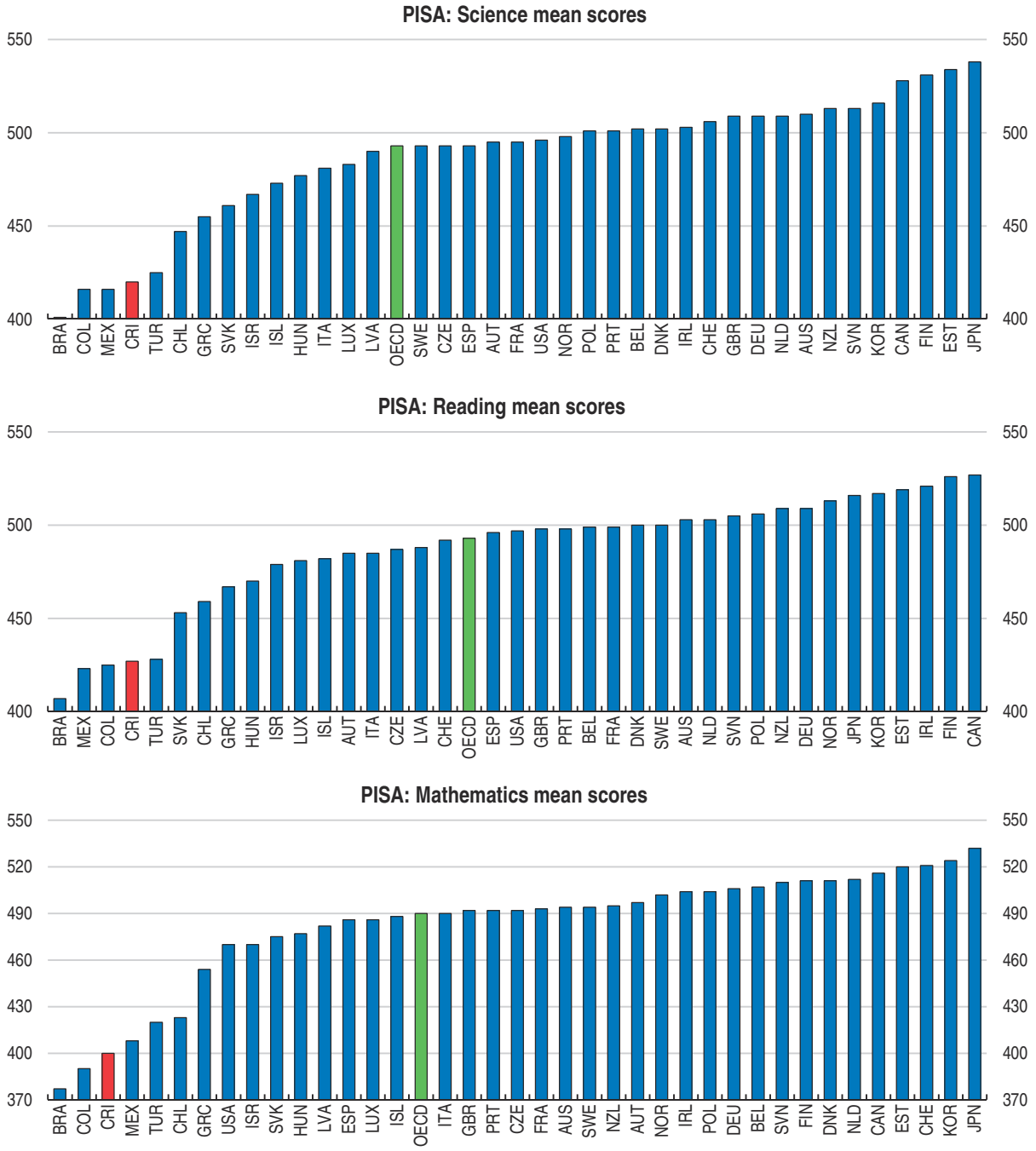


Source: OECD Labour Force Statistics.

StatLink http://dx.doi.org/10.1787/888933701319

Education Indicators

Programme for International Student Assessment (PISA) results, 2015



Source: OECD PISA 2015 Database.

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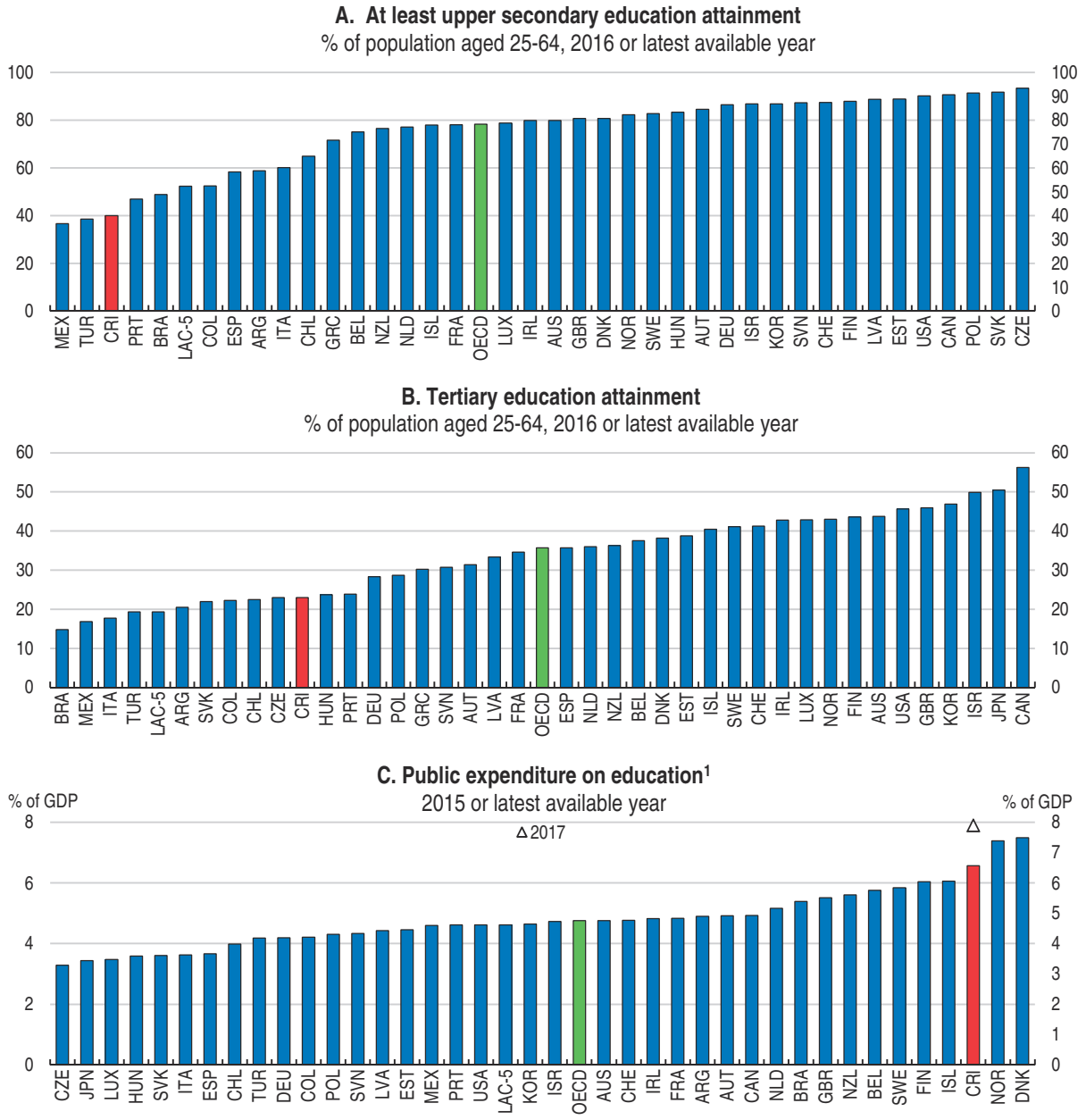
Educational Attainment and Spending



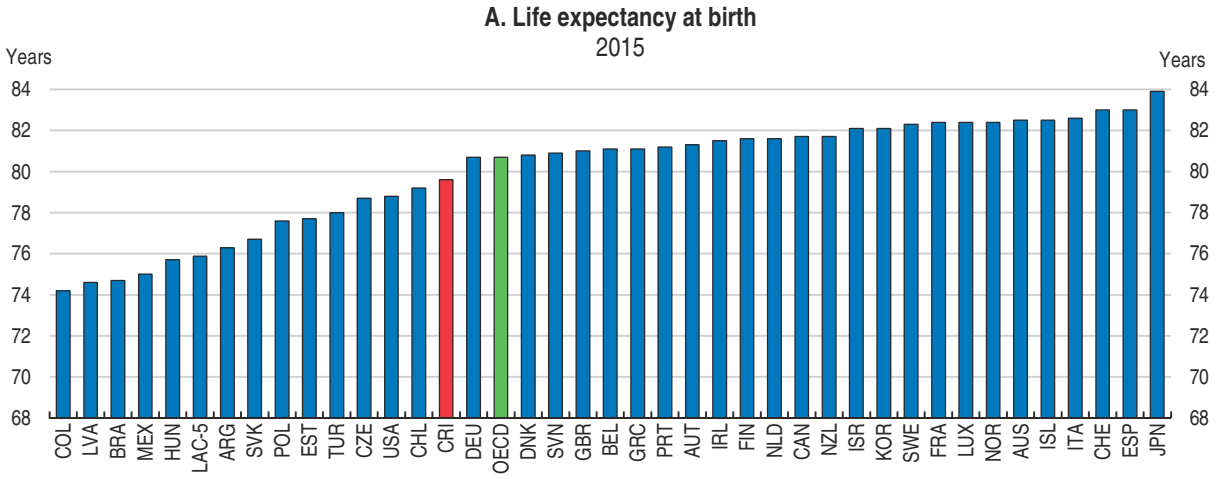
1. Expenditure on primary, secondary, post-secondary and tertiary education.

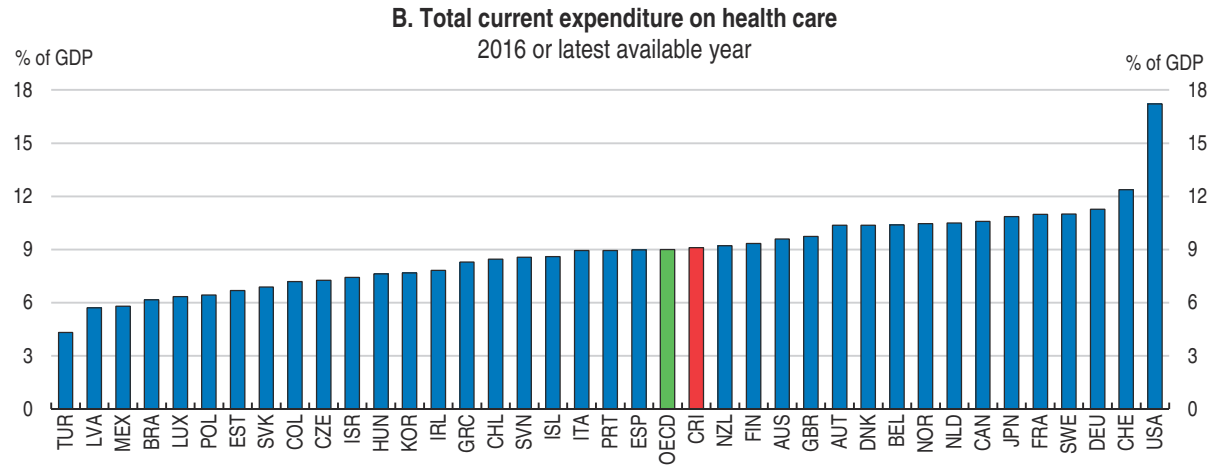
Note: LAC-5 is a simple average of Argentina, Brazil, Chile, Colombia and Mexico.

Source: *OECD Education at a Glance*; OECD Educational Finance Indicators; Ministerio de Hacienda.

StatLink http://dx.doi.org/10.1787/888933701357

Health Indicators





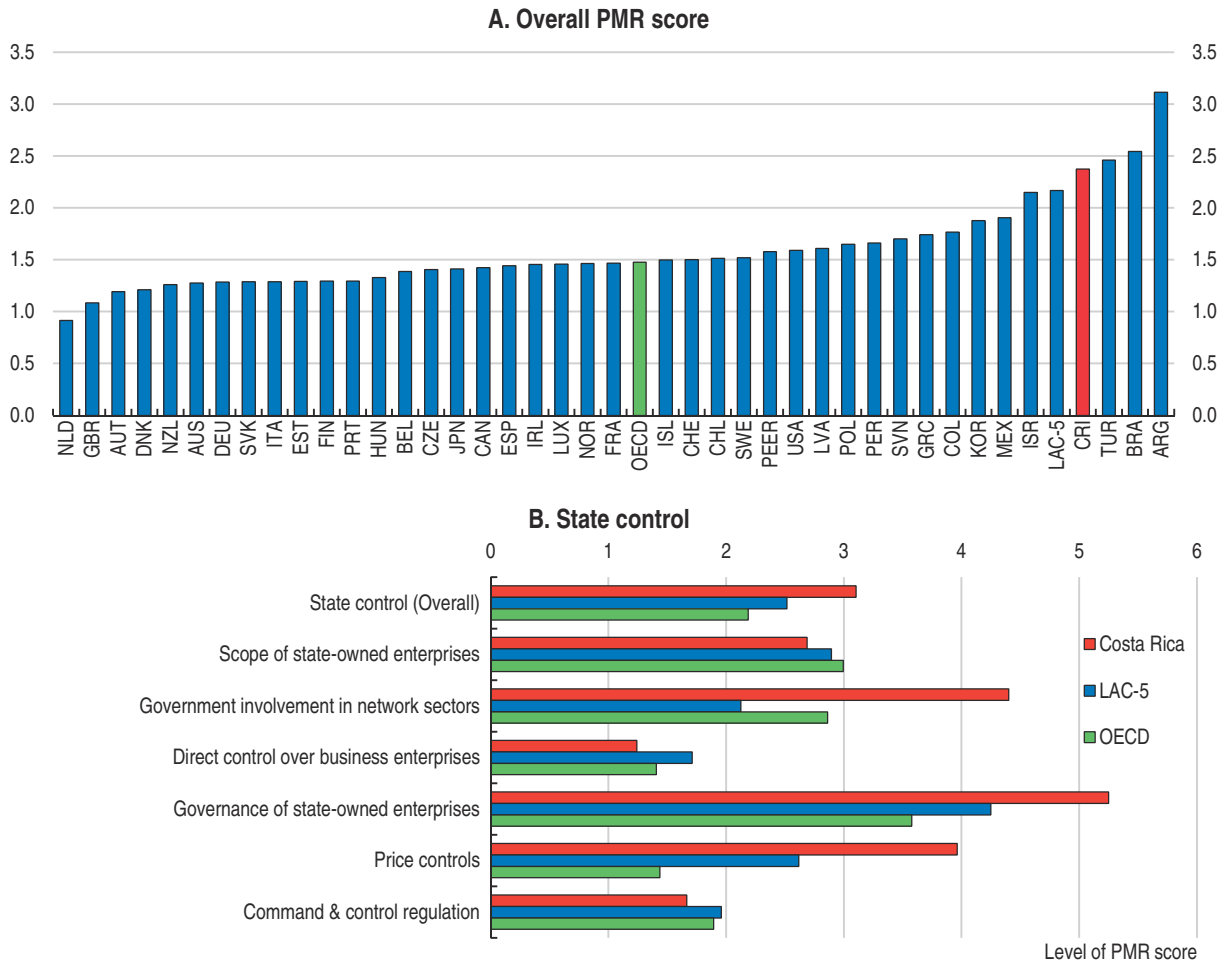
Note: LAC-5 is a simple average of Argentina, Brazil, Chile, Colombia and Mexico.
Source: *OECD Health Statistics Database* and World Bank Development Indicators.

StatLink http://dx.doi.org/10.1787/888933701376

OECD Regulation indicators

Product Market Regulation

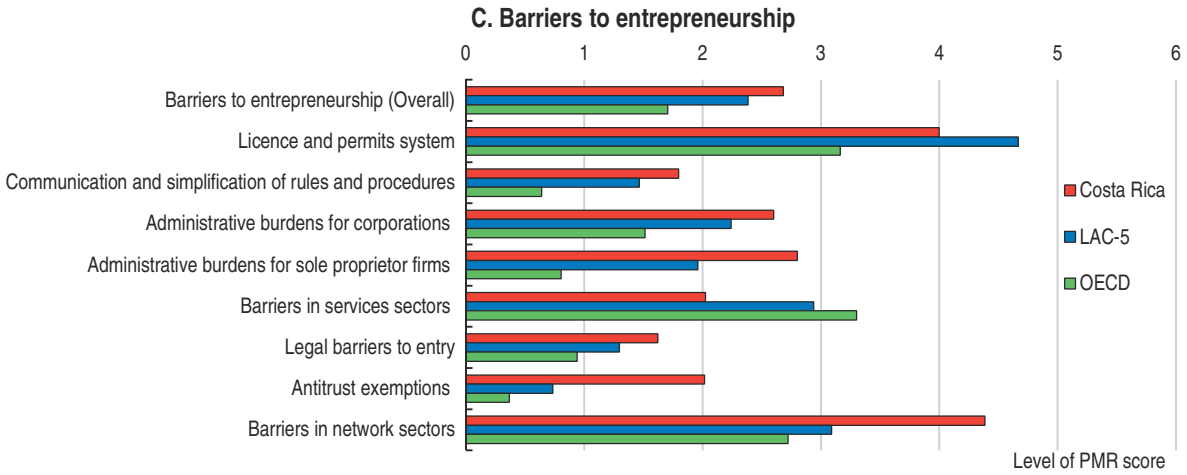
Index scale of 0-6 from least to most restrictive, latest available year

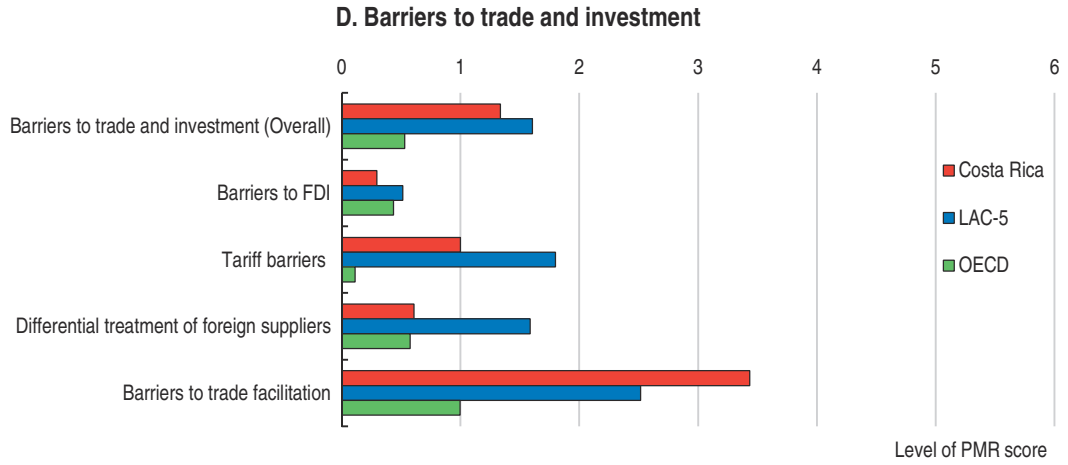


OECD Regulation indicators *(cont.)*

Product Market Regulation

Index scale of 0-6 from least to most restrictive, latest available year





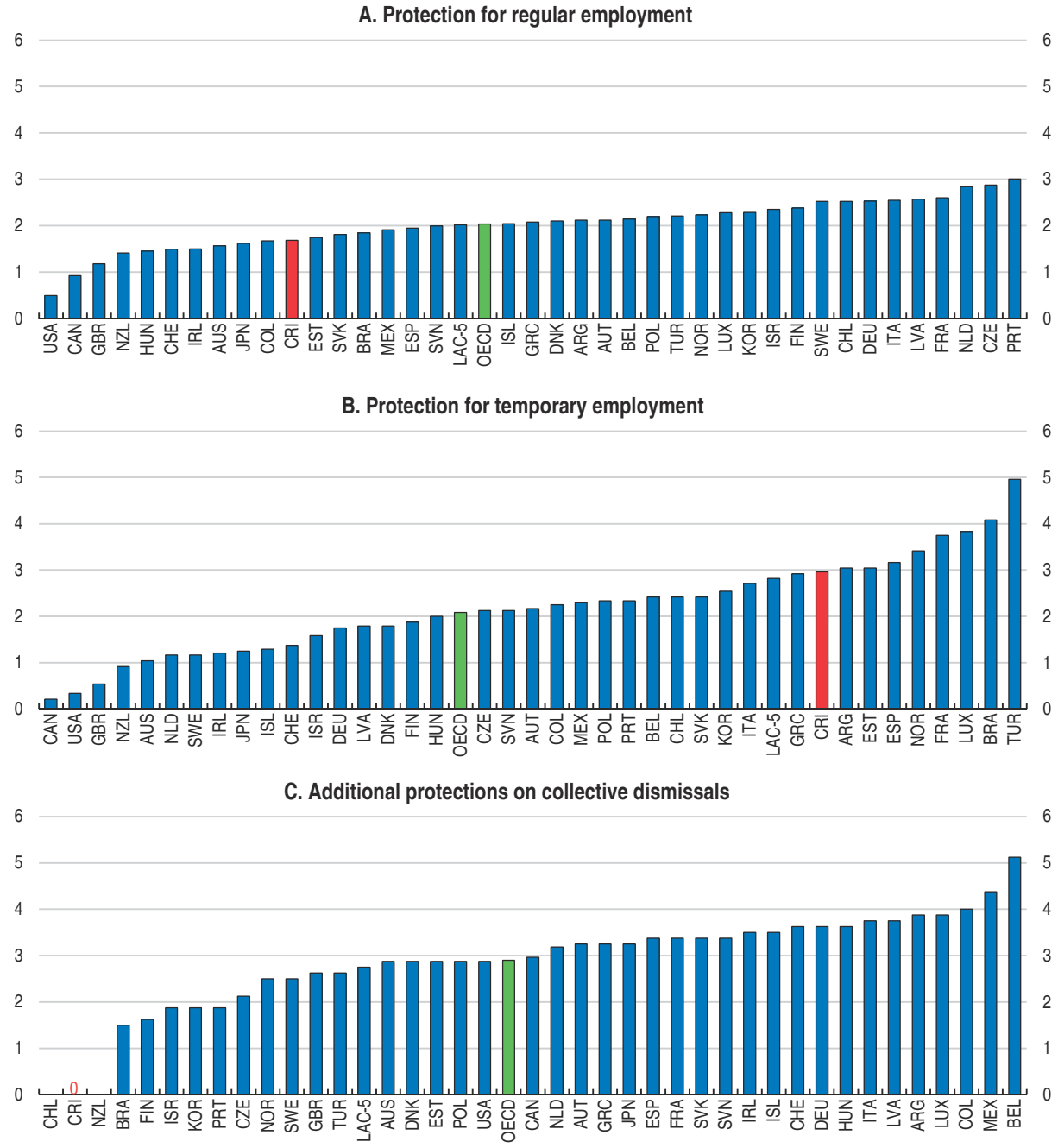
Note: LAC-5 is a simple average of Argentina, Brazil, Chile, Colombia and Mexico. Data refer to 2013.

Source: OECD-WBG Product Market Regulation Database for all LAC countries except Brazil, Chile and Mexico, and *OECD Product Market Regulation Database*.

StatLink http://dx.doi.org/10.1787/888933701395

Employment Protection Legislation Indicators

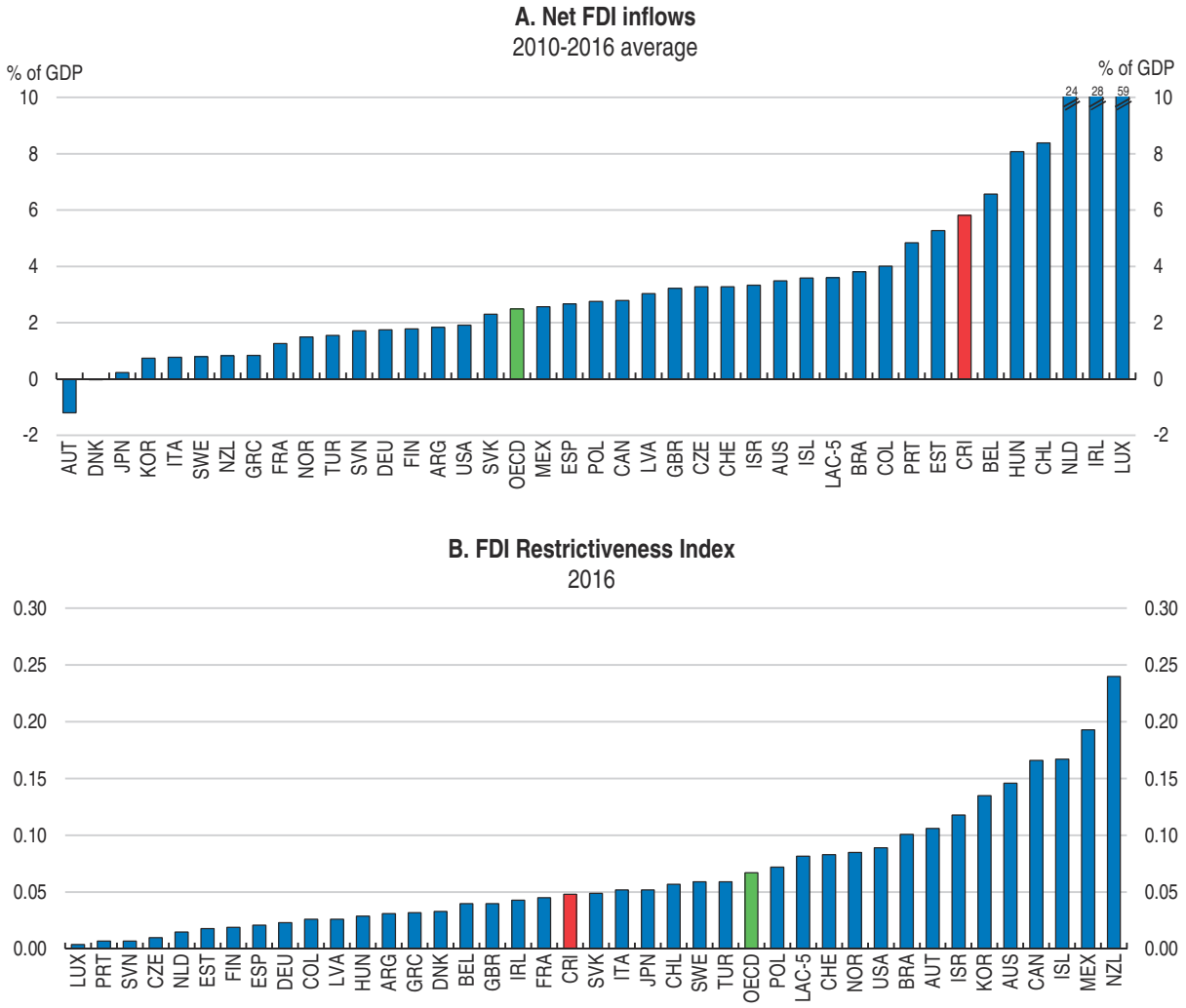
Index scale of 0-6 from least to most restrictive, latest available year



Note: Data refer to 2014 for Argentina, Colombia, Costa Rica, Slovenia and the United Kingdom; 2012 for Brazil; 2013 for others. LAC-5 is a simple average of Argentina, Brazil, Chile, Colombia and Mexico.
Source: OECD Indicators of Employment Protection.

StatLink http://dx.doi.org/10.1787/888933701414

Foreign Direct Investment (FDI) Indicators



Note: LAC-5 refers to a simple average of Argentina, Brazil, Chile, Colombia and Mexico.
Source: World Bank World Development Indicators (WDI); and OECD FDI Restrictiveness Index.

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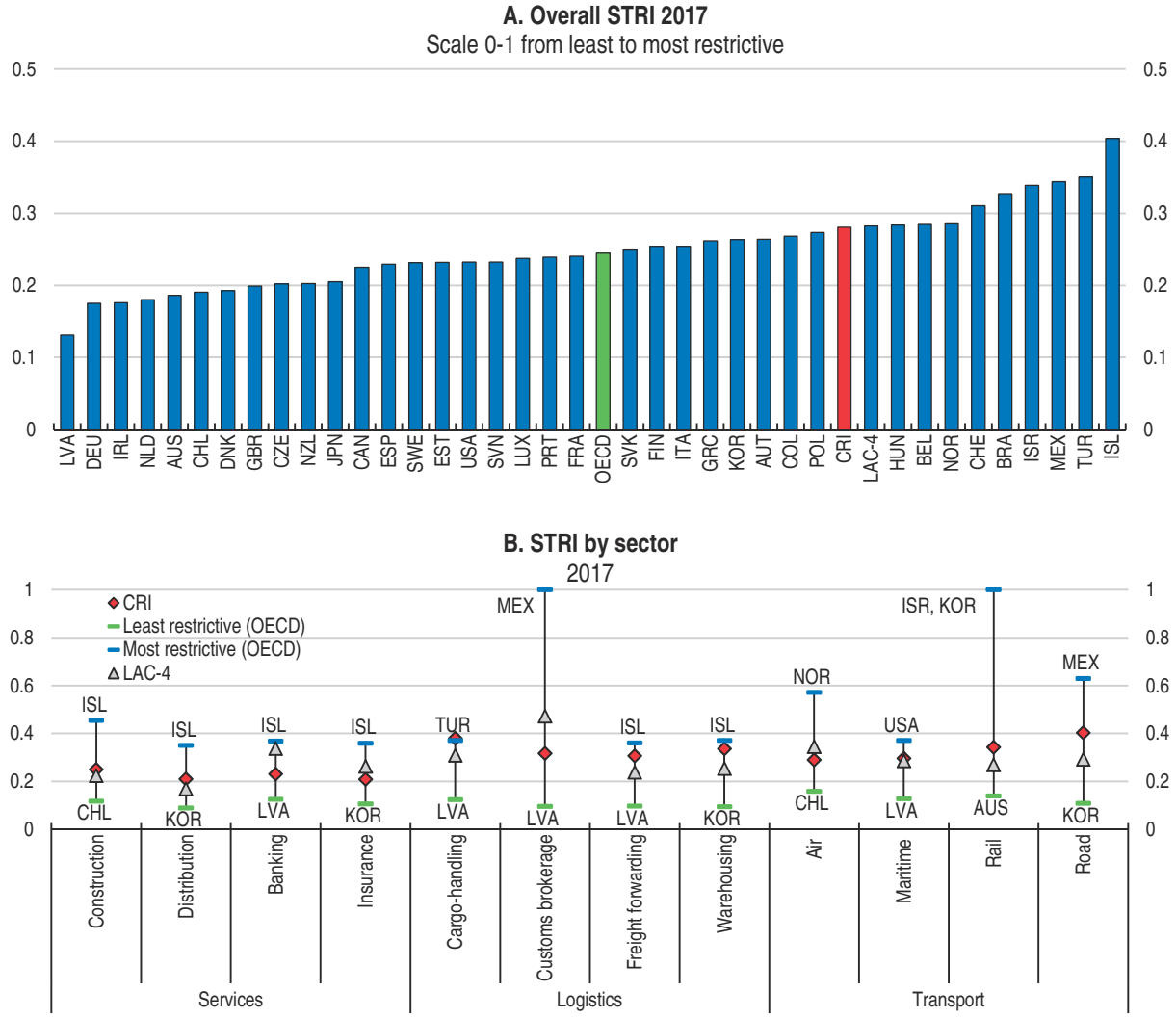
Services Trade Restrictiveness Index (STRI)



Note: LAC-4 refers to a simple average of Brazil, Chile, Colombia and Mexico.
Source: OECD Services Trade Restrictiveness Index (STRI).

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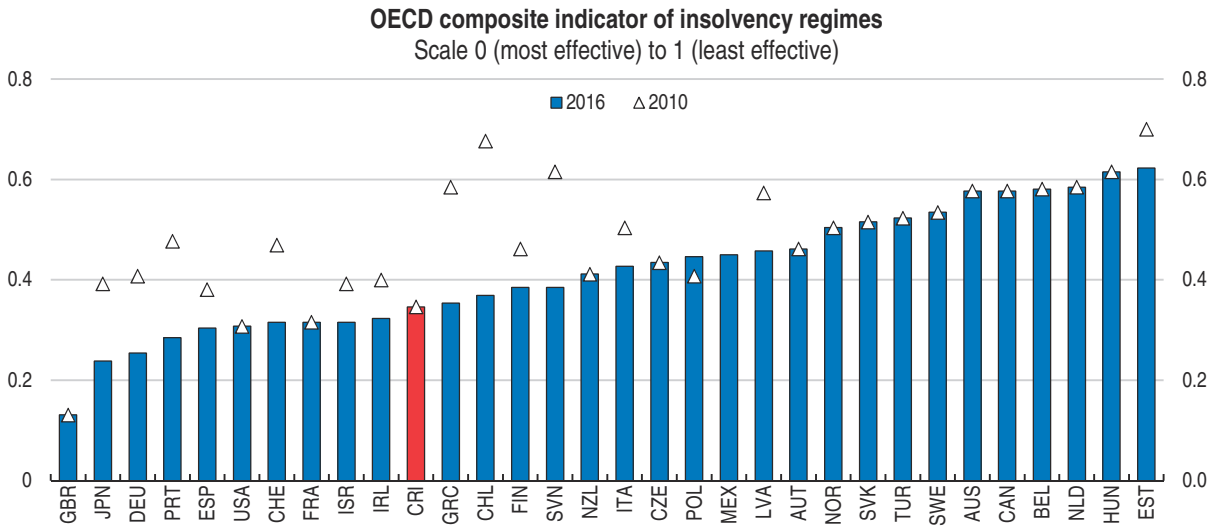
Insolvency



Source: Adalet McGowan, M., D. Andrews and V. Millot (2017), "Insolvency regimes, zombie firms and capital reallocation", *OECD Economics Department Working Papers*, No. 1399, OECD Publishing, Paris, *http://dx.doi.org/10.1787/5a16beda-en*.

StatLink *http://dx.doi.org/10.1787/888933701471*

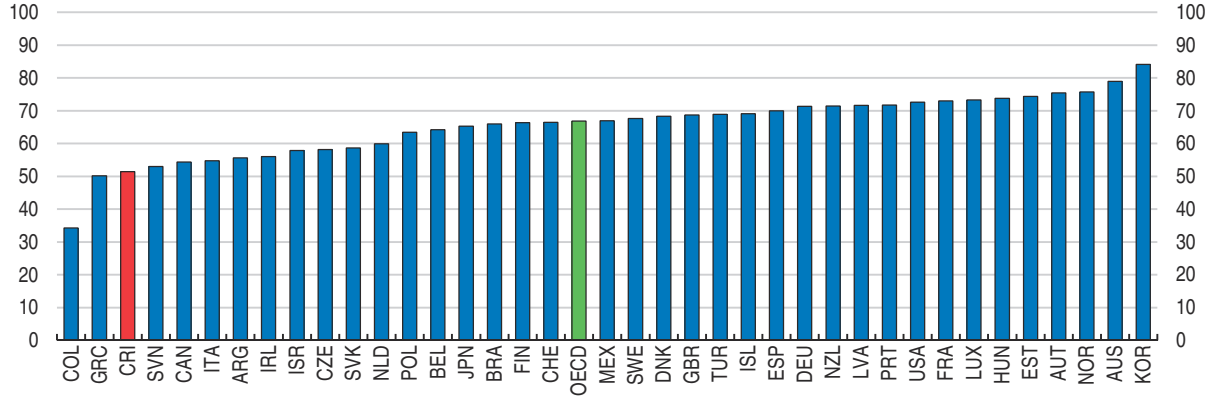
World Bank Doing Business Indicators

Distance to the frontier, 2017[1]

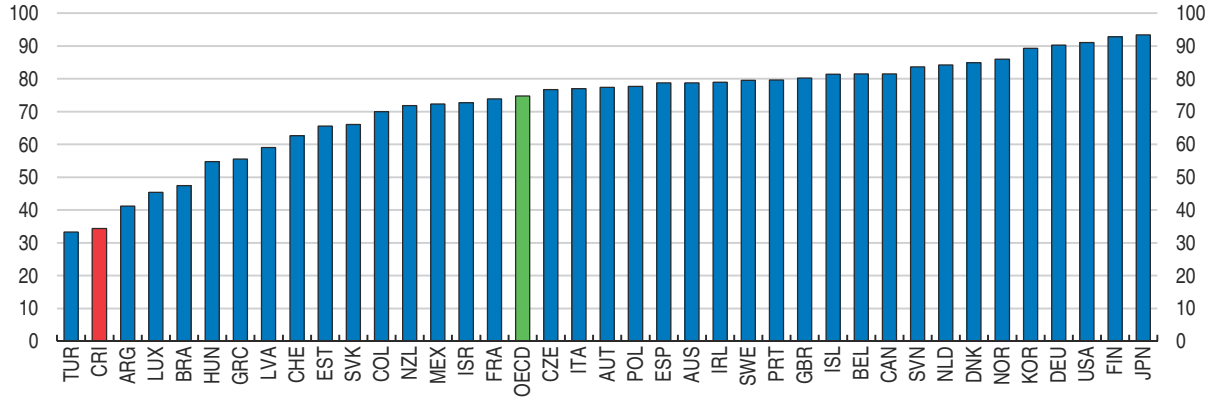
World Bank Doing Business Indicators *(cont.)*

Distance to the frontier, 2017[1]

D. Enforcing contracts



E. Resolving insolvency



1. Distance to the frontier is a measure of how far a country is from best practice, on a scale of 0-100 where 100 is best practice.

Source: World Bank Doing Business 2018 database.

StatLink http://dx.doi.org/10.1787/888933701490

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Executive summary

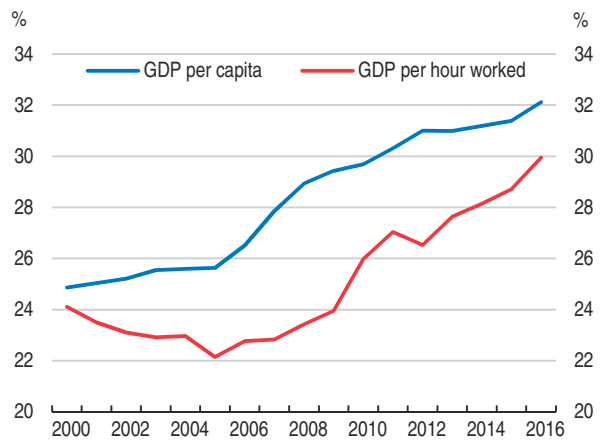
- *Economic and social progress has been impressive*
- *Restoring fiscal sustainability is a priority*
- *Strengthening monetary policy and financial stability*
- *Making growth more robust and more inclusive*
- *In spite of high education spending, outcomes are poor*
- *Overly complex regulations are holding back entrepreneurship*

Economic and social progress has been impressive

Costa Rica has achieved strong well-being and robust economic growth. Almost universal access to education, health care and pensions have contributed to high levels of life satisfaction. This has been facilitated by robust economic growth and continued convergence towards OECD living standards. Poverty, income inequality and gender gaps are low by Latin American standards, though high when compared to OECD countries. Shortcomings also exist in some well-being indicators such as work-life balance, safety and income. Costa Rica has established a world-renowned green trademark and eco-tourism industry by protecting its abundant biodiversity and developing renewable energy sources.

Convergence towards higher living standards is in progress

% of upper half OECD

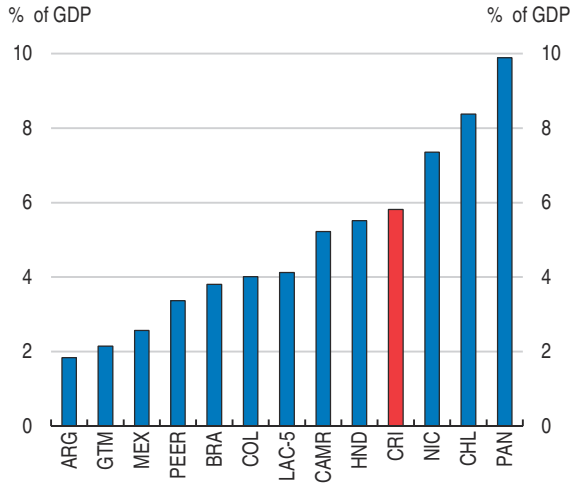


Source: OECD, *Productivity Database*.

StatLink http://dx.doi.org/10.1787/888933701509

Open trade and foreign direct investment are an integral part of Costa Rica's successful growth model. This has underpinned Costa Rica's structural transformation from an agricultural-based economy to one with a more diversified structure that is integrated into global-value chains. Building on these achievements, Costa Rica has the opportunity to increase its specialisation in medium- and high-technological intensive sectors. Robust growth of around 3.7% is projected for 2018 and 2019: a low inflation environment will protect household income and exports will benefit from the global economic recovery. Public investment is also expected to strengthen from its historically-low levels owing to ongoing large infrastructure programmes.

Costa Rica is an open economy, benefiting from strong FDI inflows, 2010-16 average



Source: World Bank Development Indicators.

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However, anti-competitive regulations and high labour market segmentation hinder the full realisation of opportunities to make growth more inclusive. Employment growth is also stagnant and unemployment remains above pre-crisis levels, hitting predominantly youth and the low skilled. As a result, and against the general trend in Latin America, informality and inequality are increasing.

The economy will continue to expand at a solid pace

	2017	2018	2019
Gross domestic product (GDP)	3.2	3.7	3.7
Private consumption	2.6	3.3	3.9
Government consumption	2.9	2.4	2.3
Gross fixed capital formation	-2.8	2.7	4.3
Exports	5.0	4.9	6.0
Imports	3.1	4.2	5.7
Unemployment rate	9.1	9.3	9.2
Consumer price index	1.6	3.1	3.1

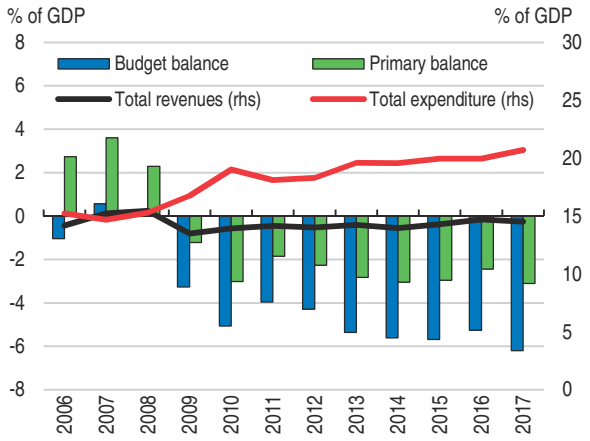
Source: *OECD Economic Outlook Database*.

Restoring fiscal sustainability is a priority

The fiscal stimulus imparted in 2009 to support the economy as the global crisis unfolded has not been reversed, in spite of a quick recovery and steady growth thereafter. The budget deficit has

exceeded 5% of GDP for the past five years. Recent efforts to increase tax collection have not reduced the budget deficit due to the extensive use of earmarking, public sector fragmentation into autonomous agencies and spending mandates. As a result, central government debt has soared, from less than 25% of GDP in 2008 to 49% in 2017.

The fiscal position continues to deteriorate



Source: Ministerio de Hacienda.

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A comprehensive fiscal reform package is needed to stabilise the debt-to-GDP ratio. There is ample room to raise additional revenue by broadening the tax base and continuing to fight tax evasion and avoidance. However, raising tax revenue will not help to contain the deficit unless strong earmarking is restricted. The government should also regain control of resource allocation, including by addressing institutional fragmentation. Reforming public-sector compensation, strengthening the budgetary framework with a new, operational fiscal rule and improving debt management would help to balance the budget.

Strengthening monetary policy and financial stability

Monetary policy has successfully achieved low inflation, but challenges remain to further reduce dollarization and strengthen the financial sector. Around 40% of deposits and credits are denominated in foreign currencies, and around 70% of such credits have been extended to unhedged borrowers. The Central Bank has raised the policy interest rate to incentivise savings in local currency and prudential regulation measures have been taken to discourage borrowing in foreign currency. The impact of these measures needs to be carefully assessed and authorities should consider the possibility of also strengthening prudential regulation with a view to continuing to reduce dollarization. Institutional reforms to enhance the independence of the Central Bank should be approved.

While the banking sector appears to be healthy, recent difficulties in two state-owned banks highlight weaknesses in governance. The government should improve the selection of board appointees to state-owned banks and other public enterprises. Opening entry to FinTech start-ups, with appropriate regulation, would boost competition and reduce the high cost of financial intermediation.

Making growth more robust and more inclusive

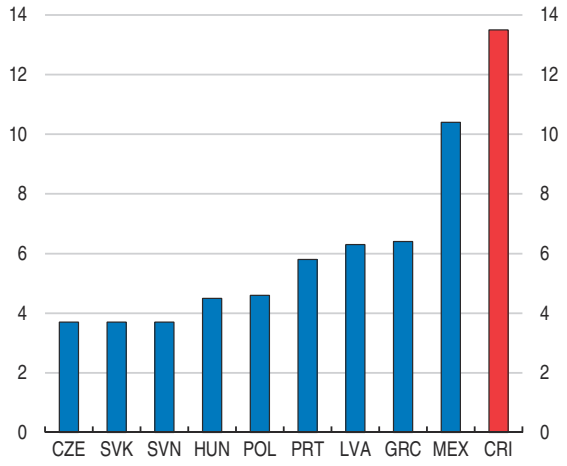
Productivity growth has gained some momentum over the past decade, but many institutional obstacles are hampering stronger growth and spreading of its gains more widely. Obstacles include labour market marginalisation, restrictions to competition and low outcomes and inequities in education. If Costa Rica does not address these challenges, it risks becoming stuck in a "vicious cycle" whereby individuals with low skills and poor access to opportunities are confined to low-productivity and low-wage jobs. Setting in motion a "virtuous cycle" will require reforms across several policy areas that present win-win opportunities to boost both productivity and inclusion.

Childcare provision is low and differs largely across income levels and geographical areas. These asymmetries impact negatively both on the future educational outcomes of children from disadvantaged backgrounds and on female labour market participation, also hampering equity. Expanding early childhood education and care for low-income groups and improving its quality should become a priority. To facilitate the improvement and expansion of services, all spending on early childcare education and care should be classified under the constitutionally-mandated spending on education and a single agency with clear responsibility for

delivering national ECEC policy across the entire sector should be appointed.

Inequality is high

Disposable income distribution (80/20 income ratio), 2016 or latest available data



Source: OECD Income Distribution Database.

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About 43% of workers hold informal jobs. High informality is a source of persistent inequalities and is also a drag on productivity. The complex minimum wage structure increases firms' compliance costs, discouraging job formalisation. The government has reduced the high number of minimum wages from 25 to 23 and plans further reductions to 10 by the end of 2019. Moving to a smaller number of categories, based on geographical and age differentiation, rather than the current complex web of sectoral, occupation, education attainment and skill categories, would significantly reduce compliance costs.

In spite of high education spending, outcomes are poor

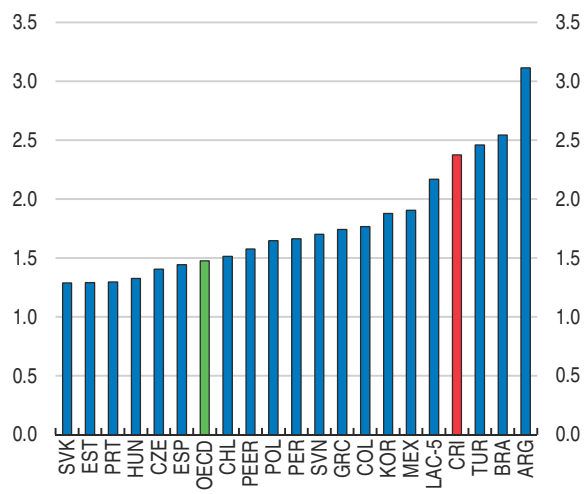
Costa Rica has a strong commitment to education as a social and economic development measure. At 7.9% of GDP, education spending is higher than in all OECD countries. However, spending is inefficient both in the learning process and in reducing inequality. PISA results reveal that one third of students lack core competencies and outcomes are strongly influenced by socio-economic background. Grade repetition and drop-out rates are high. Resources need to be channelled and even reallocated to secondary education and early childhood education and care. More focused, targeted support should be given to students at risk early on. Resources should also focus on providing initial and on-the-job training to teachers as well as education materials, which are currently in shortage. Developing good quality dual vocational education and training in secondary education would offer young people strong skills and a close link to the labour market. Overall, the government should move from the current focus on resources and funding to outcomes, and should establish clear and verifiable performance-based targeting against which to measure the success of its education policies.

Overly complex regulations are holding back entrepreneurship

Product market regulations are stringent; there are large barriers to entrepreneurship, extensive anti-trust exemptions and high state control in many sectors. The potential productivity gains from reducing anti-competitive regulations are large. Improving state-owned enterprises' governance according to OECD standards, establishing one-stop shops for business registration and licensing, streamlining insolvency procedures, removing anti-trust exemptions and enhancing trade facilitation would bring large growth benefits.

Product Market Regulations are stringent

PMR score, 2013



Source: OECD-WBG Product Market Regulation Database for all LAC countries except Brazil, Chile and Mexico; *OECD Product Market Regulation Database.*

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MAIN FINDINGS	KEY RECOMMENDATIONS
Improve macroeconomic stability	
Fiscal performance is weak and continues to deteriorate.	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 legally mandated spending and earmarking of government revenues. Streamline public sector employment to better control payroll costs. Assess contingent liabilities. 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.
The central bank's independence in the conduct of monetary policy can be improved. Monetary policy transmission mechanisms are weak, dollarization and currency mismatches are high.	Adopt the draft bill that reforms the rules for appointing the President of the Central Bank; rule out that Ministers or their representatives can vote in Board decisions. Gradually reduce interventions in the foreign exchange market.
Financial systemic risks remain.	Strengthen prudential regulation on FX loans to unhedged borrowers. Create a bank resolution mechanism and a deposit insurance scheme for all banks.
Make growth more inclusive	
The system of multiple minimum wages exacerbates compliance costs, creating distortions and inequities.	Continue moving to a smaller number of minimum wages.
The share of informal employment is high by OECD standards and has failed to decrease.	Implement a comprehensive plan to reduce informality, including greater enforcement of obligations to pay contributions.
Labour-market gender gaps are high.	Increase the supply of publicly-funded childcare services. Classify all spending on early-childhood education and care under the constitutionally-mandated spending on education.
Spending on education is high, but outcomes are poor. Per student spending on basic education is low, while spending on tertiary education is high. Inequalities in educational outcomes are high; the school drop-out rate is high and teaching quality needs strengthening.	Establish better educational outcomes as the main policy target, instead of a focus on spending, and develop performance indicators. Rebalance education spending towards early childhood and secondary education. Strengthen targeted support for at-risk students, and teachers' training.
Boost productivity growth	
Competition is weak. In the banking sector, weak competition drives up intermediation costs.	Adopt and implement the bill reinforcing the powers, independence and funding of the competition commission. Continue the implementation of the action plan to increase consistency with the OECD Guidelines on Corporate Governance of State-Owned Enterprises. Continue with the planned 25 sector studies evaluating the exemption from competition and eliminate unjustified exemptions. Open entry to FinTech start-ups, with appropriate regulation.
Barriers to entrepreneurship are high.	Establish a one-stop-shop for business registration and licensing. Introduce performance targets. Continue to improve the insolvency regime and trade facilitation.
Transport infrastructure is deficient due to a complex institutional setting.	Improve co-ordination among the different public-works bodies by clarifying mandates and granting overall control to a single lead agency. Prioritise projects based on cost-benefit analysis.

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Key policy insights

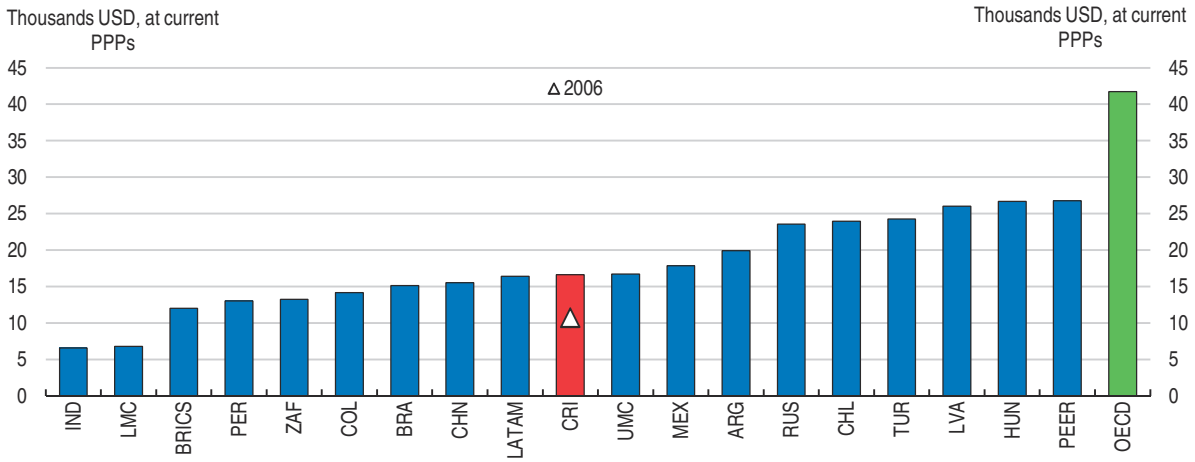
- *Costa Rica has achieved strong socio-economic progress*
- *Robust growth is set to continue*
- *Strengthening the monetary policy framework and ensuring financial stability*
- *Policies to restore fiscal sustainability*
- *Structural policies to boost productivity and inclusion*
- *Greening growth*

Costa Rica has achieved strong socio-economic progress

Costa Rica is one of the oldest democracies in Latin America. Its stable political system has supported steady economic, social and environmental progress over time. The country started progressing towards universal literacy by 1869, when primary education became compulsory and tuition free. The 1949 Constitution formally abolished armed forces, with savings being invested in health and education. GDP per capita has increased significantly over the last 30 years and the country has achieved upper-middle income levels according to the World Bank classification (Figure 1). Virtually universal healthcare, primary education and pension systems have underpinned Costa Rica's significant human development progress, with well-being benefits such as a sizeable middle class, low infant mortality and high life expectancy (Table 1). Poverty, income inequality and gender gaps are high compared to OECD countries, albeit low by Latin American standards.

Figure 1. **Costa Rica has converged towards higher income levels**

GDP per capita, 2016 or latest available year



Note: 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. For LMC and UMC, data refer to the Lower-middle-income and Upper-middle-income economies as classified by the World Bank. LATAM refers to Argentina, Brazil, Chile, Colombia, Costa Rica, Mexico and Peru. BRICS refers to Brazil, Russian Federation, India, China and South Africa.
Source: World Bank Development Indicators.

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Costa Rica has also carefully managed its natural resources, including by protecting its forests and abundant biodiversity, and by developing renewable energy sources, reaping benefits for example in terms of a world-renowned green trademark and eco-tourism industry. All these achievements are reflected in Costa Rica's well-being indicators, which are comparable to or even above the OECD average on a number of dimensions, including the environment, community life, civil engagement and health. By contrast, there is a gap in well-being for work-life balance, safety, education and income. Costa Ricans also enjoy levels of life satisfaction that are similar to the best performing OECD countries.

Table 1. **Costa Rica's social achievements are impressive**

Key indicators, 2016 or latest available year

	Costa Rica	Chile	Mexico	Colombia	LAC	OECD
Share of the population in the middle class (%)[1]	47.0	44.0	27.0	27.0	34.0	..
Primary education net enrolment rate (%)	96.4	94.3	95.1	90.6	93.0	97.1
Life expectancy at birth (years)						
Total	79.6	79.2	75.0	74.2	75.2	80.6
Men	77.2	76.7	72.3	70.7	72.0	77.9
Women	82.1	81.8	77.7	77.8	78.5	83.2
Infant mortality (deaths per 1000 live births)	8.5	7.2	12.5	13.6	15.2	3.9
Perceived health status (%)[2]	73.5	57.4	65.5	..	..	68.8
Life satisfaction (0-10 scale)	7.1	6.7	6.6	6.4	..	6.5
Relative poverty rate after taxes and transfers (%)[3]	21.5	16.1	16.7	..	..	11.4
Absolute poverty measures (%)[4]	1.6	1.3	3.0	5.5	4.9	..

1. The middle class is defined as the proportion of individuals with an income between USD 10 and USD 50 a day.
2. Perceived health status is the percentage of adults reporting "good" or "very good" health.
3. Relative poverty rate after taxes and transfers (threshold of 50% of median income).
4. Absolute poverty rate is based on an international poverty line of 2011 PPP USD 1.90 a day.

Note: LAC refers to Latin America and the Caribbean.

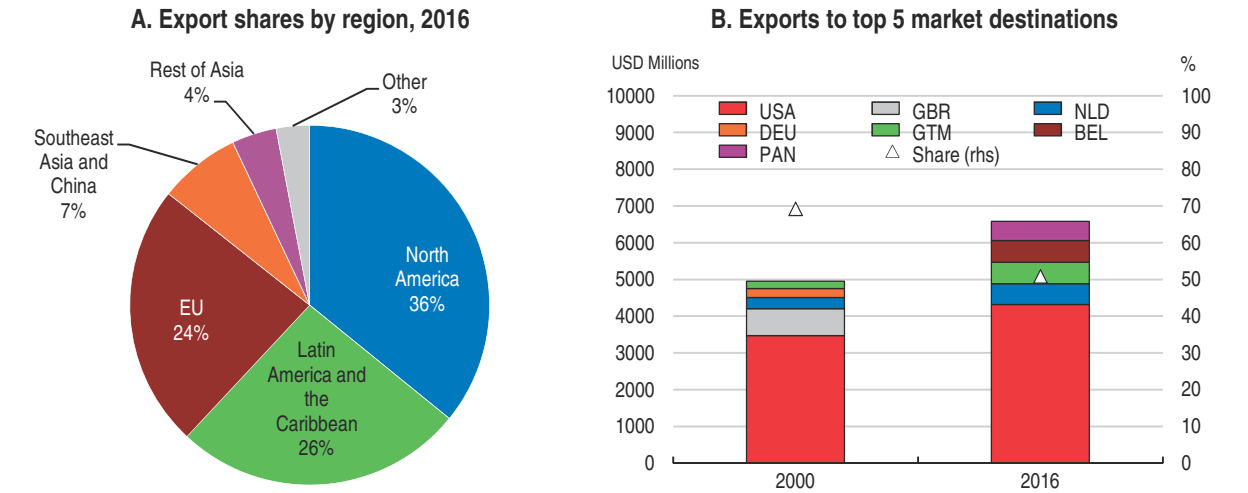
Source: OECD Better Life Index; OECD database on income distribution; OECD Health Statistics; World Bank Development Indicators; UNESCO Statistics; Oviedo et al. (2015).

Open trade and foreign direct investment (FDI) are an integral part of Costa Rica's successful growth model. Strong FDI inflows, favoured by an educated population and a friendly FDI regime, have supported Costa Rica's structural transformation from a rural and agricultural-based economy to one with a more diversified structure that is integrated into global-value chains (GVCs). This has allowed for a sustained expansion of production since the mid-1980s (Rodriguez-Clare, 2001; Araújo and Linares, 2018). Costa Rica's exports are geographically concentrated in North and Latin America, especially the United States, its main export destination market (Figure 2). This model continued to bear fruit and during the first decade of the 21st century Costa Rica's average growth rate exceeded that of Central American countries and of Latin America as a whole (Beverinotti et al., 2014).

This pattern of production is mirrored in the country's comparative advantage, which points to an increasing level of sophistication of its exports and, similarly to advanced OECD economies, narrower product specialisation (OECD, 2017a; Figure 2). In spite of these positive developments, Costa Rica's export basket still shows a higher reliance on less sophisticated products relative to the OECD average. Harnessing on the existing productive experiences and specialisation patterns, Costa Rica could benefit from upscaling opportunities in a number of medium- and high-technological intensive industrial sectors (Araújo, Linares and Chalaux, 2018; Figure 3).

Costa Rica was severely hit by the global financial crisis in 2008-09. The unemployment rate, which stood at 4.4% in 2007, rapidly increased during the global financial crisis. The recession was however short lived as growth rebounded quickly to almost 5% in 2010-12, on the back of a supportive fiscal stance and strong FDI inflows, particularly in high-tech manufacturing and knowledge-intensive services (Figure 4). The services sector registered the fastest growth in the post-crisis period, accounting for more than 70% of GDP and employing about two-thirds of the workforce in 2016 (Figure 5). The overall performance of Costa Rica's economy depends crucially on its service sectors as they are also used intensively as inputs into exported goods (OECD, 2016a).

Figure 2. **Export destinations are increasingly diversified**



Source: OECD calculations using BACI database.

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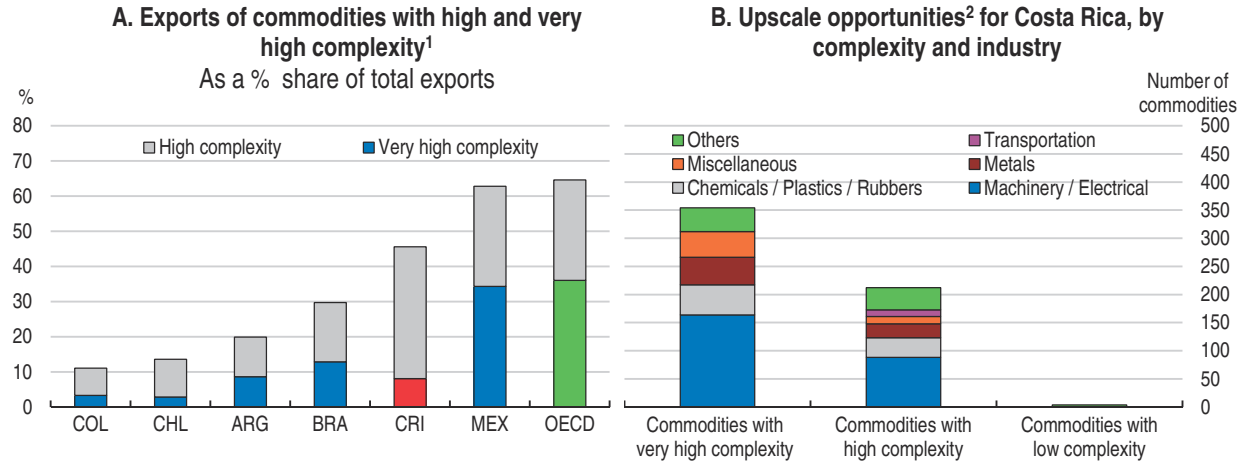
Figure 3. **Costa Rica is specialising in complex products**



1. "High" and "very high" complexity commodities are those with complexity scores in the 3rd and 4th quartiles of the distribution of the total set of commodities traded worldwide. These are calculated on the basis of the Product Complexity Index (PCI) which is a measure of the relative knowledge intensity of a commodity. An example of a product in the 4th quartile is "Ethylene dichloride", which ranked 10th in 2015 out of 4 214 products listed in the Harmonized System 6 classification. A product in the 1st (lowest) quartile is "Cocoa paste wholly or partly defatted" ranked 4 201st in 2015.
2. Upscale opportunities are those commodities currently exported with no comparative advantage, with a level of complexity (PCI) higher than the country's complexity index and which are closer to the country's specialisation pattern.

Source: Panel A: Araújo, Chalaux and Haugh (2018); Panel B: Araújo, Linares and Chalaux (2018).

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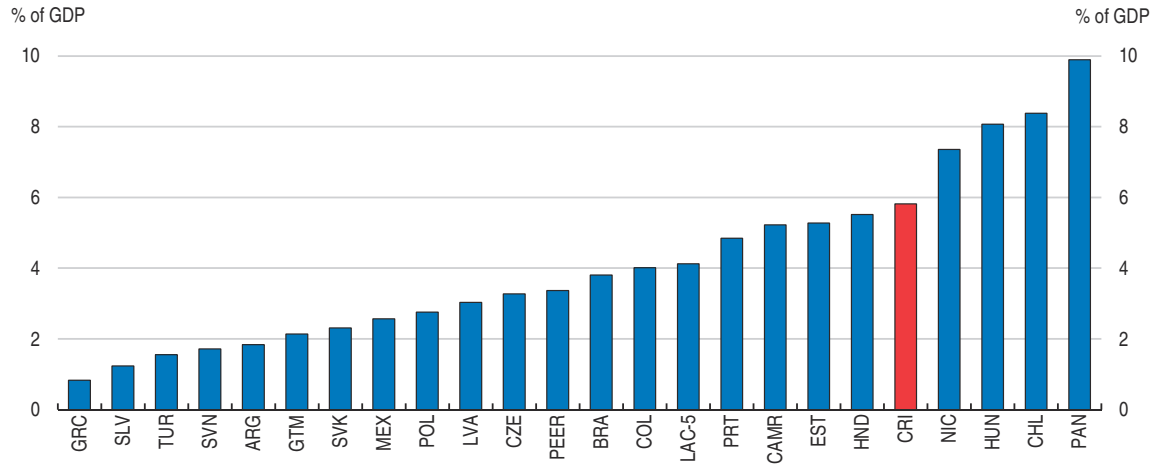
The rapid expansion of skill and knowledge-intensive sectors is contributing to robust growth. However, the economy retains a dual structure, with traditional, low-productivity sectors employing low-skilled and low-paid workers, while high-productivity exporting and FDI industries employ high-skilled individuals (OECD, 2016b). The education system and the labour market struggle to keep pace with the growing demand for skilled workers (see below). As a result, employment growth has been stagnant and unemployment has remained stubbornly high, hitting predominantly youth and the low skilled (Figure 6; Figure 23).

Figure 4. **Strong FDI inflows helped Costa Rica weather the recession**

FDI inflows as % of GDP, 2010-16[1]



1. Average yearly net inflows between 2010 and 2016, as a percentage of GDP.

Note: LAC-5 refers to the unweighted average of Argentina, Brazil, Chile, Colombia and Mexico. CAMR refers to the unweighted average of Central American countries Guatemala, Honduras, Nicaragua, Panama and El Salvador. 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.

Source: World Bank Development Indicators.

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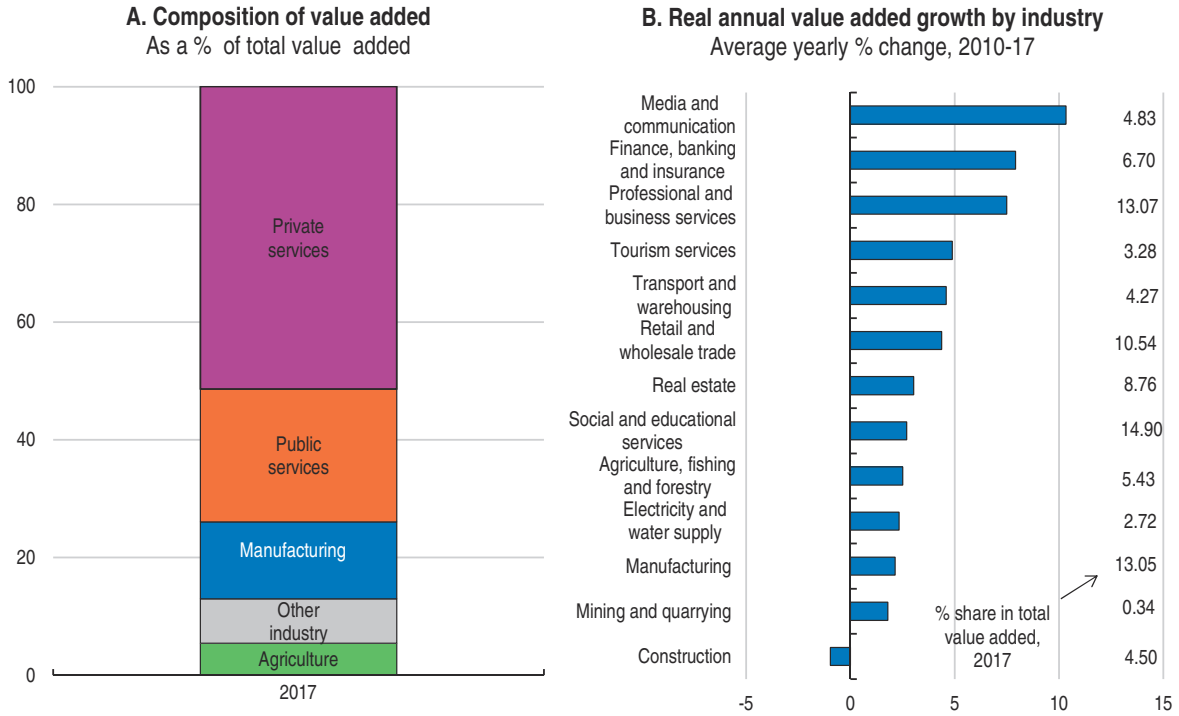
Figure 5. **Services account for an increasing share of value added**



Note: In Panel A, the "public services" category comprises public administration and defence, education, health and social activities together with other activities included in ISIC Rev. 4 sectors R, S, T and U; In Panel B, the numbers after each sector indicates its contribution to value-added in 2017.

Source: OECD calculations using Banco Central de Costa Rica (BCCR) data.

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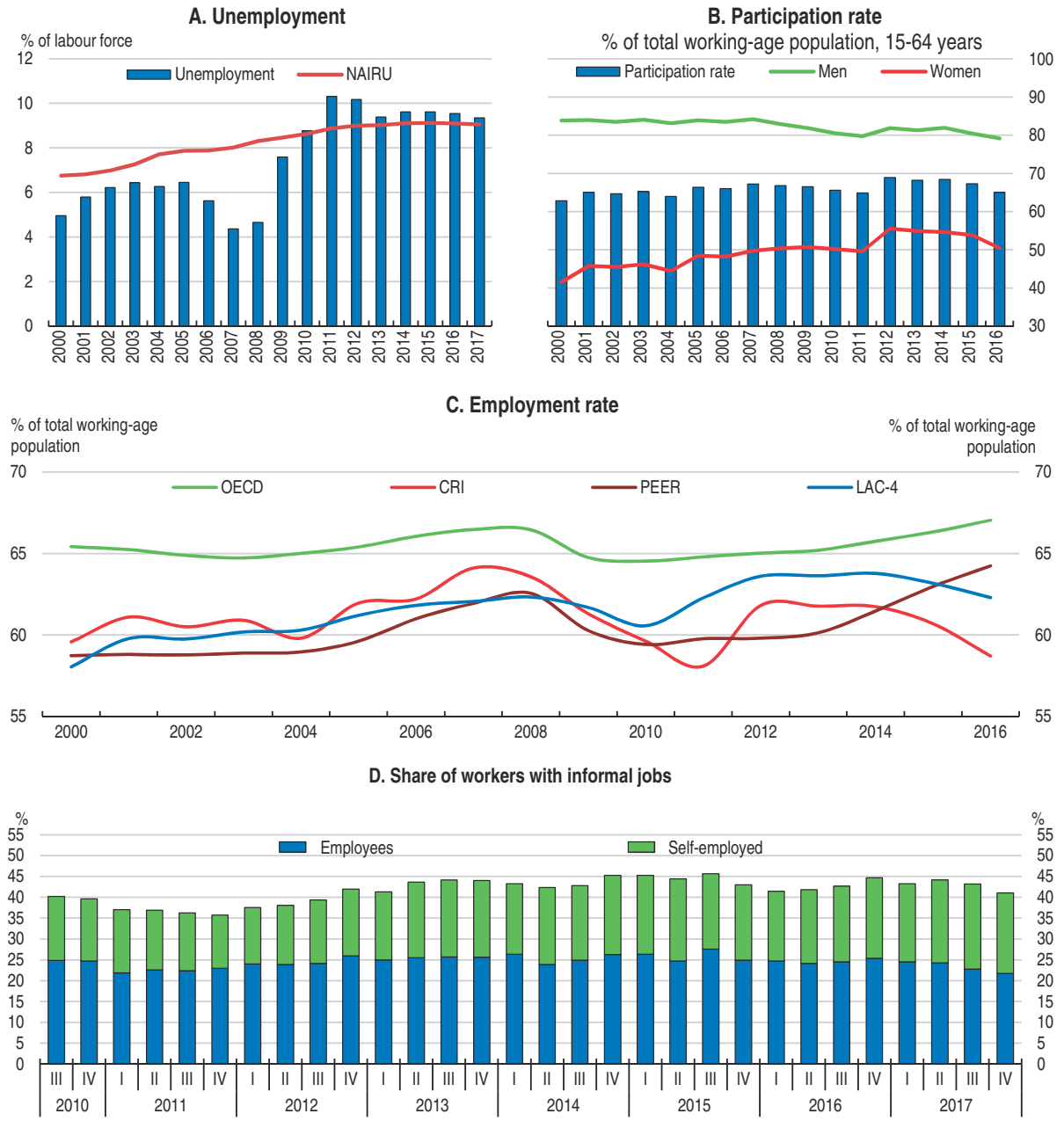
Figure 6. **Labour market outcomes have deteriorated**



Note: LAC-4 refers to Brazil, Chile, Colombia and Mexico. 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.
Source: *OECD Analytical Database*; *OECD Labour Force Statistics Database*; INEC Encuesta Continua de Empleo (ECE).

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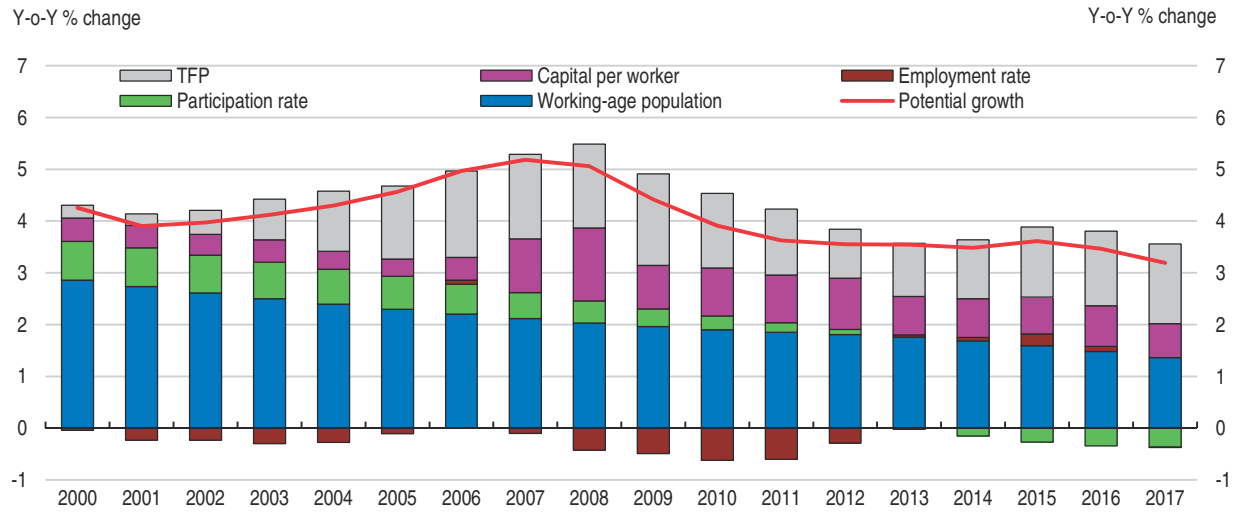
At the same time, the wage premium for skilled workers has been increasing, which has contributed to higher inequality (González Pandiella and Gabriel, 2017). Against the general trend in Latin America, informality has remained stubbornly high (Figure 6, Panel C; Figure 22). Lower labour utilisation is also curbing potential growth (Figure 7).

After decades of stagnation, productivity has gained some momentum since the mid-2000s (Figure 8). However, its sluggish pace is disappointing and a large gap relative to the OECD

Figure 7. **Growth remains robust but has declined after the crisis**

Decomposition of potential output growth



Source: OECD Economic Outlook Database.

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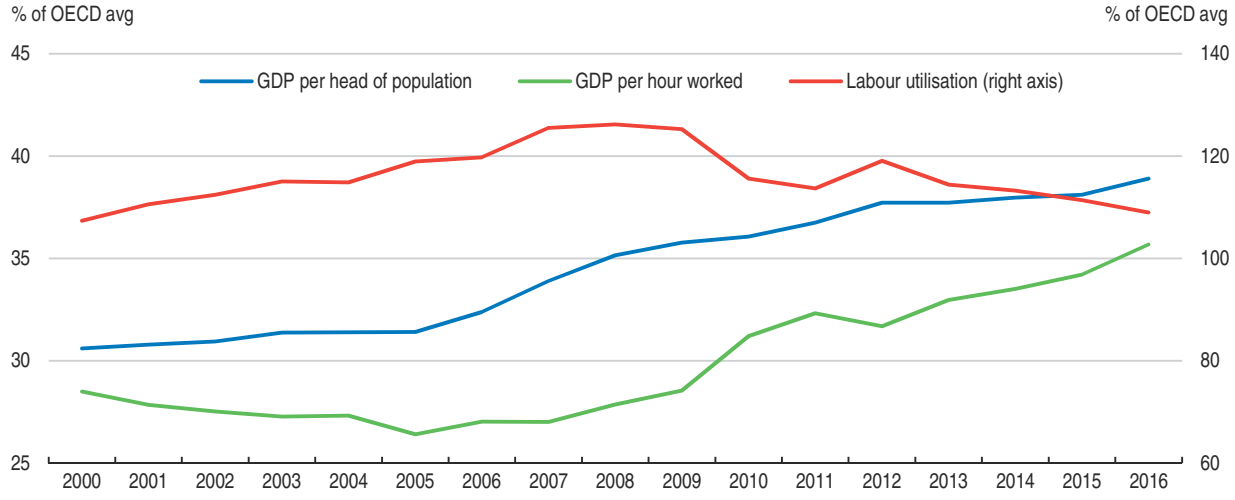
Figure 8. **GDP per capita and labour productivity are converging, but remain at low levels**



Source: OECD Productivity Database.

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persists, associated with poor education outcomes, labour market segmentation, anti-competitive regulation, infrastructure bottlenecks and limited spillovers from FDI into the domestic sector (Sandoval et al., 2018). Boosting sustainable economic growth will also require raising the skill set and making the most of existing human capital, including facilitating women's participation in the labour market, reducing youth unemployment and informality, and improving the labour market conditions and social integration of migrants.

Macroeconomic imbalances are rising as the budget deficit continues to deteriorate. The counter-cyclical measures implemented during the global crisis, mostly in the form of increased compensation of public sector workers and transfers to autonomous institutions, have not been reverted. Rigid earmarking rules, fragmentation of the public sector into

multiple deconcentrated and decentralised institutions combined with weak steering and co-ordination capacity by the central government, legislatively-mandated increases in public spending and political gridlock, which is preventing the adoption of reforms to overhaul the fiscal situation, are at the origin of the build-up of persistently large fiscal deficits. As a consequence, sovereign debt is rising fast and, if left unaddressed, will threaten macroeconomic stability, and ultimately Costa Rica's successful growth model.

Against this backdrop, this second *OECD Economic Survey of Costa Rica* sets a road map of policy reform priorities. To boost sustainable and equitable economic growth, the main areas for action are:

- Restoring the sustainability of public finances has become more urgent. A comprehensive package of reforms must be implemented immediately to stabilise the debt-to-GDP ratio, involving measures to curb government expenditure, raise tax revenues, strengthen the fiscal rule, and decrease legislatively-mandated spending and budgetary earmarking. Streamlining public sector employment and better controlling payroll costs, creating a multi-year expenditure framework, and modernising debt management would help to reduce the debt-to-GDP ratio to prudent levels while building fiscal space to address contingencies. Costa Rica should also assess fiscal risks linked to guarantees of deposits in state-owned banks, public-private partnerships and other contingent liabilities.
- Boosting productivity is key to achieving higher living standards. Reforms should focus on enhancing competition, including by adopting and implementing the bill reinforcing the powers, independence and funding of the competition commission. Other priorities include restricting the scope for anti-trust exemptions from competition, and reducing burdensome regulation that limits firm entry and exit and business formalisation. Shortcomings in public infrastructure should also be addressed.
- The benefits of growth should be more widely shared, which would also lay the foundations for more robust and sustainable growth. Policies should focus on reducing inequities in access and improving quality in education, facilitating women's access to the labour market and reducing informality. Priority actions include expanding early childhood education and care, refocusing spending to pre-tertiary education, further progressing towards a simpler minimum wage structure, and reducing businesses' compliance costs.

Costa Rica is actively engaged in the process of accession to the OECD (Box 1). Many initiatives aimed at adopting the 2016 OECD Economic Assessment recommendations are underway. This has been catalysed by the creation of a taskforce that encompasses all the institutions that have legal competencies in their implementation. The team includes high-level officials, meets regularly to assess progress and produces updates that are shared with the OECD Secretariat for feedback. This top-down approach has been effective in steering progress and has proved valuable in understanding the need for co-operation among the different public institutions to achieve results and facilitate implementation. It has also been very helpful for the OECD Secretariat to keep updated of advances in structural reform. A similar taskforce has also been established to address the recommendations of the OECD Committee on Financial Markets. Annex 1 summarises the state of play of many legislative initiatives to address OECD recommendations and set Costa Rica on a path of more robust growth and shared prosperity.

Box 1. **Costa Rica's accession to the OECD**

On 9 April 2015, OECD member countries agreed during a meeting of the OECD Council to open membership discussions with Costa Rica. The Accession Roadmap to the OECD Convention was adopted by the OECD Council on 8 July 2015, setting out the terms, conditions and process for the accession of Costa Rica [C(2015)93/FINAL]. In accordance with the Roadmap, 22 technical committees have been asked to evaluate Costa Rica's willingness and ability to implement OECD legal instruments within the Committee's competence, as well as Costa Rica's policies and practices as compared to OECD best policies and practices. For the delegates of the Economic and Development Review Committee (EDRC) this involves an evaluation of Costa Rica's policies and practices as compared to OECD best policies and practices with reference to the three Core Principles outlined in the Appendix to the Roadmap. Costa Rica next submitted its Initial Memorandum on 16 February 2016, in which a candidate country sets out its position on each of the OECD legal instruments in force, marking the start of the technical reviews which are now well under way.

Costa Rica's accession process has triggered an acceleration of reform momentum towards OECD best practices. In particular, concrete policy actions have been taken to limit base erosion and profit shifting (BEPS), fight tax evasion and avoidance, strengthen the role of the tax administration, improve cash management practices in the Ministry of Finance, align corporate governance of state-owned enterprises (SOEs) with the OECD Guidelines and simplify the complex minimum wage structure. Over time, moving towards OECD best practices will be a catalyst for more robust, sustainable and equitable growth and well-being.

Robust growth is set to continue

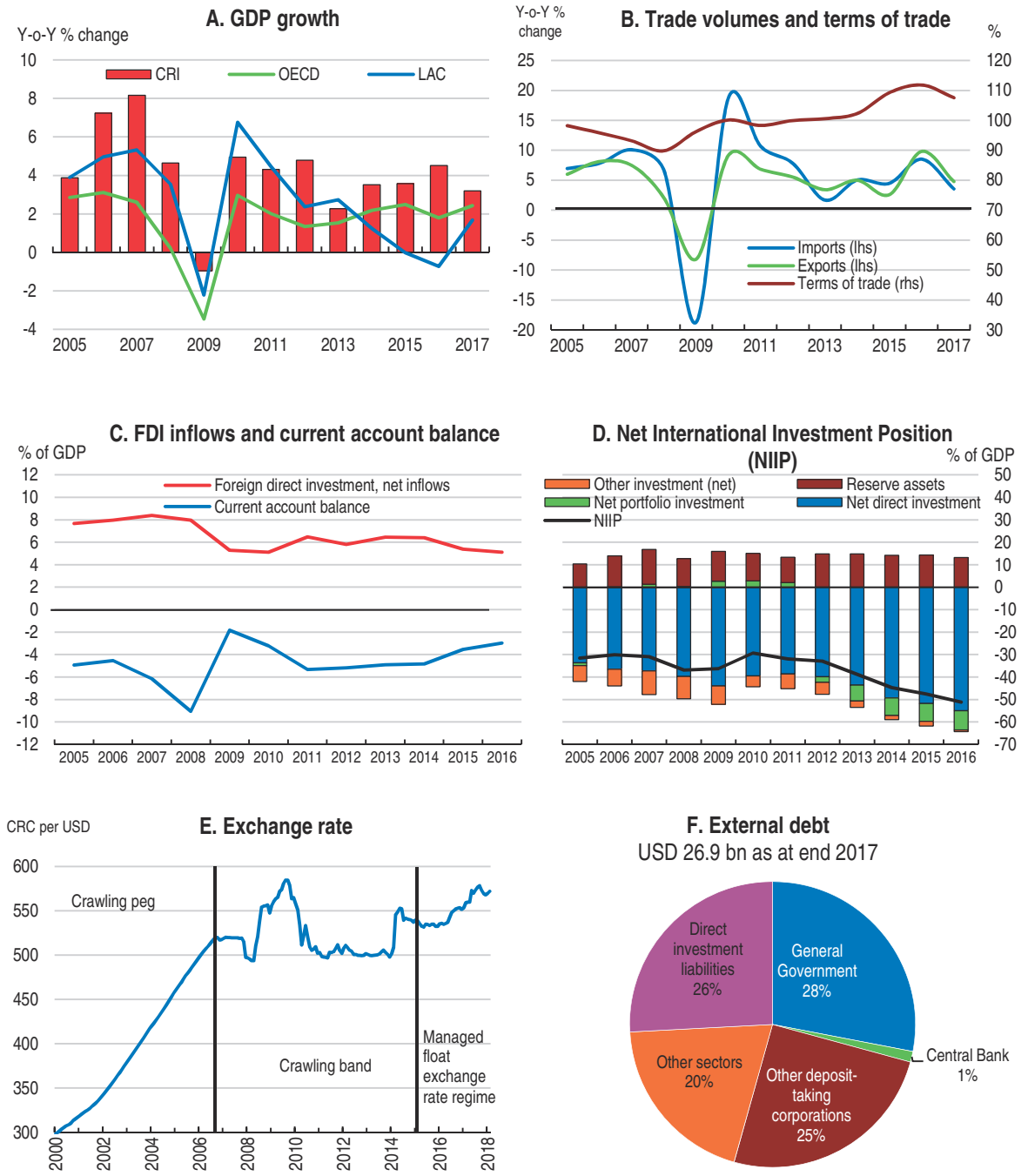
Growth will be broad-based

Growth remains solid at above 3%, supported by strong exports and inflows of foreign direct investment (Figure 9). Output was lower than expected in the second half of 2017 due to adverse weather conditions, including the tropical storm Nate. Nate caused major disruptions in agriculture production and construction, as well as widespread damage to transport infrastructure and damage to dwellings in Guanacaste. Private consumption growth has decelerated, owing to a deterioration in the terms of trade in 2017, weaker household credit growth and poor labour market conditions. In spite of strong output growth, labour participation has declined and informality has remained high. The unemployment rate has decreased from its peak of 10.3% in 2011 to 9.1%, but it is well above the pre-crisis low of 4.4% in 2007.

Strong growth in export volumes has contributed to the narrowing current account deficit, which continues to be entirely financed by FDI. Costa Rica enjoys a large trade surplus in services, due to the strong performance of tourism and professional services. Strong growth in exports is also associated with solid growth in imports, given that Costa Rica is well integrated into global value chains from a backward participation perspective (i.e. the share of foreign value added in Costa Rica's gross exports is significant) (Araújo and Linares, 2018). The negative net international investment position (NIIP), standing at just below 50% of GDP, does not present sustainability concerns, as FDI comprises more than 65% of total external liabilities and the share of short-term external debt is low (IMF, 2017a).

The central bank (BCCR) has intervened recurrently in the foreign exchange market to avoid large fluctuations of the colón (CRC). The BCCR's operations in the foreign exchange

Figure 9. **Recent macroeconomic developments**



Note: In Panel A, 2017 figures for OECD and LAC are forecasted; LAC refers to Argentina, Brazil, Chile, Colombia, Costa Rica and Mexico. In Panel F, "Direct Investment Liabilities" includes only inter-company lending; "General Government" comprises central government, local governments, and non-corporation decentralised institutions; "Other sectors" category comprises non-bank financial corporations, non-financial corporations, and households and non-profit institutions serving households subsectors, as defined by the IMF's External Debt Statistics: Guide for Compilers and Users.

Source: *OECD Economic Outlook Database* and Banco Central de Costa Rica.

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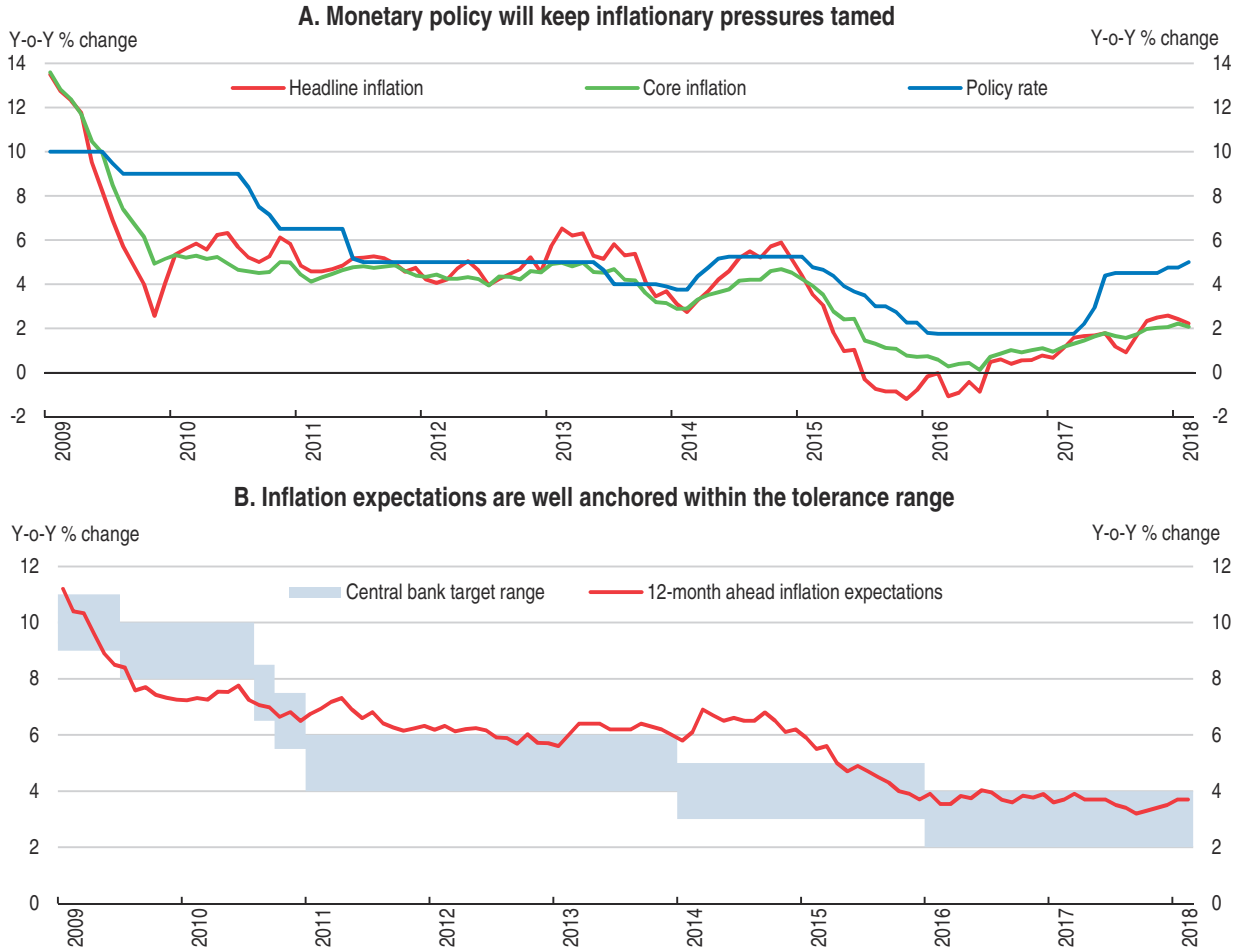
market to reduce excessive currency volatility not linked to fundamentals resulted in a decline in international reserves in the first half of 2017. As a precautionary measure, the central bank signed a credit for USD 1 billion with the Latin American Reserve Fund. By

March 9th 2018, international reserves totalled USD 8.01 billion, representing 13.2% GDP and about 6.4 months of imports. Although this is a comfortable level, international reserves have declined by 5.7% relative to the end of December 2016.

After a period of decelerating, and even negative inflation, core and headline inflation have started to pick up to the 2-4% target range established by the BCCR (Figure 10). However, inflation remains very low by historical standards. Inflation expectations remain well anchored. In response to a sharp depreciation of the colón, and concerns of spillovers into inflation, but also to discourage savings in USD and borrowing in the domestic currency, the central bank started to withdraw its accommodative stance and hiked the policy interest rate in several steps, from 1.75% in March 2017 to 4.75% in November 2017. On February 1st 2018, monetary policy authorities raised again the policy rate by 25 basis points, to contain inflation expectations, which are moving towards the upper tolerance range. As monetary transmission mechanisms are weak, the hikes in the policy rate have only a limited effect on economic performance (see below).

Figure 10. **Monetary policy and inflation developments**



Note: The shaded area in Panel B represents the inflation target range.
Source: Banco Central de Costa Rica.

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Going forward, growth will accelerate to close to potential as improving external demand supports exports, including tourism services and skill-intensive professional services, also helping to contain the current account deficit (Table 2). The continuation of a low inflation environment will protect consumers' purchasing power. Public investment is also expected to strengthen, owing to ongoing public infrastructure programmes such as the Moín Container Terminal and reconstruction related to hurricane Otto and tropical storm Nate. However, the construction sector is unlikely to return to its pre-crisis growth rates, contributing to the higher unemployment rates among the lower-skilled.

Table 2. **Macroeconomic indicators and projections**

	2014	2015	2016	2017	2018	2019
	Current prices CRC trillion	Percentage changes, volume (2012 prices)				
GDP at market prices	27.2	3.6	4.2	3.2	3.7	3.7
Private consumption	18.0	4.6	3.5	2.6	3.3	3.9
Government consumption	4.8	2.3	2.4	2.9	2.4	2.3
Gross fixed capital formation	5.3	3.1	3.8	-2.8	2.7	4.3
Final domestic demand	28.1	3.8	3.3	1.7	3.1	3.6
Stockbuilding[1]	- 0.2	0.3	0.0	0.8	0.2	0.0
Total domestic demand	27.9	4.2	3.5	2.5	3.4	3.7
Exports of goods and services	8.8	2.8	11.4	5.0	4.9	6.0
Imports of goods and services	9.5	4.4	8.7	3.1	4.2	5.7
Net exports[1]	- 0.7	-0.7	0.5	0.6	0.2	0.0
Memorandum items						
GDP deflator	_	3.7	1.8	2.0	2.1	3.0
Consumer price index	_	0.8	0.0	1.6	3.1	3.1
Core inflation index[2]	_	1.8	0.1	1.2	2.9	3.1
Unemployment rate (% of labour force)	_	9.6	9.5	9.1	9.3	9.2
Current account balance (% of GDP)	_	-3.5	-2.6	-3.0	-3.2	-3.4
Central government fiscal indicators[3]						
Headline balance (% of GDP)	_	-5.7	-5.2	-6.2	-6.2	-6.3
Primary balance (% of GDP)	_	-2.9	-2.4	-3.1	-2.4	-2.1
Gross financial debt (% of GDP)	_	41.0	45.1	49.0	53.1	_

1. Contributions to changes in real GDP, actual amount in the first column.
2. Consumer price index excluding food and energy.
3. Ministry of Finance (Hacienda) official estimates.

Source: OECD Economic Outlook Database and Ministerio de Hacienda.

The major domestic risk to the outlook relates to the persistently high fiscal deficit and rapidly growing public debt (see below). Failure to pass the comprehensive package of reforms that is needed to improve fiscal performance would result in further loss of confidence and increases in the risk premium for public debt, which would spread to the private sector, hurting investment and growth and potentially also external stability. On international markets, disorderly corrections in asset prices, deleveraging in China that creates financial turbulence, tighter or faster than expected monetary policy normalisation in developed economies could trigger capital outflows that would lead to currency depreciation (OECD, 2017b). This would in turn weaken even more Costa Rica's fiscal position and threaten financial stability, as the Costa Rican banking sector is heavily dollarized and a high share of dollar-denominated credits has been extended to unhedged borrowers. Also, currency depreciation would reduce households' purchasing power, thereby hampering

growth (Box 2). On the positive side, the BCCR's adequate foreign reserves are a safeguard against negative shocks and the authorities consider that the banks are adequately capitalised. Also, sovereign debt has a favourable currency composition, tilted towards local currency, although foreign-currency denominated debt is increasing.

A continuation of political gridlock in Congress and weak institutional capacity to implement necessary structural reforms would dampen growth and inclusion. Costa Rica's good economic performance rests on open borders and a friendly FDI regime. An international retreat from globalisation could endanger Costa Rica's successful growth model, weakening growth, investment, employment and jeopardising the continuous progress to a more sophisticated production structure.

Box 2. **Vulnerabilities and low probability events that could lead to major changes in the outlook**

Vulnerabilities	Possible outcome
Financial turbulence	A disorderly adjustment in financial markets, stemming from sudden asset valuation corrections, financial stress in large emerging markets such as China, a higher than expected rise in interest rates in the US or faster than expected monetary policy normalisation in developed economies could lead to large capital outflows and exchange rate depreciation, creating volatility and dampening household's purchasing power. It would also create tensions in the banking system, as private sector debt is highly dollarized and largely unhedged.
Retreat from cross-border integration	Costa Rica's good economic performance rests on its successful integration into the world economy. Possible modifications of existing trade deals, or a more general globalisation backlash would hurt jobs and the possibility of continuing to climb up the value added chain, and ultimately deterring its convergence towards higher living standards.
Environmental risks and natural disasters	Costa Rica is subject to seasonal yet unpredictable unfavourable weather events, such as El Niño and La Niña, which lowers agriculture and agro-food production. Earthquakes and volcanos can harm tourism and also damage infrastructure which could cause supply disruptions.

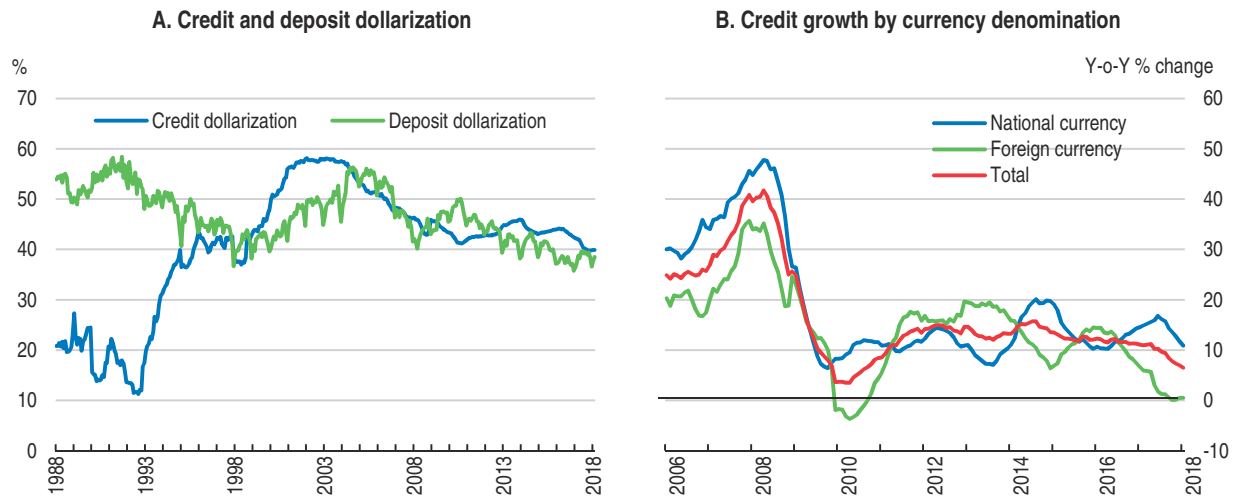
Strengthening the monetary policy framework and ensuring financial stability

Costa Rica has been moving towards an inflation-targeting framework since 2005, having officially adopted one on February 1st 2018. However, institutional shortcomings remain. The independence of monetary policy decisions should be strengthened by delinking the designation of the President of the central bank from the political cycle and by improving the clarity of dismissal rules and motives. A draft bill has been prepared which stipulates that the President of the Executive Board of the BCCR will be appointed a year after each new Government is sworn in, and also makes explicit the grounds for dismissal. Currently, the Minister of Finance of Costa Rica has a voting right in the BCCR's Board of Directors, an approach that is not aligned with international best practices. Going forward, the independence of the central bank could be strengthened further by not allowing Ministers or their representatives to vote in Board decisions.

The heavy dollarization of the monetary system impairs the ability of the central bank to control inflation and also endangers financial stability (OECD, 2017c). Deposit dollarization markedly increased in the aftermath of the 1980s balance of payments crisis, while credit dollarization grew in the 1990s as a result of a sharp reduction in reserve requirements on

dollar deposits. Credit dollarization was reinforced by the low exchange rate risk perceived by economic agents (households, firms, banks) stemming from the crawling peg regime and by the relatively low cost of dollar financing, especially after the 2008 global economic crisis. Credit dollarization peaked in the first part of the 2000s at close to 60%. Since then, dollarization has been on a downward trajectory. As of December 2017, around 40% of credits are denominated in foreign currencies, of which 70% have been extended to unhedged borrowers (Figure 11).

Figure 11. **Dollarization remains high**



Source: Banco Central de Costa Rica.

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Highly dollarized financial systems limit the effectiveness of monetary policy by weakening its transmission mechanism to market rates and by intensifying the impact of the exchange rate channel on the inflation rate. Financially-dollarized economies are also exposed to a vast number of risks, including more unstable demand for money, a greater propensity to suffer banking crises after a depreciation of the local currency, and slower and more volatile output growth (Levy Yeyati, 2006). Banks, firms and households could suffer severe financial losses in the event of a sharp real depreciation, which would drive up the costs of servicing foreign currency debt without necessarily raising debtors' income (Armas, Ize and Levy Yeyati, 2006; Ostry, Ghosh and Chamon, 2012).

Dollarization is a persistent phenomenon, even in countries that have implemented macroeconomic stabilisation policies and successfully reduced inflation (Ize and Levy Yeyati, 2005). Although there is no unique recipe for de-dollarization, international experience reveals that effective strategies involve credible monetary and exchange rate frameworks, low and stable inflation, and deep financial markets (Ben Naceur, Hosny and Hadjian, 2015).

Besides achieving a decline in inflation to low levels over the past decade, Costa Rica has implemented three kinds of measures to tackle high dollarization: i) increased flexibility of the exchange rate from 2006; ii) increased reserve requirements for dollar liabilities of financial intermediaries in 2012; and iii) enacted prudential regulations for dollar loans to unhedged borrowers in 2013 (differentiated capital-risk weights). In 2011 authorities initiated a gradual process to apply reserve requirements to external liabilities.

Reserve requirements have been broadened over time from 100% in 2013 to 125% in March 2015, applicable to foreign currency loans to unhedged borrowers. Since June 2016, risk weights for mortgage loans to unhedged borrowers have been defined as an increasing function of the loan-to-value ratio, for capital adequacy purposes. Technical assistance from the IMF to design additional measures to reduce dollarization is ongoing.

To counter the increased pressure to save in dollars and borrow in colones felt during the first half of 2017, the BCCR has re-opened the electronic platform "Central Directo", which allows the public to deposit their savings in national currency directly with the central bank. By offering a higher return than commercial banks on short term deposits, the BCCR seeks to accelerate the transmission of monetary policy. However, besides being asymmetric, this policy may have unintended consequences at it puts pressure on commercial banks' already low profitability. The ratio of credits in dollars to total credits in the financial system decreased 2.5 percentage points from December 2016 to December 2017 and it has been kept below 40% since August 2017, for the first time in 20 years. However, it is too soon to evaluate the individual impact of recent measures.

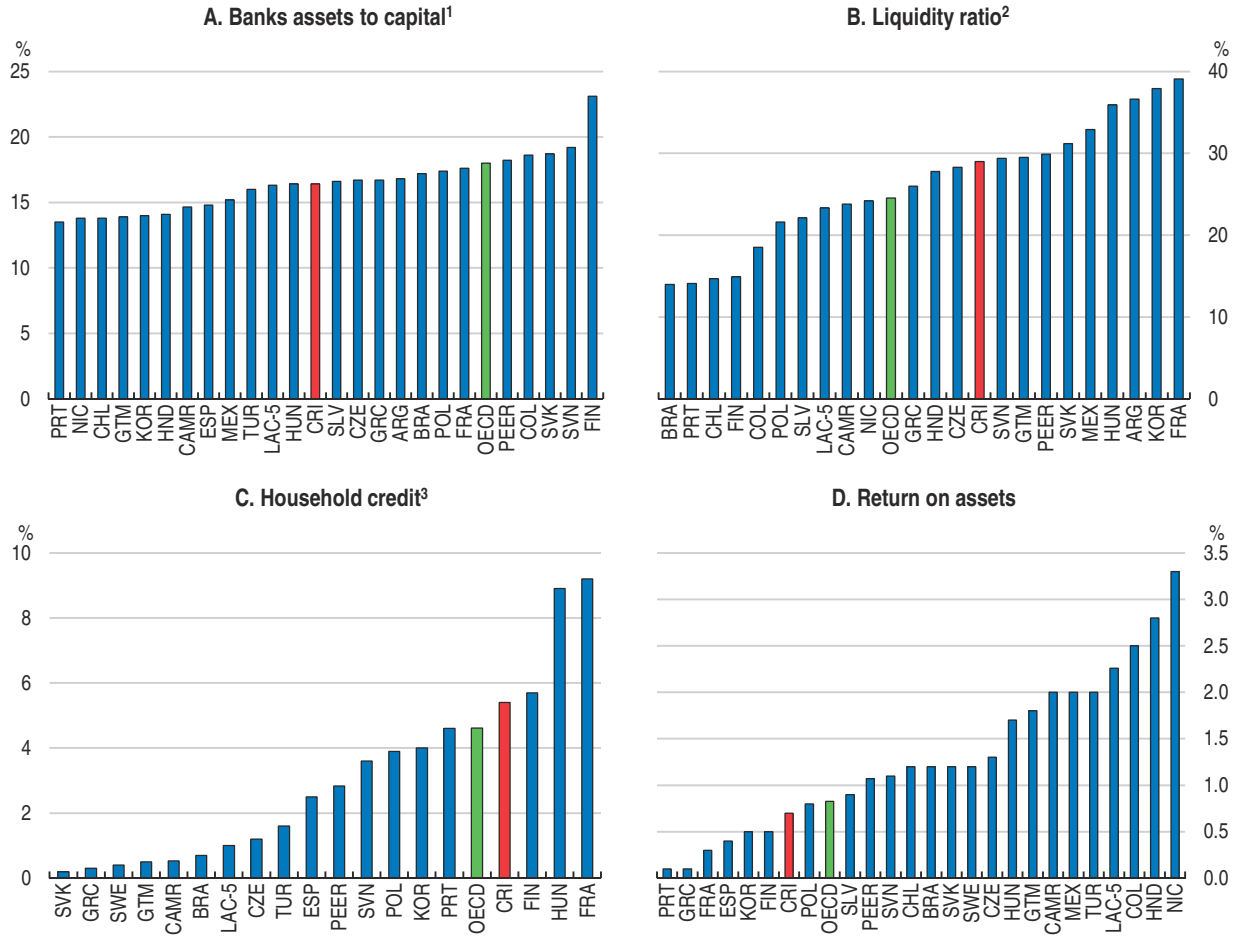
Strengthening the monetary policy framework will require further bringing down the level of dollarization. Lower inflation has played an important role in reducing dollarization but there are signs of hysteresis in the response of economic agents to more stable economic conditions (Mendez and Kikut, 2003; Esquivel Monge, 2008; Araújo and Montoya, 2018). Yet, the decline in the level of dollarization is associated with the move from the crawling peg to the crawling band late in 2006, indicating that the choice of foreign exchange regime plays a role in the level of dollarization (Araújo and Montoya, 2018; Figure 9, Panel E; Figure 11). This suggests in turn that the BCCR's precautionary interventions in the foreign exchange market may be creating overconfidence and moral hazard, preventing economic agents from internalising exchange rate fluctuations, hampering de-dollarization and contributing to sustained large currency mismatches and unhedged positions.

Costa Rica should therefore assess the possibility of gradually moving to a more floating exchange rate regime, which would not only improve the effectiveness of monetary policy but also allow the exchange rate to act as a shock absorber. For this policy to succeed, some pre-conditions need to be met. These include a more liquid and deeper foreign-exchange market and the use of derivative instruments to hedge against foreign exchange risk should also be encouraged. Authorities should press for the issuance of more liquid standardised derivative contracts to be traded in organised markets, instead of over the counter, as is done presently, as the latter involves large transactions (Brunner and Esquivel, 2010). Finally, to address currency mismatches authorities should keep and step up, if necessary, legal reserve requirements differentiated by currency for banks and could consider imposing an additional margin on loans to unhedged borrowers whose main source of income is in colones, also for consumer protection concerns. Additional prudential measures would ensure that the costs associated with financial dollarization are fully internalised in financial contracts.

Apart from dollarization, the banking sector is considered by the authorities and the IMF to be solid and holding enough buffers to face negative shocks. Banks appear to be well capitalised and the liquidity profile seems to be strong, even though reliance on non-deposit liabilities has increased (Figure 12).

The main issue with Costa Rica's banking sector is its lack of competition. The sector opened up to competition in 1995, when the state-owned banks' monopoly on current and

Figure 12. **Selected banking sector indicators, 2016**



1. Regulatory Tier1 capital to risk-weighted assets.
2. Liquid assets as a % of total assets.
3. Loans distributed to deposit-takers, as a % of total loans.

Note: 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 Argentina, Brazil, Chile, Colombia and Mexico.

Source: IMF Financial Soundness Indicators.

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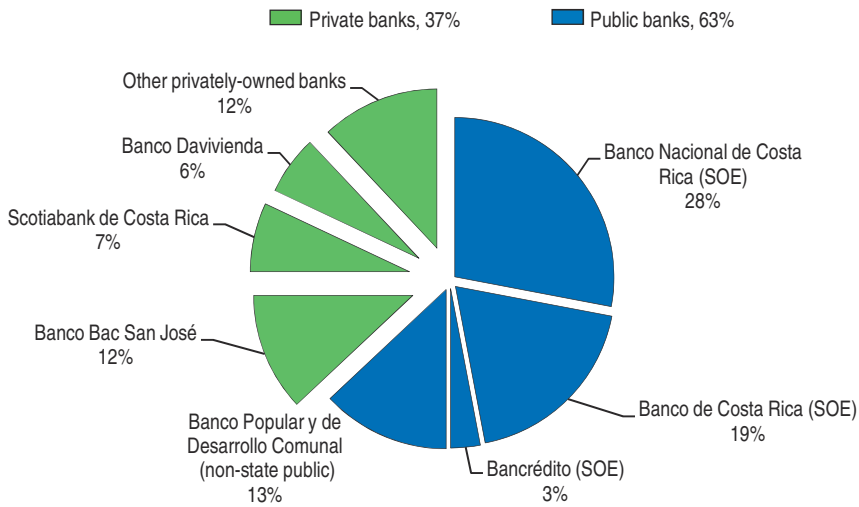
savings accounts was eliminated. However, state-owned banks still largely dominate the market. In 2017, the three state-owned banks and Banco Popular accounted for 63% of the total banking system assets and 60% of total banking system loans (Figure 13). Foreign-owned banks account for the lion's share of private banking activity, representing more than 90% of privately-held assets and loans extended by private banks in 2017 (a similar situation occurs with liabilities). The BCCR has mentioned in its Macroeconomic Programs as well as in research documents that the domestic banking sector shows reduced competition which has led to higher intermediation margins and a lack of responsiveness to movements of the monetary policy rate, impacting negatively on the country's economic performance. However, there is no specific BCCR policy related to competition in the financial sector (OECD, 2017d).

High intermediation margins by state-owned banks are a result of profit earmarking and regulatory burdens. Some operations of state-owned banks are motivated by public policy objectives, as stated in the National Development Plan (PND). This subjects them to

Figure 13. **State-owned enterprises are dominant in the banking sector**

Share of banking sector assets



Source: OECD, 2017d.

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directed lending to support policy goals such as affordable housing, agriculture and infrastructure, or SME development. State-owned banks are also required to contribute to a number of other state funds, with such contributions being expensed in the income statement (OECD, 2017d). Mandatory contributions to funds and taxes amount to 63% of state-owned banks' earnings (OECD, 2016c). Also, long-term deposits are taxed at 8% of the fees charged to the depositor. In addition, state-owned banks have been increasing their holdings of bonds issued by the Ministry of Finance (see below). These may be purchased either directly or through the market. State-owned banks are subject to closer control by inspectors, as they are considered too big to fail.

On the other hand, all public institutions are required by law to deposit their cash with one of the state-owned banks, ensuring easy access to funding for the latter. State-owned banks also enjoy an advantage relative to private banks as they have a guarantee against the totality of deposits (including those denominated in foreign currency). However, private banks can operate more flexibly both in their decision making, including in their capacity to select board members with relevant profiles, and the rules under which they operate (OECD, 2016c).

As a result of regulatory differences and business and corporate practices, profitability is lower in state-owned banks. Intermediation margins are lower for state-owned banks when compared to private banks. Moreover, while state-owned banks' intermediation margins show a declining trend, the opposite is occurring for private banks as a whole. However, state-owned banks' dominant position in the market results in the typical leader-follower market equilibrium, by which state-owned banks set the interest rate and private banks follow suit (Estado de la Nación, 2016).

Overall, levelling the playing field between private and state-owned banks would spur competition in the banking sector and also contribute to increased monetary policy effectiveness. It would also be a pre-condition for possible future bank privatisation. Although there is no political appetite towards privatisation and a social consensus seems to exist to maintain the status-quo, Costa Rica has embarked on administrative reforms to

increase the efficiency of SOEs and is currently working towards improving the governance of state-owned enterprises (OECD, 2016c).

Opening entry to FinTech start-ups and innovation would also be a way to boost competition and reduce the high costs of financial intermediation. Technology-driven innovation in financial services has the potential to increase competition in the financial sector, improve access to credit, financial inclusion and reduce the cost of cross-border transactions. Several governments have therefore implemented, or are considering options for, FinTech regulatory frameworks. By providing greater certainty to innovating businesses and allowing space for experimentation, these aim to facilitate the development of FinTech while ensuring consumer protection and financial stability. For example, the UK launched a regulatory sandbox in May 2016 to provide a testing ground for new FinTech services, allowing for innovation under equal conditions for all players, while containing any consequences of failure. Several other governments have since created regulatory sandboxes, such as Singapore and Hong Kong. Mexico has also recently approved a bill to create a regulatory framework for FinTech and the European Commission is considering regulatory options as well. In Costa Rica, to foster competition in the financial sector, where high transactions costs prevail, the Central Bank has updated its "Regulations for the Payments System" so that FinTech companies can register with and use the "National System of Electronic Payments", managed by the central bank, and widely used by the population. Building on this positive step, to further facilitate the development of FinTech the Costa Rican authorities should explore options and implement an appropriate regulatory framework.

The 2016 OECD Economic Assessment made a number of recommendations to align banking practices and regulation with international best practices. Costa Rica should also create a deposit insurance scheme covering all banks in order to ensure competition and level the playing field between state-owned banks, which enjoy an unlimited state guarantee, and private banks, which do not. The OECD has also recommended designing a regulatory framework to deal with bank resolution, as currently there is none. The BCCR has prepared a bill that would introduce simultaneously a deposit-insurance fund for banks and non-financial entities (private and public) currently supervised by SUGEF (the banking sector superintendent) or that may come under its supervision in the future and a bank resolution mechanism. Furthermore, CONASSIF (the governing body of the financial sector supervisors) has established a calendar to adopt Basel III principles, which should be approved by the first quarter of 2019, although some of them will be implemented in a more gradual manner.

Stress tests reported by the IMF show that banks' capital ratios would remain adequate in most situations, apart from a few small banks when exposed to extreme scenarios (IMF, 2017a). The OECD has recommended that regulatory authorities publish regularly the key results of the stress tests carried out by SUGEF, the banking superintendent, as is done in other jurisdictions to improve transparency and bolster credibility. The authorities think that better financial literacy is needed so that the public can grasp appropriately the results of the tests. Hence, they have developed an action plan leading to the publication of aggregate stress test results undertaken by SUGEF and BCCR.

This plan, which also includes actions to improve financial literacy of the media and general public as well as capacity building for supervised entities, is a step in the right direction. Following its successful implementation, authorities should consider publishing individual stress test results. This would strengthen public confidence of the soundness of the financial system and induce corrective measures early on. Research finds that the

disclosure of bank stress tests contributes to financial stability, although disclosure should be done carefully, to avoid possible inefficiencies at the level of individual banks (Petrella and Resti, 2013; Goldstein and Sapra, 2014).

The cessation of intermediation activities at one public bank and investigations into the business practices of another, highlight weaknesses in banking regulation and in the corporate governance of public banks. In September 2016 SUGEF identified a number of financial, risk management and corporate governance weaknesses in Bancrédito (Banco Crédito Agrícola de Cartago, a small state-owned commercial bank whose assets were worth about 2% of GDP in March 2017). The action plans proposed by the bank were deemed insufficient to correct the identified weaknesses. As a result, SUGEF requested a revision of the activities and deadlines proposed by the bank, and a revised plan was approved in April 2017. Financial assistance of CRC 2 billion was also agreed with Banco Nacional de Costa Rica, another state-owned bank, as an advance on expected revenue from the collection of airport exit taxes, paid directly by airlines to Bancrédito. During the first quarter of 2017 Bancrédito was unable to reverse the non-renewal of institutional investments, which increased its liquidity risk. The government encouraged other state-owned banks to take over the portfolio of loans of Bancrédito, which could potentially have spread losses to other banks. Bancrédito's portfolio acquisition did not occur to the extent intended by the government as state-owned banks applied their own risk assessment criteria, which discouraged acquisition. In May, the Government Council decided to cease any financial intermediation activities carried out by Bancrédito until the end of 2017, and to reconvert the bank into a development bank. It also agreed to inject CRC 118 billion, equivalent to about 0.4% of GDP, to address the bank's liquidity needs, potentially increasing fiscal costs. In December 2017, confronted with the deterioration of liquidity, profitability and asset quality indicators, CONASSIF decided for direct intervention in Bancrédito. By mid-2018, a final decision about the future of Bancrédito will be issued. Afterwards, the losses on Bancrédito's portfolio will be known, as well as whether the Ministry of Finance will recover the CRC 118 billion loan extended to the bank. The term of the intervention is six months, at which time the controller of the intervention must inform CONASSIF about the financial viability of this bank.

The draft legislation being prepared introduces new forms of bank resolution to the current alternatives of liquidation or voluntary purchase by another bank, including the transfer of assets and liabilities to a bridge entity or to a special purpose vehicle or trust; internal recapitalisation; or any other resolution mechanism proposed by the administrator of the resolution and approved by the Resolution Authority. It should be approved swiftly.

Table 3. **Past OECD recommendations to enhance monetary credibility and strengthen financial stability**

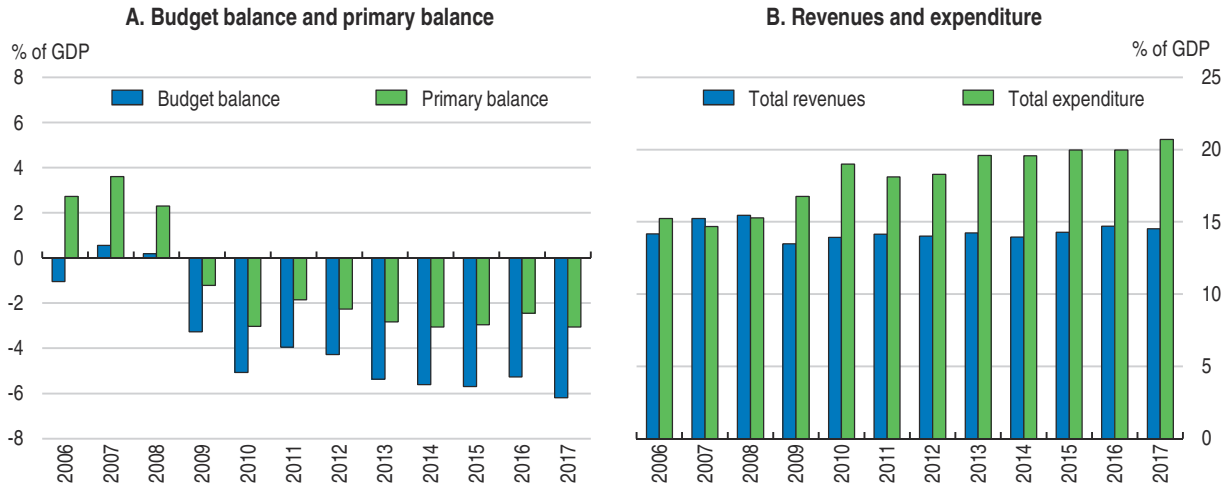
Recommendations in 2016 Economic Assessment	Actions taken
Strengthen the effectiveness of monetary policy to achieve price stability with appropriate institutional reforms, in particular by delinking the designation of the President of the Central Bank from the political cycle, and clarifying motives for dismissal.	A draft bill has been prepared by the BCCR but has not yet been submitted to the Legislative Assembly.
Establish a deposit-insurance scheme covering all banks to help level the playing field in the banking sector, accelerate the adoption of Basel III principles, and release publicly the results of banks' stress tests.	A deposit insurance scheme and bank resolution mechanism has been drafted with participation of the BCCR and the regulatory authority overseeing the financial system. The authorities have prepared a phased plan to progressively disclose aggregate results of stress tests. Adoption of Basel III principles: authorities are on track with a calendar that foresees implementation of most principles by the first quarter of 2019.

Policies to restore fiscal sustainability

The fiscal outlook has deteriorated

Fiscal sustainability has been a long-standing issue in Costa Rica but its recent deterioration requires urgent action. The country has run negative budget and primary balances for the past nine years, which is unprecedented in Costa Rica's recent history (Figure 14, Panel A). The government implemented counter-cyclical fiscal policy in response to the global financial crisis, consisting of increases in the compensation of public sector employees and current transfers, especially to the Costa Rican Social Security Agency (CCSS, which is the largest decentralised autonomous entity in the government), both of which are considered rigid components of expenditure, and not easily reversed. Recent efforts to increase tax collection have not reduced the budget deficit due to the extensive use of earmarking and legal spending requirements (Figure 14, Panel B). In 2017, the fiscal deficit deteriorated to 6.2% of GDP, the worst performance in three decades, and the primary deficit worsened to 3.1% of GDP, from 2.4% in 2016.

Figure 14. **Budgetary imbalances are mounting**



Note: Data refer to the central government only.
Source: Ministerio de Hacienda.

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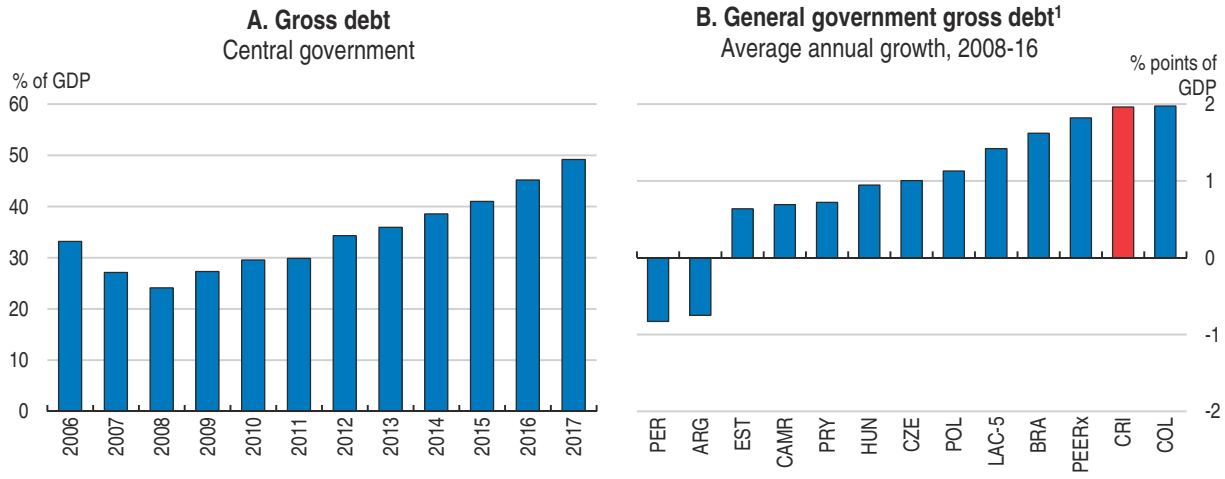
Consecutive years of budgetary deficits increased the interest payment bill, which now accounts for almost half of the current deficit (3% of GDP). As a result, while local government debt has been kept stable at very low levels, central government debt has soared, from 24% of GDP in 2008 to 49% in 2017 (Figure 15, Panel A). Total public sector debt, consisting of the consolidated sum of general government plus financial and non-financial state-owned enterprises was already over 60% of GDP in 2016. State-owned enterprises have quadrupled their leverage in the past 10 years. As a share of tax revenue, total public debt stock increased to about 300%, illustrating an increasing pressure of the public debt stock on budgetary decisions (Figure 16, Panel A).

Unfortunately, Costa Rica has not taken advantage of favourable conditions to revert its fiscal situation. In spite of robust growth and an extended period of low interest rates, political fragmentation has prevented Congress from approving the various draft bills presented by the Government that would allow the budget deficit to be reined in. As a

Figure 15. **Public debt is growing rapidly**



1. Includes only central government debt for Costa Rica.

Note: LAC-5 refers to the average value of Argentina, Brazil, Chile, Colombia and Mexico. CAMR refers to the average value of Guatemala, Honduras, Nicaragua, Panama, and El Salvador. PEERx refers to the average value of Czech Republic, Slovak Republic, Estonia, Latvia, Hungary, Slovenia, Poland and Turkey.

Source: Ministerio de Hacienda de Costa Rica; IMF World Economic Outlook database.

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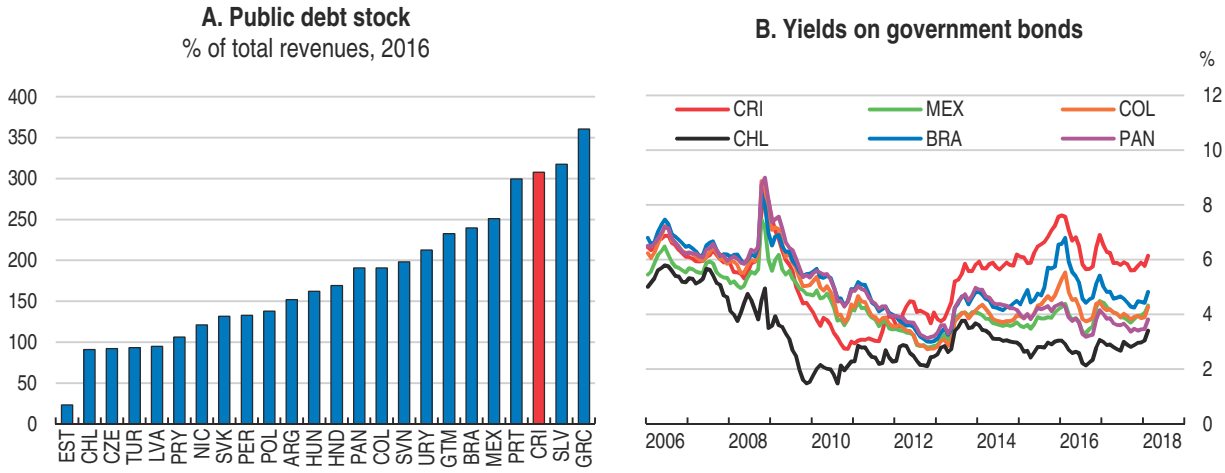
Figure 16. **Fiscal performance has deteriorated**



Note: Data refer to central government.

Source: IMF World Economic Outlook Database; Thomson Reuters Datastream.

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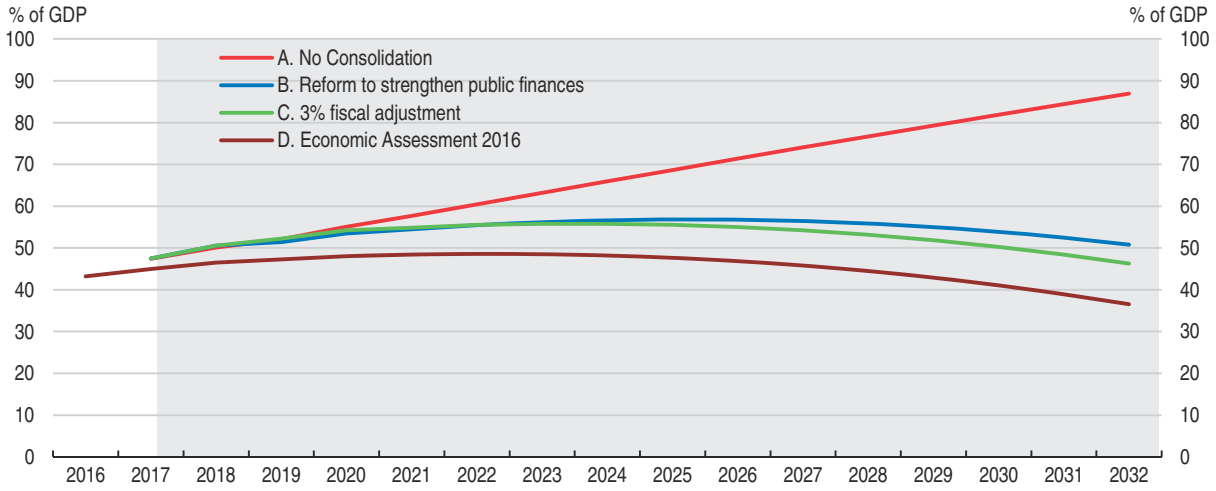
result, major rating agencies have classified Costa Rica's sovereign bonds as below investment grade and its external sovereign bond yields are among the highest in Latin America (Figure 16, Panel B).

With a gridlocked Congress, authorities were only able to enact a number of piecemeal reforms, including measures to contain the public wage bill growth, a reduction in pension expenditures and transfers to decentralised institutions, as well as improving the effectiveness of tax revenue collection, by fighting tax evasion and strengthening the tax administration, which has led to an increase in the number of taxpayers (see Chapter 1). These measures contributed to a reduction of about 0.5 and 0.3 percentage points of GDP in the primary and

headline deficits in 2016, respectively. These reforms are welcome, albeit it is clear that they are insufficient to put debt on a sustainable trajectory as revenue collection is not able to meet the rise in current expenditures (Figure 17: A. No Consolidation).

Figure 17. **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 Públicas 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. For more details, see Box 1.1.
Source: OECD calculations based on data from Ministerio de Hacienda.

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The deterioration of fiscal performance in 2017 is explained by constitutional court rulings mandating stricter enforcement of earmarking provisions for social and education expenditure. As a result, while tax revenues increased by 5.3%, spending increased by 9.1%, one of the largest increases since 2009. In particular, the wage bill and transfers to the institutionally-decentralised sector are rising fast, and so are capital expenditures, following many years of underinvestment in infrastructure, which is now choking competitiveness and harming sustainable growth (see below).

Without efforts to raise additional tax revenues and cut spending, the gap will be financed by issuing additional debt, which, under current trends, is projected to reach 65% of GDP by 2022, a level that is deemed excessive for an emerging economy such as Costa Rica with limited tax collection capacity. OECD analysis suggests that the threshold for debt to start exerting negative effects on the economy could be as low as 30 to 50% of GDP for emerging economies and therefore recommends prudent debt targets that are on average 15 percentage points lower than debt thresholds (OECD, 2015a). A prolonged weak fiscal position will leave very limited room for manoeuvre to deal with the consequences of external negative macroeconomic shocks or natural disasters. Costa Rica will also have to pay an even higher risk premium for investors to hold its debt, crowding out business investment (Demirci, Huang and Sialm, 2017).

Weak fiscal performance could hurt Costa Rica's successful development model. First, FDI inflows have been shown to be highly sensitive to domestic conditions (Koepke, 2015;

Eichengreen, Gupta and Masetti, 2017). Second, rising debt service payments will divert resources from investment in education, health, infrastructure and security. Costa Rica needs to increase growth-friendly spending, such as infrastructure, innovation, health care, and child care, while dealing adequately with the consequences of population ageing. According to UN projections, by 2050 the share of the population over 60 will more than double to over 30% (from 12.8% in 2015) and the share of population over 80 will reach 8% (less than 2% in 2015), which will put additional pressure on Costa Rica's near-universal health care and pension systems. Difficulties in financing large and increasing debt would also force Costa Rica to make damaging cuts to, or even freeze, the welfare system, potentially increasing poverty, inequality and ultimately social instability. It would also mean postponing again the much needed upgrade in public infrastructure (Chapter 2).

A comprehensive fiscal package comprising measures on both the expenditure as well as the revenue side is urgently needed to overhaul the ongoing deterioration of Costa Rica's fiscal position and stabilise the debt-to-GDP ratio. Growth alone will not stabilise the debt path, and each year of inaction adds to the level of fiscal consolidation that will be necessary to do so. In the 2016 Economic Assessment, the OECD recommended that the authorities adopt measures to curb expenditure growth and improve spending efficiency, increase tax revenues, and introduce a medium-term fiscal framework with a clear and verifiable expenditure rule. All these measures should be part of a single policy package to put public finances on track and ensure fiscal sustainability. At that time, a phased fiscal consolidation process of 3.5% of GDP would have allowed central government debt to stabilise at around 50% GDP by 2023 and abate thereafter (Figure 17: D. Economic Assessment 2016). Going forward, reducing the debt-to-GDP ratio to a prudent level (OECD, 2015a), will require additional consolidation measures in the medium term.

Under current plans, the measures to increase revenue and the fiscal rule put forward in the current draft bill to strengthen public finances (*Ley de Fortalecimiento de las Finanzas Públicas*) are worth 1.92% of GDP. This bill comprises i) a bill to transform the current sales tax into a fully-fledged value-added tax (VAT), also including the enlargement of the tax base by removing 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 (Table 4). Rapid deterioration of public finances requires urgent action and the bill should be implemented already in 2018, in which case central government debt would increase until 2028, reaching 56% of GDP and slowly abating thereafter (Figure 17: B. Reform to strengthen public finances). Recently, the Legislative Assembly approved a fast-track approval procedure for this bill of law.

An additional consolidation effort of 1% of GDP in a third consecutive year, which would result in a total fiscal effort of almost 3 percentage points of GDP over 3 years, could stabilise debt four years earlier to below 50% of GDP (Figure 17: C. 3% fiscal adjustment). This strategy seems more appropriate to Costa Rica given the current context of worsening debt dynamics, 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.

There is ample space to increase tax revenue collection, by pursuing current efforts to fight tax avoidance and evasion, increase VAT and personal income tax (PIT) rates, and reduce informality via greater compliance enforcement. On the spending side, improving the efficiency of spending, by reducing high public sector fragmentation and revenue earmarking, and better controlling costs associated with public sector remuneration would produce long-lasting results. However, such a public sector reform would require time to implement. Against this backdrop, the most effective strategy in the short term would be to cut mandated expenditures by 1.08% of GDP (Table 4). One way of achieving this would be to adopt a broader definition of education services and classify all spending on early childhood education and care, the National Training Institute (INA) – providing vocational training – and civil service training, under constitutionally-mandated spending on education (equivalent to 8% of GDP).

Table 4. **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**	**1.60**
Compensation of public sector workers	0.02	0.02
Fiscal Rule	0.50	0.50
Cut mandated spending	-	1.08
Total	**1.92**	**3.00**

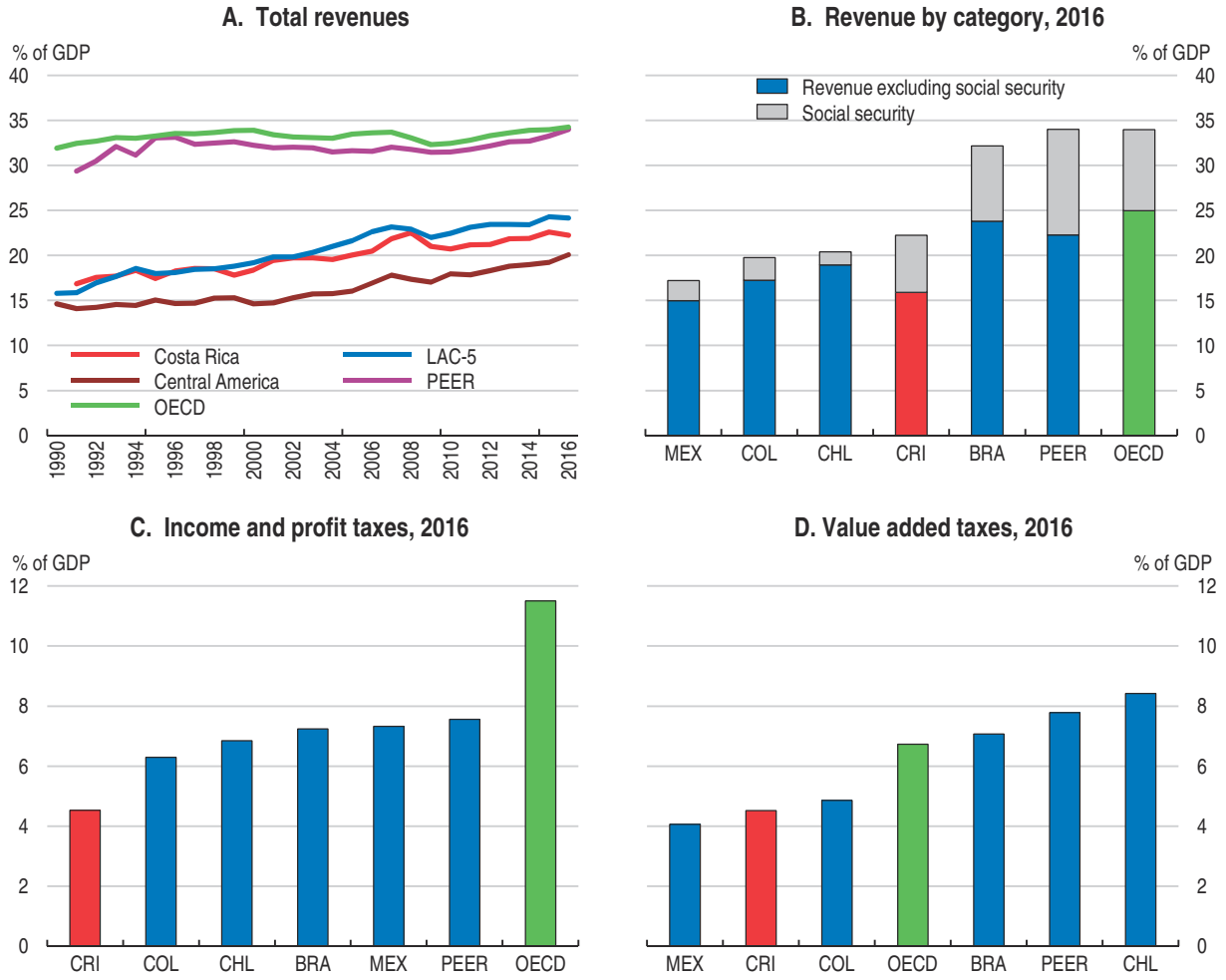
Source: OECD calculations based on data from Ministerio de Hacienda.

Raising tax revenues and enhancing the redistributive power of tax policy

Tax revenue is close to the Latin American average but substantially lower than in OECD countries (Figure 18, Panel A). However, the tax mix differs substantially from both of these regions. The fiscal system is overly reliant on social security contributions (SSCs) paid by the formal sector (Figure 18, Panel B). Contributions of income taxes and VAT are low because of tax evasion, a narrow tax base and low marginal tax rates (Figure 18, Panels C and D). For instance, PIT raises little revenue as the tax-free threshold is around twice the average wage in the private sector – much higher than in most OECD countries (see Chapter 1).

To raise additional revenue, the Executive had submitted to Congress 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 had also submitted a VAT tax reform, intending to increase the tax rate from 13% to 15% and enlarge the tax base by extending VAT collection to all service sectors. This measure would allow for a significant increase in revenue collection and would also improve tax neutrality (OECD, 2017e). Political gridlock has not allowed these reforms to go through. However, the current tax reform proposal that forms part of the comprehensive fiscal sustainability package (*Ley de*

Figure 18. **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).

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Fortalecimiento de las Finanzas Públicas) 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 instead of the originally planned 2.03% of GDP (see Chapter 1).

Once the debt-to-GDP ratio is stabilised, Costa Rica could gradually move away from excessive reliance on SSCs which discourages job formalisation, thereby further enlarging the tax base. While this would be a growth- and equity-friendly policy, the uncertainty generated by such changes in tax revenues suggests it should not be pursued at the current juncture.

The potential to collect additional tax revenues by fighting tax evasion and avoidance is large, in particular within the corporate income tax (CIT) and the sales tax (OECD, 2017e). This is an area where there has been significant progress. Recent reforms that set

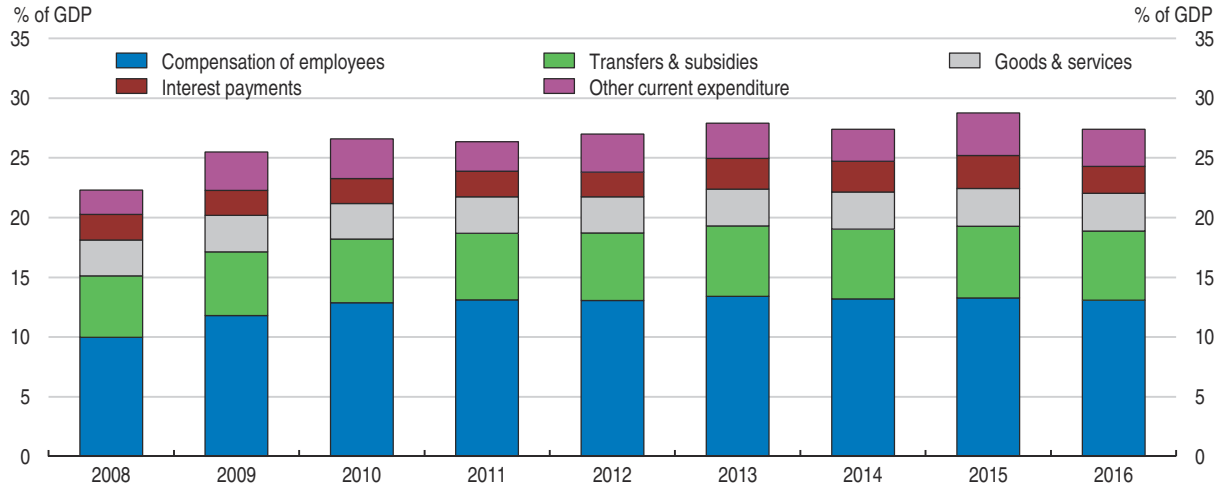
obligations on information disclosure and establish a tax on legal entities and domestic subsidiaries enrolled on the National Registry, and mandating the automatic liquidation of those that fail to pay the tax for three consecutive years, are a step in the right direction. Modernising tax administration with electronic detection of tax fraud, strengthening the tax authority's auditing capacities, and enhancing the co-operation between the social security and tax administrations, including via information sharing could also help reduce evasion, as firms tend to understate their labour costs to the social security system and overstate them to the tax administration (OECD, 2017e). Also, the phased introduction of electronic invoicing, starting with large enterprises on a voluntary basis in 2017 and extended to the entire health sector in 2018 and made compulsory, is a step in the right direction to further curb tax evasion and will raise additional tax revenue.

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

Costa Rica's public-sector wage bill as a share of tax revenues is higher than in most OECD countries, even though its public employment share is among the lowest, and public-sector wages account for a large share of total government expenditure (Figures 19 and 20). Besides creating distortions in the labour market and reducing employee mobility, increases in the public sector wage bill have also contributed to recent rises in inequality (González Pandiella and Gabriel, 2017). The Executive submitted to Congress a bill aimed at reforming public sector employment, establishing a new performance management system and limiting pay increases for the whole public sector. However, this was opposed by trade unions and has also been withdrawn.

Figure 19. **Compensation of public-sector employees accounts for an increasing share of spending**

General government; decomposition of current expenditure



Source: IMF Government Finance Statistics database.

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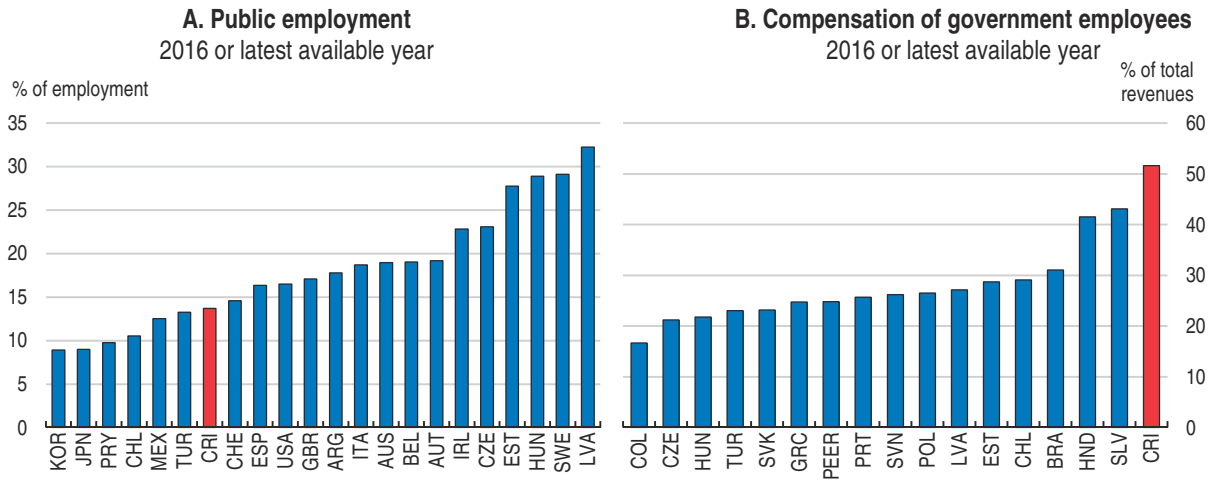
Another problem is the budget's excessive rigidity, due to mandated transfers to a number of highly fragmented decentralised public sector institutions, and extremely high revenue earmarking, severely constraining the government's public finance options. The most important mandated spending and transfers are the constitutional mandate to allocate 8% of GDP to education spending, 6% of tax revenues paid to the judicial branch, 7% of

Figure 20. **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.

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income tax collection paid to the National Child Welfare Agency (PANI) and 593 000 base salaries transferred to FODESAF (Fund for Social Development and Family Allowances). In 2018, more than 60% of central government expenditure is mandated by constitutional and other legal provisions which, added up to debt servicing, leaves only about 5% of the Central Government's budget for discretionary spending (Table 5).

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 and IDB, 2014). Although 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, 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).

The excessive use of earmarking in Costa Rica is also constraining fiscal consolidation, ultimately threatening macroeconomic stability, as an increase in tax revenues translates into increased transfers to earmarked programmes irrespective of whether they need additional funding or whether a cost-benefit analysis on the use of public money is undertaken. The OECD Principles of Good Budgetary Governance, in its Principle 7, stresses that earmarking should be kept to a minimum (see Chapter 1).

The "Ley Caja Única" (Law 9371), approved by the Legislative Assembly on August 2016, allows the government to reclaim mandated transfers to autonomous institutions that have

not been spent and is a step in the right direction. These funds should be used to abate debt. However, in August 2017 a bill was presented to the Legislative Assembly stipulating that all new public spending projects will have to designate the respective financing source, potentially increasing earmarking. In the near term this decision will help rein in the deficit. However, reducing budgetary rigidities to allocate public funds according to changing needs and to enhance the contribution of fiscal policy to stabilise the economy should be an integral part of a future fiscal reform. As a response, the government presented a bill of law to the Legislative Assembly in November 2017 (bill of law 20.595), aimed at reducing earmarking expenditures.

Table 5. **Costa Rica's central government budget is excessively rigid**

	2018
Total budget expenditure	**100.0%**
Constitutional and legal mandates	44.0%
Debt service, public sector remuneration and social security contributions	51.5%
Other	4.5%

Note: Constitutional and legal mandates include remunerations of workers in the Ministry of Education and civil servants working in the Judicial branch. Debt service includes principal repayments.
Source: OECD calculations based on Ministerio de Hacienda data.

The bill to strengthen public finances (*Ley de Fortalecimiento de las Finanzas Públicas*) would significantly contribute to stabilising the debt-to-GDP ratio and should be approved swiftly (Figure 17: B. Reform to strengthen public finances). Costa Rica is making considerable progress in curbing tax evasion and avoidance. However, there is scope to raise additional revenue while making the tax system more equitable and earlier versions of the VAT and PIT bills should be reconsidered. Raising additional tax revenue will only contribute to solving fiscal imbalances if Costa Rican authorities enact reforms to reduce public sector fragmentation, mandated spending and revenue earmarking. These measures will restore the Ministry of Finance's control of the budgetary process and spending allocation, thereby setting the basis for raising spending efficiency, to allocate resources according to evolving priorities, and for the budget to support growth and equity more effectively.

High public sector fragmentation into numerous deconcentrated and decentralised institutions also hinders the Ministry of Finance's ability to take control of the budget and allocate spending according to identified priorities and changing needs. Only half of the general government budget is under the budget process headed by the Ministry of Finance (OECD 2017f). The existence of a large institutionally decentralised sector is also not associated with strong co-operation mechanisms neither between the different institutions of the decentralised sector, nor with the relevant Ministries, which significantly dampens the effectiveness and quality of public services. To date, spending by deconcentrated and decentralised institutions and public corporations has been approved by the Office of the Comptroller General of the Republic, but mostly from a legal standpoint (see below). In addition, decentralised institutions' funding schemes are extremely rigid and funds cannot be re-allocated between the different institutions and the spending areas they represent 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. In 2017, a study carried out by the Ministry of Planning and Economic Policy (*Ministerio de Planificación Nacional y Política Económica* – MIDEPLAN) identified 22 non-functional institutions that 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 as part of a strategy to gradually rationalise the institutionally decentralised sector. The bill should be approved swiftly but further efforts to identify non-functional institutions and specify the responsibilities of each government body, in order to avoid loopholes and duplication of responsibilities, enhance accountability, co-ordination and steering, should also proceed.

Reducing earmarking and public sector fragmentation will restore the Ministry of Finance's control of the budgetary process and spending allocation, thereby setting the basis for raising spending efficiency, to allocate resources according to evolving priorities, and for the budget to support growth and equity more effectively. Additionally, in February 2018 a law that strengthens the Ministry of Finance's control over the budgeting process, by including more than 50 decentralised institutions in the National Budget, was approved by Congress. In the past, these entities submitted their budget to the Comptroller's Office, which only checked its compliance to the legal framework.

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 the state-owned insurance company (where insurances also benefit from a state guarantee) hold large amounts of public debt in their portfolios. As part of the process of strengthening Costa Rica's budgetary policy framework, authorities should identify all sources of exposure to fiscal risks and assess their potential future implications.

Even though the central government debt as a share of GDP soared by around 10 percentage points between 2013 and 2016, interest payments have remained stable until recently. This reflected the pass-through of domestic monetary loosening but also the use of floating rates and dollar-denominated bonds. Since 2012, the National Treasury has managed to increase the average maturity of sovereign debt from 9 to 15 years. However, this is also a source of medium-term vulnerability, especially in the current context of deterioration in public finances and sovereign rating, and domestic monetary policy tightening, which contributed to an increase in interest payments in 2017. Debt servicing costs could be reduced further by improving institutional quality and adopting more modern management tools. Policy options include introducing a fully-fledged multi-year expenditure framework and a fiscal council, and a focus on developing the local currency market. Authorities should also modernise debt management by merging the two debt management agencies, reducing the number of benchmark securities and improving communication with markets. Additionally, a high-level Chief Economist in the Ministry of Finance could be appointed to advise on the government's economic policies and improve communication with international investors. These reforms would bolster credibility and hence demonstrate the willingness of Costa Rica's authorities to tackle worrying fiscal trends.

Table 6. **Past OECD recommendations to restore fiscal sustainability**

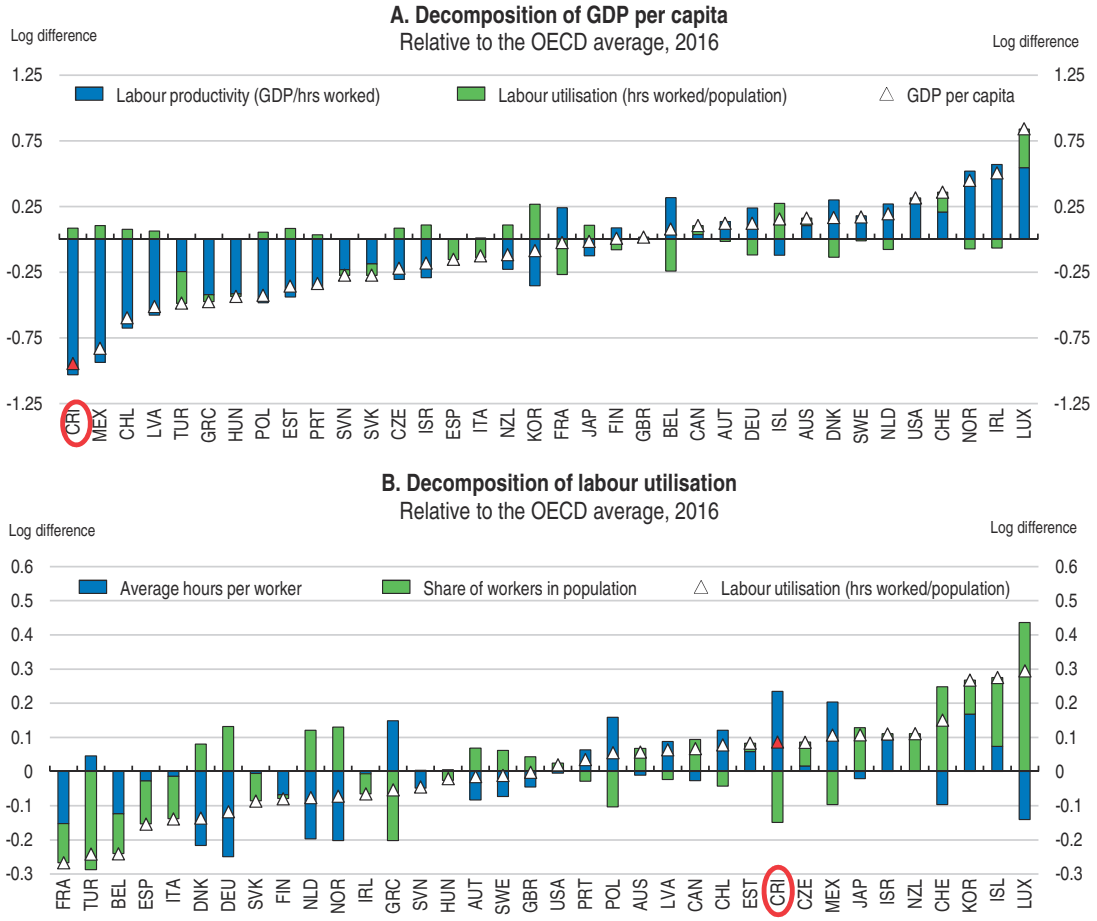
Recommendations in 2016 Economic Assessment	Actions taken
Cut the central government deficit by 2% of GDP in 2016-17 approving and implementing the proposed tax reform, combatting tax evasion, eliminating tax exemptions and curbing expenditure growth.	The government has implemented a number of reforms aimed at reducing tax evasion: the introduction of electronic invoicing for large taxpayers, tightening the criteria to criminalise smuggling activities, enlarging the population of firms that pay corporate tax to all corporations in the National Registry, and easing the access of the tax administration to tax payer information filed by financial institutions. A reform of the pension regime has eliminated automatic increases, links pension adjustment to price developments, has increased contribution rates for special pension regimes, introduced tax on pensions exceeding 10 minimum wages and reduces the inheritance of pension benefits on some special pension regimes. The law on governmental efficiency ("Caja Única") adopted in 2017 will allow the government to reclaim mandated transfers to autonomous institutions that were not spent. These funds will have to be used to abate debt.
Introduce a medium-term fiscal framework with a clear and verifiable expenditure rule.	A bill has been submitted to the Legislative Assembly.
Improve spending efficiency by strengthening the authority of the Ministry of Finance to control overall public-sector expenditure and introducing performance-based budgeting.	A bill has been submitted to the Legislative Assembly stipulating that all new projects with an impact on expenditures need to make explicit their source of financing. It is not clear whether this resolution will impact on automatic transfers to autonomous public institutions, or constitutionally mandated expenditure. Also, this decision has the potential to increase budgetary rigidity. A bill to introduce performance-based budgeting has been submitted to the Legislative Assembly.

Structural policies to boost productivity and inclusion

Costa Rica faces the twin challenges of boosting productivity growth and inclusion. Since the mid-2000s, Costa Rica's productivity performance has gained momentum, and is slowly converging towards OECD countries after many years of stagnation (Figure 8). This pick up in productivity has been broad based, with most industries experiencing a structural break towards higher growth rates (Escobar and Meehan, 2018). However, a large GDP per capita gap persists, driven by labour productivity that is 36% of the OECD average (Figure 8; Figure 21, Panel A). In addition, not everyone has benefited from robust output growth (Estado de la Nación 2017). While labour utilisation is above the OECD average, this reflects long working hours for those with jobs (Figure 21, Panel B). Employment rates are below average due to low labour market participation and high unemployment, particularly among women and youth (Figure 6; Figure 21, Panel B; Figure 23). Unemployment has been elevated since the global financial crisis, with much of the increase reflecting structural unemployment (Figure 6, Panel A). Furthermore, the already high labour market informality rate has increased in the recent past while labour participation has decreased (Figure 6, Panels A and B). These developments have worsened the already high levels of inequality as disadvantaged groups and those less able to adapt to the ongoing structural change are most affected, including those with low education levels and the young (Figures 22 and 23).

Structural policies reforms are needed to boost both productivity and inclusiveness. If it does not address these issues, Costa Rica risks becoming stuck in a "vicious cycle", whereby individuals with low skills and poor access to opportunities are confined to low-productivity and low-wage jobs, reducing aggregate productivity and further worsening inequality (OECD, 2016d). Setting in motion a "virtuous cycle" will require reforms across several policy areas that present win-win opportunities (OECD, 2012a). There is no shortage of such policies, which underscores the importance of directing immediate reform efforts to areas that are likely to bring large gains and/or that set the framework conditions necessary to fully realise

Figure 21. **The GDP per capita gap reflects low productivity and employment, but long working hours**



Source: OECD Productivity Database.

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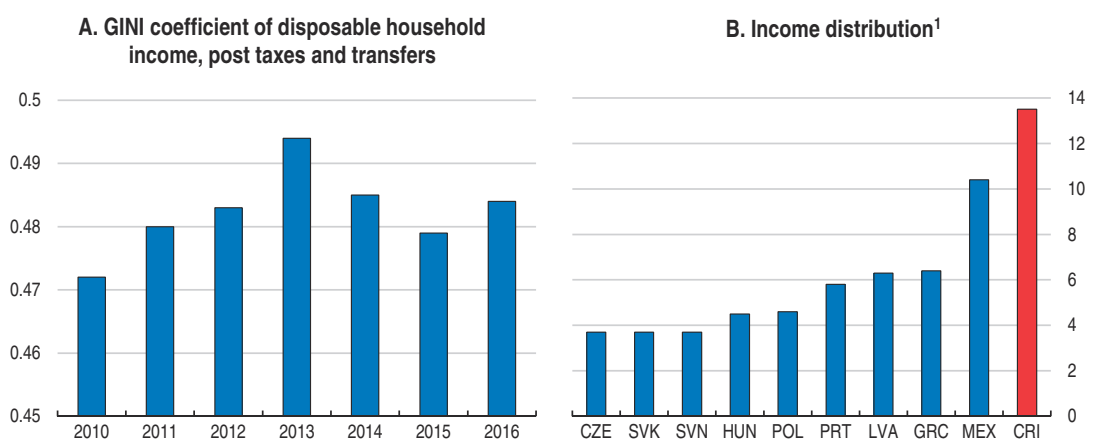
Figure 22. **Inequality is high and increasing**



1. Income distribution is computed as S80/S20. This ratio represents the share of all income received by the top quintile divided by the share of the first, or the ratio of the average income of the top quintile to that of the first.

Note: Income distribution data refer to 2015 except for Hungary (2014), Mexico (2014) and Costa Rica (2016).

Source: OECD, *Income Distribution Database* (IDD).

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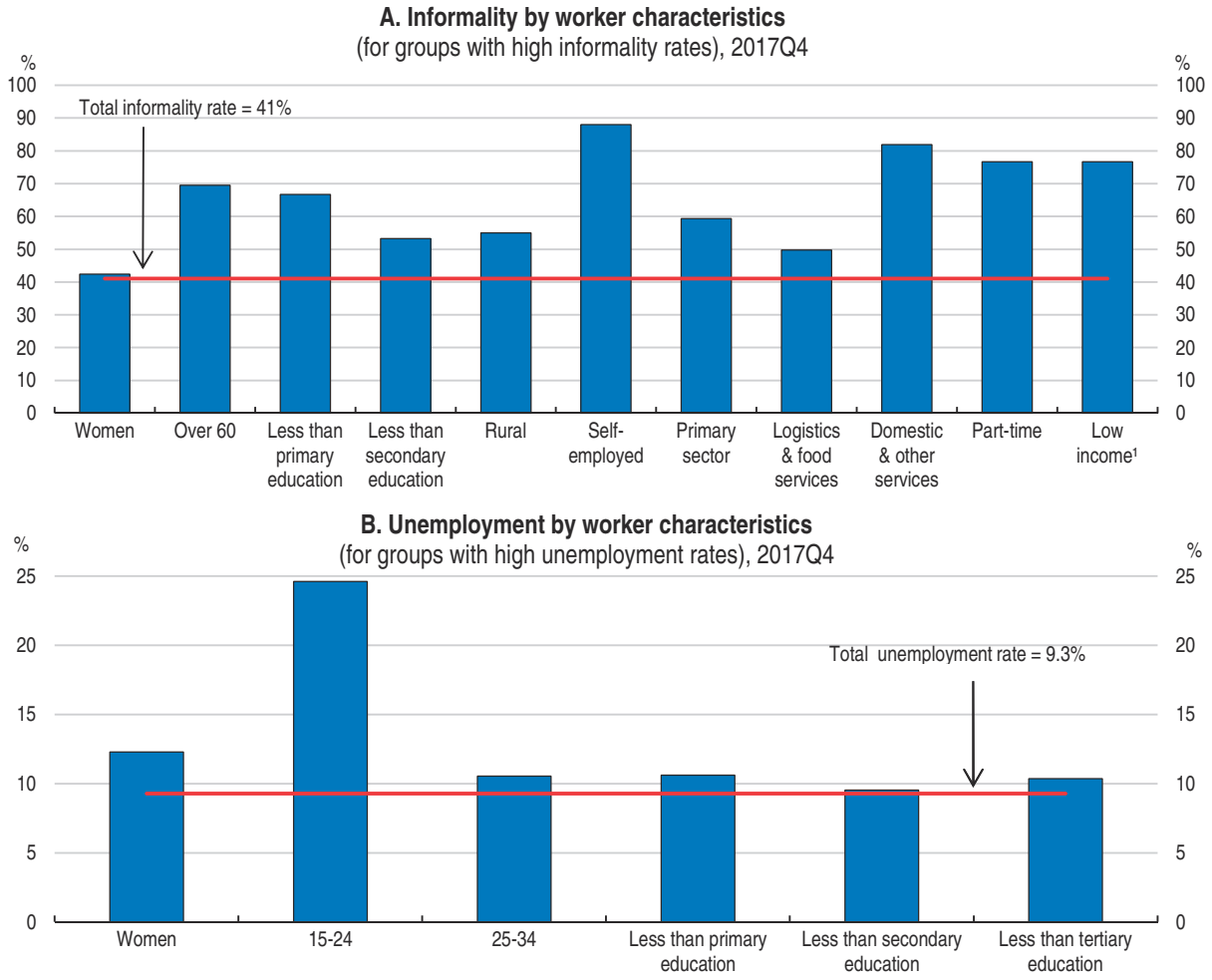
Figure 23. **Labour market outcomes are particularly poor among disadvantaged groups**



1. Panel A: Low income refers to hourly earnings of less than the lowest minimum wage.
Source: INEC, Encuesta Continua de Empleo.

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the benefits of future reforms. Based on existing research quantifying the potential gains of reforms (Box 3) and the experiences of other countries, reforms to reduce labour market informality, strengthen competition, lower regulatory burdens, improve outcomes and equality in education, and address transport infrastructure gaps are highlighted as priority areas to stimulate inclusive growth. Recognising these challenges, Costa Rica has accelerated its structural reform momentum, and significant policy improvements relating to several of these areas are underway or planned.

Box 3. **Simulations of the potential impact of structural reforms**

The quantification of the potential impact of reforms on GDP provides insights into the size of the payoff, which is a useful input into prioritisation decisions. Recent OECD research estimates the effects of structural reforms using simulations based on historical and cross-country relationships between reforms and growth in OECD and non-OECD countries. These simulations assume full implementation of the reforms detailed below, and focus on product market regulation and insolvency measures (Table 7).

Box 3. **Simulations of the potential impact of structural reforms** *(cont.)*

Table 7. **Potential long-run impact of structural reforms on GDP per capita**[1]

Structural policy[2]	Total effect on GDP per capita[3]	Impact on supply side components		
		MFP	Capital deepening[4]	Employment rate[4]
	in percent			
Product market regulation				
Improve the governance of SOEs	1.1	0.6	0.4	0.3
Streamline the licences and permits system	1.6	0.9	0.6	0.5
Reduce administrative burdens for firms	0.9	0.5	0.3	0.3
Remove anti-trust exemptions	0.5	0.3	0.2	0.2
Improve trade facilitation through better communication of regulations	0.9	0.5	0.3	0.3
Total for PMRs	*5.1*	*2.8*	*1.9*	*1.4*
World Bank Doing Business				
Time to insolvency procedures[5]	5.4	4.4	0	1.1

1. Based on Égert (2017) and Égert and Gal (2017).
2. Refer to Table 8 for details of the measures.
3. The change of GDP per capita is calculated using Equation 5 of Égert and Gal (2017) and assumes a labour force to working-age population ratio in 2013 of 56.4% for Costa Rica.
4. Capital deepening is measured as capital stock/output and the employment rate as employment/working-age population.
5. Due to estimation differences, the magnitude of the World Bank Doing Business insolvency measure is not directly comparable to the OECD Product Market Regulation results.

The proposed measures relating to product market regulations (PMRs) (outlined in Table 8) could boost GDP per capita by 5.1% in the long term. These gains are sizeable despite the fact that even if all of these product market reforms were implemented, the stringency of regulations in Costa Rica would remain significantly above the OECD average, and be at a similar level to Greece or Slovenia and slightly better than Colombia. Reducing the time it takes to resolve corporate insolvency from the current 3 to 2.5 years could boost GDP per capita by 5.4%. However, it is important to note that the magnitude of the insolvency and PMR results are not directly comparable due to methodological differences. In particular, the PMR estimates are based on average time (within) effects, whereas the insolvency estimates use cross-country (between) effects. This makes a large difference to the results – for example, using PMR estimates based on cross-country effects would yield much larger estimates, in the range of a 24% boost to GDP per capita.

Table 8. **Reforms used in the simulations**

Structural policy	Structural policy changes
Product market regulation	
Improve the governance of SOEs	SOEs no longer have access to financing that is not available to private companies. Establish an ownership unit within the Ministry of the Presidency to manage the government's equity in SOEs.
Streamline the licences and permits system	Establish one-stop shops for getting information, issuing and accepting notifications and licences, which are implemented at the local level and information available via the internet.
Reduce administrative barriers for businesses	Procedures that are currently done by the entrepreneur (e.g. seeking registration from the local municipality, notifying CCSS etc.) are done by a one-stop shop. The number of days to register a firm reduces to 20, and the number of bodies to contact in order to register reduces to 1.
Remove anti-trust exemptions	Anti-trust exemptions are removed.
Improve trade facilitation	Regulations are communicated in an accessible manner at the international level.
World Bank Doing Business	
Time to insolvency	Reduce the time to resolve insolvency from 3 years to 2.5 years.

Box 3. **Simulations of the potential impact of structural reforms** *(cont.)*

Reducing labour market gender gaps could also have a large impact on productivity and incomes. For example, it is estimated that the long-run income loss due to gender gaps in Costa Rica is 22%, compared to an average of 15.4% for OECD countries (Cuberes and Teignier, 2016).

While estimates of the efficiency gains from reducing informality for Costa Rica are not available, for Mexico, resource misallocation is much higher among informal firms and every Mexican peso of capital and labour allocated to an informal firm would be worth 28% more if allocated to a formal firm, suggesting that informality has a large negative impact on aggregate productivity and GDP (Busso, Fazio and Levy, 2012; IMF, 2017b).

Improving educational outcomes would also have a significant positive effect. OECD research estimates that achieving universal basic skills (i.e. universal secondary school enrolment for 15 year olds and PISA scores of 420 or above) could increase GDP growth by 0.65 percentage points a year in Costa Rica, versus the OECD average of 0.27 (OECD, 2015b).

Addressing skill mismatches can also have a large impact. Although estimates based on OECD Survey of Adult Skills data are not available for Costa Rica, eliminating skill mismatches in a country where about a third of workers are either under- or over-skilled for their jobs (such as in Italy) could increase productivity by 10% (Adalet McGowan and Andrews, 2015).

Making labour markets more inclusive

To tackle informality, which has reached 41% of workers, the OECD has recommended adopting a comprehensive strategy, including actions to reduce non-wage labour costs, simplify the minimum wage structure, strengthen enforcement, and reduce barriers to entrepreneurship and improve training and education (OECD, 2016b; OECD, 2017f).

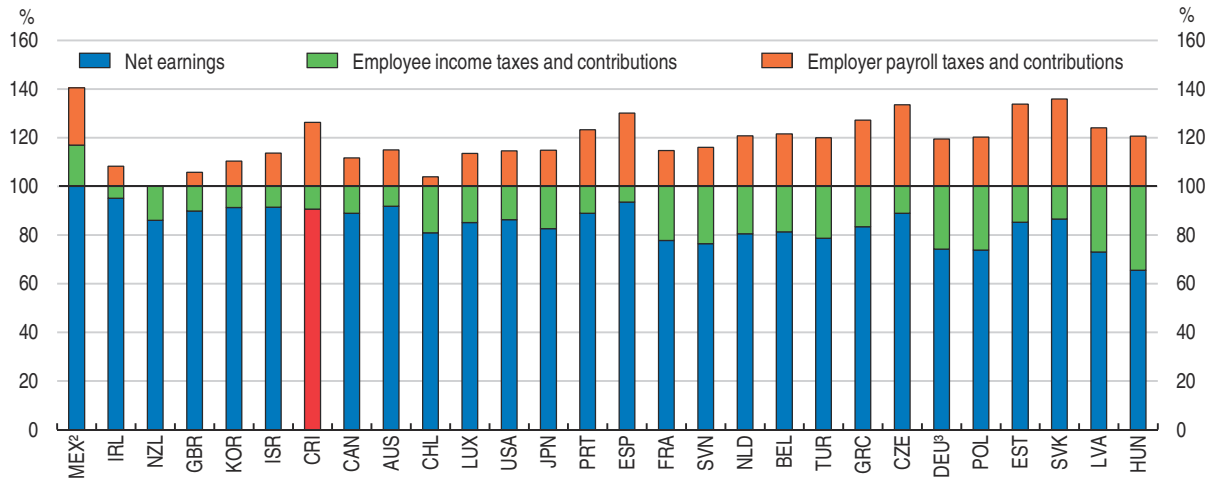
In response, a National Strategy to Transition to a Formal Economy was approved via a tripartite agreement in February 2018, with high-level actions in each of the recommended areas and an overall goal of reducing informality to 33% by 2025. A tripartite council will oversee the implementation of the strategy, and technical councils will be formed to establish detailed action plans in each of the areas. While still in its early stages, this strategy is a positive step. Incorporating the strategy and associated action plans in the National Development Plan 2018-2022 would solidify it as a priority area going forward.

High social security contributions are a barrier to formality in Costa Rica (Ramírez Alfaro, 2010; ILO, 2014; OECD, 2017e; OECD, 2017f). Social security contributions amount to approximately 36.5% of gross payroll, compared with the OECD average of 27.2%, of which about 26.33 percentage points are borne by the employer, 9.34 by the employee and 0.82 by the government (OECD, 2017e; OECD, 2017f). The large portion payable by employers drives Costa Rica's non-wage labour costs towards the top of the OECD rankings (Figure 24). While the poor state of public finances does not allow for a significant reduction in social security contributions, the government is investigating options to increase coverage in selected sectors with high levels of informality. Since July 2017, the minimum base contribution for domestic service workers has been lowered, and payments can now be spread across multiple employers. In addition, a pilot scheme for coffee pickers involving a reduced rate to cover health insurance during the harvesting season will begin in 2018.

The Transition Strategy also includes plans to establish similar schemes for at least two additional groups of workers. Furthermore, the government is considering lowering the employer contribution rate for new, small businesses for the first four years of operation from approximately 25% of gross payroll to between 13.33% and 15.33%. It is

Figure 24. **High non-wage labour costs discourage formality**

Percentage of gross earnings for a single individual earning the minimum wage, 2013[1]



1. Tax burdens are calculated for a full-time worker in a single-person household earning a minimum wage at the standard (adult) rate. Full time refers to usual full-time hours in each country. Employer and employee social contributions also include any mandatory payments to private insurance for health, retirement pensions, etc.
2. Mexican low-wage earnings have negative income taxes because they receive a wage supplement in the form of a tax credit.
3. Minimum wage levels refer to 2015 for Germany.

Source: OECD (2017f).

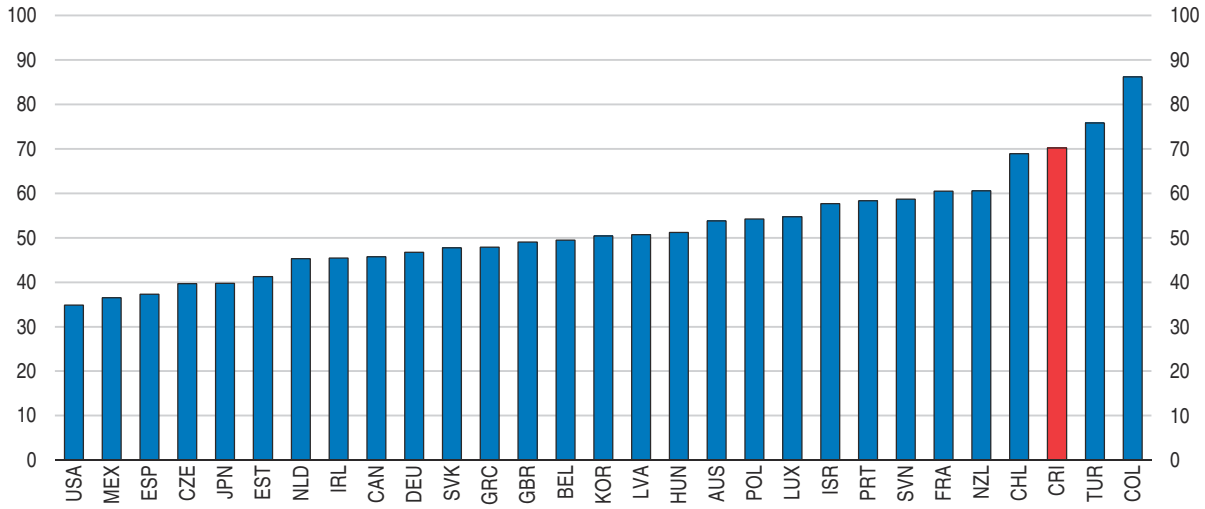
StatLink http://dx.doi.org/10.1787/888933702041

expected that an agreement will be reached with the Costa Rican Social Security Agency (CCSS, *Caja Costarricense de Seguro Social*) during 2018 to allow the employer contributions to be reduced to between 18.83% and 20.83%, with a proposed bill to reduce the rate by an additional 5.05 percentage points also being considered. While the design details of this proposal will be important, including consideration of the fiscal impact and the potential for firm-size distortions, evidence from other countries suggests that this could contribute to increasing formalisation (European Commission and OECD, 2015; OECD, 2017g). When public finances are back on track, the government should consider a broad-based reduction in social security contributions, to avoid distortions that might arise from targeted cuts.

The minimum wage in Costa Rica varies by skill, occupation and educational attainment. The number of minimum wage categories has decreased significantly over time, from 520 in 1987 to 23 currently. The most recent reduction from 25 to 23 categories came into effect in January 2018. In addition, market studies are currently underway to investigate options to further reduce the number of categories, with the intention of gradually moving to 10 categories by the end of 2019. While this reduction is positive, the system remains complex and the minimum wage for unskilled workers is 70% of the median wage, which is higher than in all OECD countries except Turkey (Figure 25). These features contribute to low levels of compliance, with about a third of workers paid below the relevant minimum wage and about a quarter of workers paid below the lowest minimum wage (Estado de la Nación 2014; OECD, 2017f). A more modest minimum wage differentiated on the basis of age and/or location would serve to better protect the most vulnerable workers while curtailing the negative effects on formal employment and business compliance costs. Differentiating on this basis should be informed by analysis of relevant factors such as regional economic conditions and the impact of the minimum wage on formal employment opportunities and

Figure 25. **Costa Rica's minimum wage is high**

Minimum wage as a percentage of the median wages of full-time workers, 2016



Note: For Costa Rica, the calculations use the minimum wage for unskilled workers.
Source: *OECD Labour Force Statistics Database.*

StatLink http://dx.doi.org/10.1787/888933702060

education decisions of young people. But, as an example, it could involve a higher minimum wage in San José to account for higher living costs and a lower rate for young workers to recognise that the minimum wage is a greater hurdle to employment for those with less experience.

More rigorous enforcement of labour regulations would also increase minimum wage compliance and deter informality. Several improvements have already been made, including increasing the resources of the labour inspectorate and streamlining the judicial process for labour tribunal complaints. The current proposal to grant labour inspectors the right to impose sanctions directly on employers without going through the labour courts would also help accelerate the process and increase the deterrent effects. Going forward, the authorities should ensure that penalties imposed for breaches of labour regulations are high enough to act as a deterrent (OECD, 2017f).

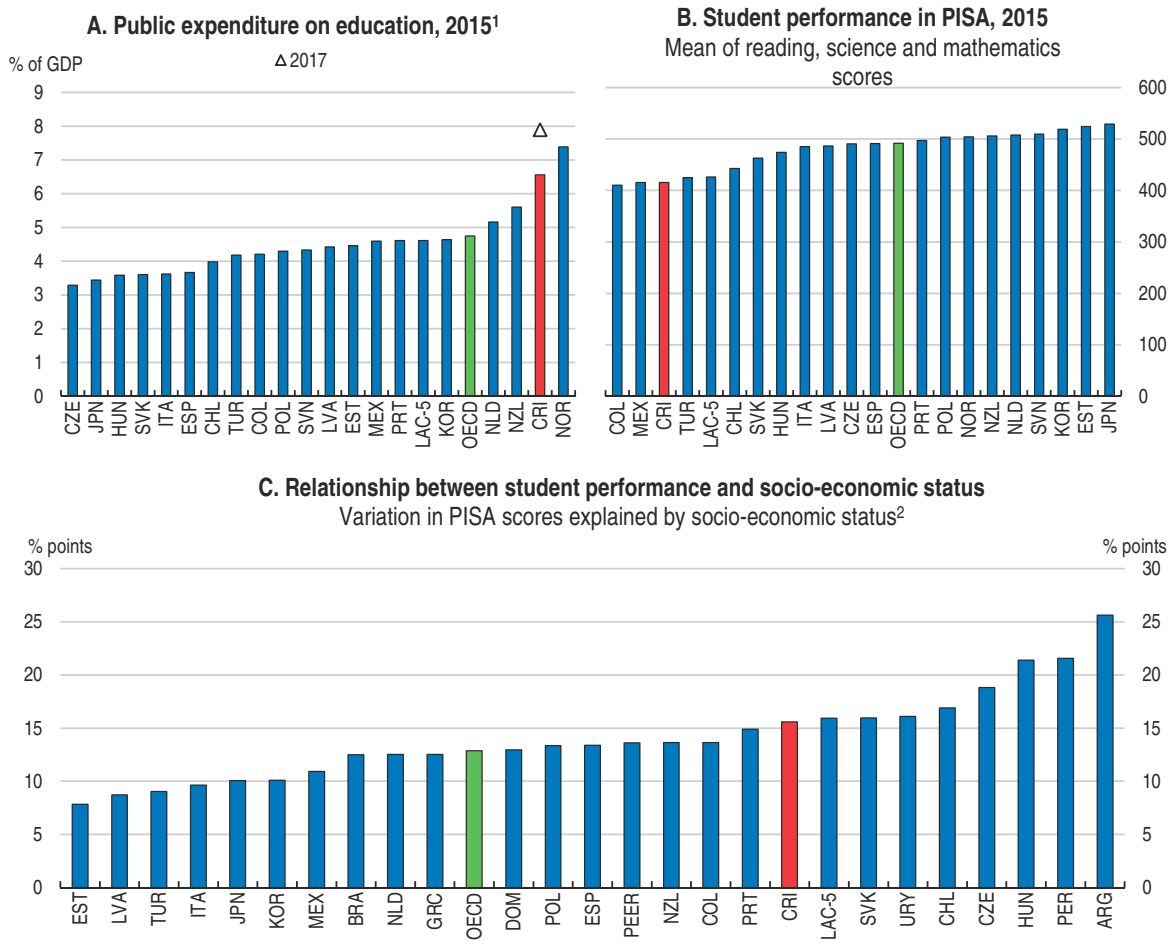
In Costa Rica, immigrants account for about 11% of the adult population, which is a higher share than other countries in the region and similar to the OECD average (OECD, 2017f). Most migrants come from Nicaragua, are of working age, have lower education levels than the native population and are over-represented in low-skilled occupations and sectors with high rates of informality, such as construction, domestic services and agriculture (OECD, 2017f). The 2010 Migration Law and the subsequent Comprehensive Migration Policy provide a solid regulatory framework, but the take-up of provisions for immigrants with irregular status to acquire legal residence has been lower than expected, partly due to the requirement to provide a formal employment contract. Greater access to formal jobs with social security benefits would improve immigrant integration. Programmes such as the pilot health insurance scheme for coffee pickers, 60% of whom are immigrants, should support greater inclusion. In addition, work on a new IT system is expected to begin in 2018 which will not only reduce visa processing times, but will also include linkages to relevant government services, which should improve current low coverage rates among immigrants

for programmes such as conditional cash transfers aimed at encouraging participation in education (OECD/FUNDEVI, 2017).

Enhancing the quality and efficiency of the education system

Costa Rica has a strong commitment to education and at 7.9% in 2017, government spending as a percentage of GDP is higher than all OECD countries. However, spending could be more efficient, as PISA results are low and strongly influenced by socio-economic background (Figure 26). This may partly reflect the spending mix as spending per student for basic education remains relatively low. Cumulative spending by the age of 15 is around half of the OECD average. In contrast, public spending per tertiary student is one of the highest among OECD and Latin American countries (OECD, 2017h).

Figure 26. **Low outcomes and inequities in education persist despite high levels of spending**



1. Data refer to expenditure on primary, secondary, post-secondary and tertiary education. Year of reference is 2015 or latest available year.
2. Measured as the average change in PISA scores associated with a one-unit change of the PISA index of economic, social and cultural status.

Note: OECD is a simple average of OECD member countries. LAC-5 is a simple average of Argentina, Brazil, Colombia, Chile and Mexico. PEER is a simple average of the 10 OECD countries with the lowest GDP per capita (excluding Latin American members): Czech Republic, Estonia, Greece, Hungary, Latvia, Poland, Portugal, Slovak Republic, Slovenia and Turkey. For Argentina, PISA data refer to Ciudad Autónoma de Buenos Aires only.

Source: *OECD Educational Finance Indicators* and Ministerio de Hacienda; *OECD PISA 2015 Database*; OECD (2016e).

StatLink *http://dx.doi.org/10.1787/888933702079*

There is a constitutional mandate to increase public education spending to 8% of GDP in 2018. There is no underlying reason for this specific target. To increase efficiency and incentives to improve outcomes, the main policy objectives should focus on educational outcomes, with clear and verifiable performance-based targets (OECD, 2016b). To further improve outcomes and equity, the spending mix should be re-balanced away from tertiary education and towards early childhood education and care (ECEC) and secondary school (where there are growing demographic pressures and a need to increase access). This could be achieved through more effective and equitable cost sharing between government and the students who benefit from tertiary education, including by targeting financial support to students on the basis of need and their ability to benefit (OECD, 2017h). While the need to shift the focus to outcomes is recognised, measurable performance targets have not been developed. Moreover, the spending mix has not materially changed.

While enrolments have increased significantly over the 2000s, ECEC in Costa Rica remains underdeveloped (OECD, 2017h). Expanding ECEC services would facilitate increases in the currently low levels of female labour market participation, reduce the impact of socio-economic background, and improve skills and employment prospects later in life (Cunha et al., 2006; OECD, 2007; Almond and Currie, 2011; OECD, 2016b). In recognition of these issues, a new early childhood policy for 0-8 year olds has been established and is currently being implemented, which envisages an expansion of community-based care centres. The National Development Plan also includes a goal to increase coverage of the first grade of preschool (age 4) from 63% to 69.5% between 2015 and 2018, with a focus on 75 target districts with low enrolment and high poverty rates. In the first half of 2017, enrolment rates stood at 66.1%. A geo-referenced database of centres and child identifiers is currently being developed to improve planning and targeting. Preliminary terms of reference for the project have been defined and authorities are currently exploring options to secure the necessary resources. While these initiatives are very positive, more clearly defined goals, milestones, timelines for implementation and performance assessment criteria should be established.

Promising steps have also been taken in recent years to strengthen ECEC governance and reduce fragmentation, including the establishment of the National Network for Childcare and Development (REDCUDI) in 2014 to improve co-ordination between the different public and private providers. However, these steps fall short of the needed governance improvements (OECD, 2017h). While preschool services are currently funded out of the substantial public education budget and fall under the responsibility of the Ministry of Education, childcare services fall under the responsibility of REDCUDI, which is funded from several sources (OECD, 2017h). Classifying all spending on early childhood education and care under the constitutionally-mandated spending on education would facilitate the expansion of services. Appointing one agency with clear authority and responsibility for delivering national ECEC policy across the entire sector (care and preschool) would strengthen sector leadership and create a clear champion for reform, facilitating co-ordination and improvements in and expansion of services.

With a view to improve outcomes, a major initiative to modernise the school curriculum will be completed in 2018 and guidelines for school self-evaluations have been introduced. A welcome proposal is also being discussed to make accreditation mandatory for all teacher training programmes in private universities. The OECD has also recommended several additional reforms to strengthen teaching quality and school leadership and evaluation. These include improving initial teacher selection and training, the introduction of an effective teacher evaluation system, stronger leadership development programmes,

establishing peer-learning schemes, creating instructional leadership positions within schools, and setting clearer standards for the evaluation of school quality and criteria to focus supervision efforts on the schools that are most in need (OECD, 2016b; OECD, 2017h).

Reducing student drop-out rates would increase the country's human capital and productivity potential as well as reduce inequalities. While drop-out rates have decreased in recent years, they remain high by OECD standards (OECD, 2017h). About 30% of Costa Rican students have dropped out of school by the time they are 15, with drop-out rates particularly high among those from disadvantaged backgrounds (OECD, 2017f). A greater focus on early education, particularly among disadvantaged children, would improve performance and retention at higher levels of education (OECD, 2007). Furthermore, the OECD has commended the targeted approach of the *Yo me Apunto* programme. High schools in the programme have reduced drop-out rates from 14.4% in 2013 to 9.2% in 2017. The OECD has recommended scaling up early detection and interventions for disadvantaged students who are at risk of leaving the education system (OECD, 2016b; OECD, 2017h).

The development of a vocational education track in close consultation with employers to ensure that training matches labour market needs could also curb drop-out rates (OECD, 2010). A very small-scale dual education pilot programme in the automotive sector for upper-secondary students started in February 2017. In addition, tripartite discussions are underway to formally introduce a dual apprenticeship system and regulate the contractual situation of students in the workplace, with a proposed legislative reform currently being analysed by sector representatives and issues relating to the remuneration of apprentices, including social security contributions, being negotiated. The pilot programme should be monitored and evaluated, and efforts to further develop vocational education should continue.

Fostering competition and reducing barriers to firm entry and exit

Competition in Costa Rica is weak. Product market regulations are stringent, there are extensive anti-trust exemptions, state control in many sectors is high and barriers to entrepreneurship are large. The potential gains in productivity and growth are substantial – improving product market regulations in Costa Rica could increase GDP per capita by 5.3% (Box 3) and would also reduce inequalities (Ennis, Gonzaga and Pike, 2017).

There are considerable weaknesses in the institutional arrangements for the enforcement of competition law in Costa Rica (OECD, 2016e). To address this, a bill to create a new competition authority with greater independence and resourcing is being considered by Congress and may be adopted in 2018. While this will involve greater financial commitment at a time of fiscal difficulties, it represents good value-for-money given the accompanied payoffs in terms of strengthened competition. This reform should be made and implemented in a timely manner.

Many sectors in Costa Rica are exempt, in whole or part, from competition law, including electricity, fuel transportation and distribution, alcohol distillation, sugar, rice, professional services and maritime transport. The OECD has recommended eliminating unjustified exemptions. In response, in-depth studies of 25 sectors that have some degree of exemption will be completed by 2020. This is a positive first step, but how these studies will lead to concrete action to eliminate exemptions should be clarified.

State-owned enterprises (SOEs) play a dominant role in many key sectors, such as electricity, transport infrastructure, banking, insurance and petroleum products. For example, public banks are dominant in the financial sector (discussed above). The

Table 9. **Past OECD recommendations to boost inclusion**

Recommendations in 2016 Economic Assessment	Actions taken
Increase the supply of publicly-funded childcare services to facilitate women participation in the labour market.	The National Development Plan includes a goal to expand coverage of the first grade of preschool (age 4) to 69.5% by 2018, with the expansion targeting 75 districts with low enrolment and high poverty rates. Enrolment rates stood at 66.1% in the first half of 2017. With the aim of achieving universal preschool enrolment, the Higher Council for Education, established a new policy to make preschool mandatory and a requisite for children enrolling in primary school. A geo-referenced database of care centres and child identifiers is being developed to improve planning and targeting. Roll-out is expected to begin in the first quarter of 2018. A feasibility study of alternative mechanisms of financing childcare is currently being undertaken. Improved articulation processes between the Ministry of Public Education (MEP) and the Child Care and Development Network (REDCUDI) are being implemented in order to leverage on existing resources to expand childcare provision and its quality.
Simplify the minimum wage structure and enforce compliance with the law.	The number of minimum wage categories has been reduced from 520 in 1987 to the current 23. Most recently, this involved the reduction from 25 to 23 categories from January 2018. Market studies are being undertaken with the aim to further simplify the minimum wage structure, with an intention of reducing the number of categories to 10 by 2019. The budget for labour inspections has been increased and processes to improve targeting have been implemented. While this has increased the number of workers covered by inspections, it is not yet clear whether it has increased the number of breaches identified nor whether it is having an additional deterrent effect. A bill has been drafted to increase the powers of labour inspectors by allowing them to impose sanctions on employers directly without needing to go through the labour courts.
Adopt a comprehensive strategy to reduce high labour market informality by strengthening enforcement, reducing administrative burdens to entrepreneurship, and enabling the poor to become formal workers.	A National Strategy to Transition to a Formal Economy was launched in February 2018, with the goal of reducing informality to 33% by 2025. The minimum base social security contribution rate for domestic service workers was reduced from July 2017. A pilot scheme for coffee pickers involving a reduced contribution rate to cover health insurance during the harvesting season will start in 2018. Consideration is being given to lowering the employer social security contribution rate for new, small businesses for the first four years of operation.
Establish better educational outcomes as the main policy target, with special emphasis on improving the performance of disadvantaged students and schools.	No substantial actions taken to establish measurable performance targets. However, there are several individual initiatives to improve outcomes and reduce inequalities in the education system which are not being subject to impact evaluation. A bill has been submitted to Congress requiring the accreditation of teacher training programmes delivered by private universities. The continued implementation of *Yo me Apunto* program to reduce secondary education dropout rates is proving successful in reducing dropout rates in the targeted secondary schools
Develop an apprenticeship system that closely involves employers.	A small-scale dual education pilot programme in the automotive sector started in 2017. Tripartite discussions are also underway to formally introduce a dual apprentice system and regulate the contractual situation of students in the workplace, with a proposed legislative reform currently being analysed and issues relating to the remuneration and social security of apprentices being negotiated.

electricity sector is dominated by a vertically-integrated SOE, and private-sector participation is limited to 15% of generation. Two SOEs dominate maritime transport, with each having exclusive rights to manage all ports on respective coasts.

Despite their importance, most SOEs lack a clear mandate and adequate oversight. Since many were created by specific laws, consistent operational and reporting standards have not been established. Governance issues have been highlighted by recent cases involving two public banks: the cessation of intermediation activities at Bancrédito (discussed above) and investigations into the business practices of Banco de Costa Rica. Several months before the government implemented a change to the technical regulations relating to cement in order to increase competition in the market, Banco de Costa Rica extended a loan to a company to import cement from China. Irregularities relating to the loan and allegations of undue political influence have, to date, led to the arrest of the importer and six senior bank executives, the dismissal of the bank's board, the suspension of

a judge and Prosecutor General, and an ongoing investigation by a committee of the Legislative Assembly.

The OECD has made a number of recommendations for alignment with the OECD *Guidelines on Corporate Governance of State-Owned Enterprises* (OECD, 2015c). In response, an SOE Action Plan was launched in July 2017 and is expected to be fully rolled out by the end of 2018. If successfully implemented, it will represent significant progress. As a priority, authorities are currently working to get the newly-created ownership unit operational and to establish regulations for board member nominations ahead of the next round of appointments that will occur after the new administration takes office in May 2018. From June 2017, a new corporate governance regime applicable to all financial institutions came into effect under CONASSIF's revised Corporate Governance Regulations. In line with international benchmarks, it is based on a principles-based model and covers a comprehensive set of governance issues.

Costa Rica's high barriers to entrepreneurship are reflected in low business start-up rates and high informality. While the time and cost involved in starting a business has reduced over the last decade, according to the World Bank's *Doing Business* indicators, Costa Rica's distance-to-the-frontier score is 81.7 out of a possible 100, which is lower than all OECD countries. The government has several positive initiatives in this area. The majority of the 22.5 days it takes to start a business according to the World Bank measure is accounted for by the issuing of a business licence by the local municipality. Therefore, the Ministry of Economy, Industry and Commerce (MEIC) is working with several municipalities to reduce the time and paperwork involved, including by establishing one-stop shops in the Brunca, Central Pacific and Chorotega regions. In addition, MEIC and the Costa Rican Export Promotion Agency (PROCOMER) have started a joint project to extend the sub-national initiatives to simplify and digitalise business processes, including not only the business registration phase, but also obtaining other licenses and permits (such as construction, health and environmental permits). The digital platform has now been rolled out to firms within free trade zones, and is currently being extended to all firms. Authorities should continue these positive initiatives, with a view to establishing one-stop shops implemented at the local level, with clear and measurable objectives against which performance is benchmarked. As an example of what could be achieved, the number of procedures that an entrepreneur needs to undertake to start a business could be reduced from nine to one if these tasks were instead performed by a one-stop shop, as is the case in the best performing countries according to *Doing Business*, such as New Zealand.

At the other end of the firm lifecycle, facilitating the exit of unviable businesses frees resources to flow to more productive uses. According to the resolving insolvency dimension of the World Bank's *Doing Business* indicators, Costa Rica's distance-to-the-frontier score is 34.4, which is lower than all OECD countries except Turkey and significantly below the OECD average of 74.8. This reflects the lengthy time to insolvency (3 years) and the low debt recovery rate (31 cents on the dollar). However, significant progress is also being made to modernise the insolvency regulations in line with international best practice. All cases will be handled by a specialised insolvency court from February 2018. Additionally, a draft bill which establishes a unified regulatory framework for insolvency and which expedites processes (for example, by curtailing excessive appeals) is close to completion.

Despite its shift into more knowledge-intensive goods and services, Costa Rica does not score well on innovation input and outcome measures (OECD, 2017i). In addition, innovation

and technology use is concentrated among firms in free-trade zones. These high-productivity firms co-exist with low-productivity domestic (including informal) firms and there is limited integration of local firms into the supply chains of multi-national firms due to a mismatch between what foreign firms demand and the competencies of the local business sector (OECD, 2017i). However, there is evidence of modest positive spillovers from foreign firms to domestic suppliers (Sandoval et al., 2018). There is also evidence that government business assistance programmes in Costa Rica aimed at promoting innovation and linkages between domestic and foreign firms improve business performance (Monge González, Rivera and Rosales-Tijerino, 2010; Monge-González and Rodríguez-Álvarez, 2013). In line with OECD recommendations to establish a one-stop agency to further improve the effectiveness of these business assistance programmes, a bill to create the agency FOMPRODUCE to concentrate funds and responsibilities relating to firm innovation and development in one entity has been proposed, but has not progressed due to a lack of support.

In addition, in recognition of the potential to boost intra-regional trade in Latin America, a law to create a National Council of Trade Facilitation (CONAFAC) was passed in April 2017. The Council has 12 members: seven vice-ministers and five private-sector representatives. In order to improve co-ordination among the agencies involved in trade facilitation, CONAFAC's decisions are binding on the relevant government agencies. The Council will be responsible for the implementation of free trade agreements as well as the modernisation and continuous improvement of all infrastructure relating to the cross-border movement of goods and people.

Addressing transport infrastructure gaps

Costa Rica's significant transport infrastructure gaps are hindering productivity, environmentally-sustainable growth and regional development, as well as negatively affecting the population's well-being (Estado de la Nación, 2016; OECD and IDB, 2016; OECD, 2017j). Transport infrastructure spending has been lower than OECD countries due to weak fiscal management and there is a lack of strategic planning and coherence, weak accountability and poor project management and execution due to the high degree of public sector fragmentation (Pisu and Villalobos, 2016).

The OECD has recommended streamlining the institutional and legal framework of public-work agencies as well as adopting a more strategic approach to long-term planning. Co-ordination and accountability would be greatly improved by clarifying the mandates of the different agencies and granting authority and control of infrastructure management to a single institution. This lead agency should also be charged with conducting cost-benefit analyses to select and prioritise projects. Currently, this step is overlooked, with more emphasis placed on concessions and project financing, which, while important, are secondary considerations to systematic prioritisation.

Indeed, the OECD *Principles for the Public Governance of Public-Private Partnerships* (OECD, 2012b) highlight the importance of separating the decision about whether to invest in a project from the decision about how to procure and finance the investment. While there are a number of legitimate reasons for seeking the involvement of the private sector in the provision of infrastructure investment, PPPs are sometimes used inappropriately to disguise pressure on public finances. In such cases, investment decisions – by precluding appropriate alternative investment arrangements – will lead to suboptimal outcomes. This underscores that the use of PPPs should be accompanied by proper and transparent assessment of their expected long-term impact on public finances. A stark example

occurred in Hungary with major PPPs for motorways recorded off-budget in 2005 and 2006, despite the partnership involving a state-owned enterprise (Araújo and Sutherland, 2010).

Costa Rica's National Transport Plan 2011-35 envisages that a third of transport infrastructure spending will come from private sector investment (MOPT, 2011). However, Costa Rica has relatively little experience with PPPs. There have been only four PPP projects since the General Concession Law regulating private participation was passed in 1998, and these suffered from delays of up to 11 years before construction even began (OECD 2016b; Pisu and Villalobos, 2016; OECD, 2017k).

Private participation in infrastructure is governed by a fragmented legal framework and Costa Rica is in the process of developing a new framework (OECD, 2017q). Given the complexity of PPPs, the OECD guidelines highlight the importance of a robust governance structure where relevant agencies have a clear mandate and accountability (OECD, 2012b). In 2016, a public policy for PPPs was formulated and a decree was issued to regulate PPP projects. While positive, greater clarity is needed about how this new framework will be implemented within the current institutional and legal settings (OECD, 2017j). It is also positive that a PPP unit has been created within the Ministry of Finance to manage the public financing issues relating to the PPPs and it will be important for this unit to properly assess and account for the contingent liabilities arising from PPPs. It is envisaged that the National Concession Council (CNC) will continue to be responsible for contract management and technical considerations. However, additional efforts are needed to clarify the roles of the two entities and to establish mechanisms to align and co-ordinate their work (OECD, 2017j). More generally, these arrangements should continue to be monitored as they remain untested in practice as no PPP has taken place under the new regulatory and institutional arrangements.

Table 10. **Past OECD recommendations to boost productivity growth**

Recommendations in 2016 Economic Assessment	Actions taken
Give the competition commission more independence and eliminate anti-trust exemptions.	A bill to create a new competition authority with greater independence and resourcing is being considered by the Legislative Assembly.
Improve the corporate governance of state-owned banks and enterprises by adopting the OECD Guidelines on the Corporate Governance of State-Owned Enterprises.	An SOE Action Plan was launched in July 2017. An ownership entity was created in October 2017 and is expected to be operational before the next round of board nominations takes place after the new administration takes office in May 2018. A decree to align board member nomination processes with the OECD Guidelines on Corporate Governance of State-Owned Enterprises is expected to be in place before the next round of appointments in May 2018. From June 2017, a new corporate governance regime applicable to all financial institutions came into effect under CONASSIF's revised Corporate Governance Regulations. In line with international benchmarks, it is based on a principles-based model and covers a comprehensive set of governance issues.
Strengthen the institutional design to align policies to boost productivity, improve the business environment and reduce barriers to entrepreneurship.	To strengthen the Presidential Council on Competitiveness, Innovation and Human Talent (Costa Rica's productivity commission), a technical committee to establish an agenda of work priorities has been created. A productivity commission was established by Executive Decree in February 2017. A bill has been submitted to Congress to institutionalise the productivity commission, unify its three sub-councils and strengthen the technical unit.
Streamline the institutional and legal framework of public-work agencies, to achieve better policy design and execution in transport and other infrastructure sectors.	No significant action taken to date to improve the overall institutional and legal framework of public-works agencies. A PPP unit within the Ministry of Finance will manage the contingent liabilities generated by PPPs. The unit has developed a number of guidelines and project assessment criteria consistent with the OECD *Principles for the Public Governance of Public-Private Partnerships*. A decree to clarify the regulation of PPP projects was issued in December 2016.

Greening growth

Costa Rica's per capita emissions of greenhouse gases (GHG) are well below half of Chile's, which has the lowest per capita emissions among current OECD member countries. This is mainly because almost 100% of electricity is supplied from renewables, which account for half of total energy supply, but also because of relatively low incomes. Hydro power accounts for most electricity production but wind power capacity is also significant. Carbon intensity of production is very low, and has been declining slightly in recent years, while rising incomes have led to a slight increase in per capita emissions, associated in particular with rising use of motor vehicles.

Costa Rica has had much success in reversing deforestation following rampant tree clearing for agriculture and livestock production that occurred between the 1950s and the 1980s. Forest cover has more than doubled since the low reached in 1987. Costa Rica is also world-renowned for its rich biodiversity: while representing only 0.03% of the world's land surface, the country hosts 3.6% of the world's biodiversity (OECD, 2017i). Over the years the government managed to strengthen biodiversity protection, which underpins Costa Rica's green tourism trademark and has contributed to the performance of its agriculture sector (OECD, 2017i). However, more general environmental indicators show a more mixed picture.

Urbanisation and greater energy needs are putting pressure on Costa Rica's natural resources. Due to limited use of local timber in the construction sector, new houses are often built with cement and metal, which are associated with a high carbon footprint. Air quality is generally very good although, as for other environmental indicators, more comprehensive data would be useful. Low levels of pollution follow from the small amount of heavy industry and absence of thermal power stations. Rising levels of car ownership and use have nevertheless been creating local problems, in combination with congestion, in San José. Reducing carbon emissions stemming from private car use will require combining improvements in transport infrastructure with an expansion of the public transport network.

While water availability is generally good (though shortages are a problem in certain areas), water quality is likely to be an issue: until 2015, less than 10% of wastewater was subject to treatment of any kind and, according to the World Bank (Oviedo et al., 2015), only four of 16 wastewater treatment plants in San José satisfied national standards. A new treatment plant (Los Tajos), opened in 2015, brought the share receiving treatment to nearly 12%, but even in the latest facilities only primary treatment is provided. Nearly all of the population not connected to the sewage system have their own septic tank. The OECD has therefore recommended that wastewater management be improved (OECD, 2016b). A national policy on waste water sanitation was released in 2016. This establishes goals to increase the coverage of sanitation infrastructure by 2045 and provides guidelines for the management of waste water (AyA-MINAE-MS, 2016). While this is a positive initiative, given the issues with the execution of infrastructure projects in Costa Rica, it will be important to monitor progress. The extensive use of often obsolete agrochemicals is a potential source of soil contamination and acts as a significant barrier to sustainable productivity growth (OECD, 2017f). Although there are indications that the intensity of usage has been declining, official limits to the use of pesticides are not monitored and long registration processes limit access to new agrochemicals (Oviedo et al., 2015; OECD, 2017i).

Direct indicators of water quality are not collected systematically, but past reports have shown that water quality in more than half of Costa Rica's estuaries and many urban rivers is unsuitable for consumption, recreation or irrigation (AyA-MINAE-MS, 2016). A

number of beaches have been declared unsafe for swimming due to pollution in the recent past (Estado de la Nación, 2014). As an indirect indicator, the Ministry of Environment estimates that the number of deaths likely to be directly related to water quality was nearly halved between 2000 and 2014.

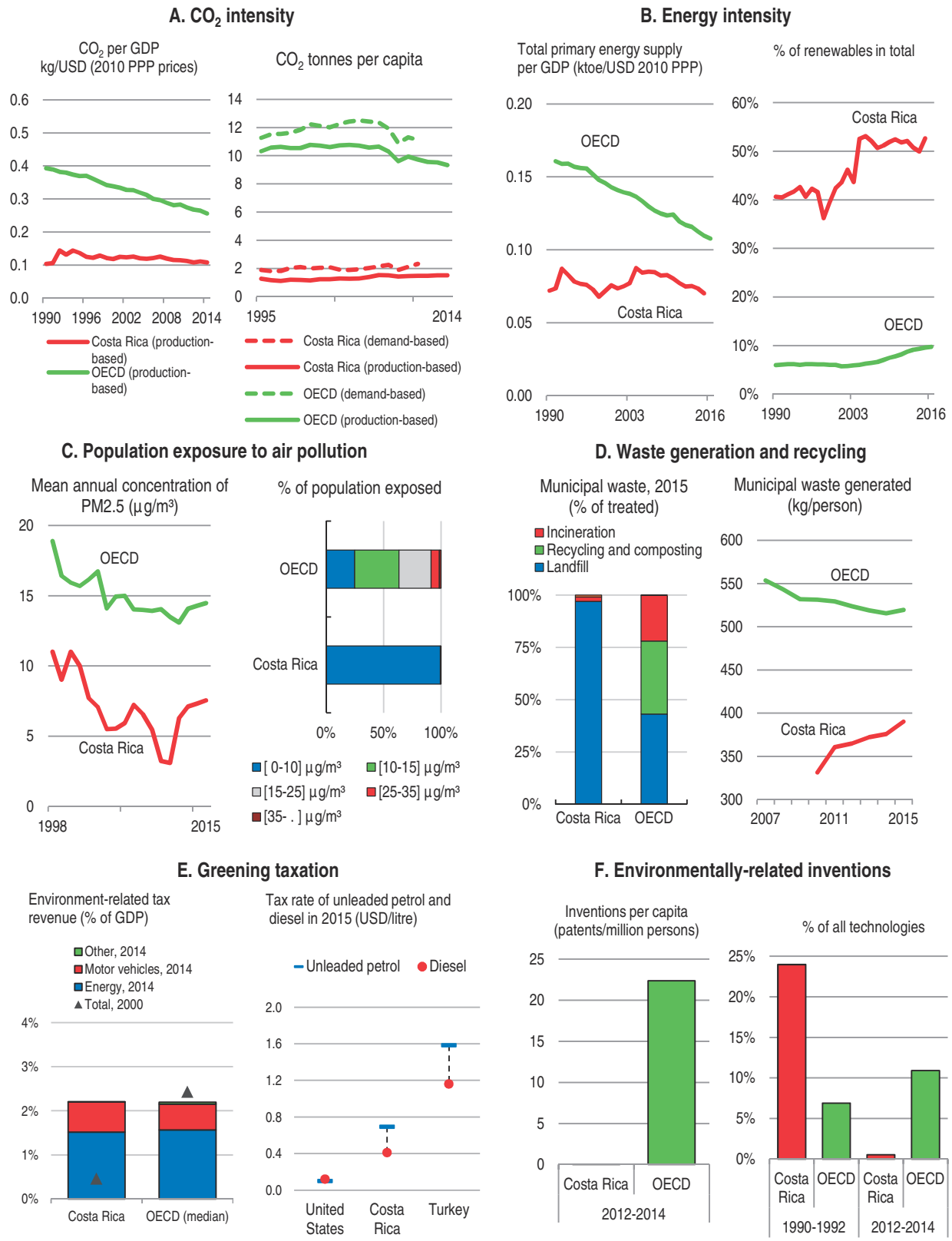
In its treatment of municipal waste, Costa Rica is well behind OECD countries in developing recycling or re-use, sending nearly all waste to landfill. Per capita waste generation has been growing towards OECD levels, despite Costa Rica's relatively low incomes.

Costa Rica's use of taxation for environmental objectives is not as well-developed as in some OECD countries, especially measured in terms of total revenue. Revenue raised is not always a good indicator of such incentives, however; for example Costa Rica has been a pioneer of pricing environmental services and paying farmers for good land management, one of the reasons for the strong recovery in forest cover. The OECD has recommended that Costa Rica continues efforts to develop the carbon market and other climate-change mitigation schemes. Consistent with this recommendation, the authorities are considering introducing a GHG emission levy scheme. It is early days for this initiative, which is currently in the planning and design phase. As such, it is unclear at this stage whether (and when) a levy will be introduced and what form it might take.

Table 11. **Past OECD recommendations on green growth**

Recommendations in 2016 Economic Assessment	Actions taken
Improve public urban transport and wastewater management facilities.	A committee has been created to develop a strategic plan to improve public transport in the Great Metropolitan Area of San José. However, there is a lack of concrete progress. A national policy on wastewater sanitation was issued in 2017, which includes sanitation infrastructure expansion goals to 2045. Ongoing work to further expand the wastewater treatment network in the Great Metropolitan Area of San José is expected to be completed in 2021.
Continue efforts to develop the carbon market and other climate-change mitigation schemes.	Authorities are considering introducing a GHG emission levy, and are in the early planning and design phase.

Figure 27. **Green growth indicators: Costa Rica**



Source: OECD Green Growth Indicators Database.

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ANNEX 1

Legislative initiatives

Table A1. **Recent and ongoing legislative initiatives of relevance to the 2018 *Economic Survey of Costa Rica***

Policy area	Bill/Law description	Status
Fiscal	Bill 20.580 to strengthen public finances, comprising: i) a bill to transform the current sales tax into a fully-fledged value-added tax, including the removal of a number of exemptions; ii) increase capital gains tax to 15%; iii) several bills to reform the remuneration schemes of public sector workers; iv) a fiscal rule bill.	Presented to the Legislative Assembly on 9 November 2017. Allocated to the Commission for Fiscal Affairs. Fast track procedure was approved on 28 February 2018.
Fiscal	Bill 20.595 to reduce earmarking by delinking certain spending categories from revenues.	Presented to the Legislative Assembly on 17 November 2017. Allocated to the Commission for Fiscal Affairs.
Fiscal	Bill 20.203 to include deconcentrated agencies in the national budget and increase the Ministry of Finance's control of the budget.	Presented to the Legislative Assembly on 13 December 2016; affirmative vote of the Special Commission on 3 August 2017; affirmative vote after the first debate (7 February 2018) and second debate (22 February 2018). Enactment of the Law is pending.
Fiscal	Bill 20.649 to reduce public sector fragmentation by eliminating non-functional institutions.	Presented to the Legislative Assembly on 13 December 2017, allocated to the Commission on Legal Affairs.
Fiscal	Law 9371 allowing the Ministry of Finance to reclaim mandated transfers to autonomous institutions that have not been spent within 2 years.	Adopted in 2016 and effective from 2018.
Fiscal	Bill 19.787 to reform public sector employment by establishing a new performance management system and limiting pay increases.	Bill 19.787 was withdrawn following opposition from trade unions. However, components have been included in Bill 20.580 to strengthen public finances.
Fiscal	Law 9428 re-introducing a tax on all legal entities on the National Registry, not just those registered with the tax administration.	Approved in 2017.
Fiscal	Law 9416 to fight against fiscal fraud allows the tax administration to access information on taxpayers through a centralised registry of ultimate beneficiary owners.	Approved in 2016 and came into force in 2017.
Fiscal	Law 9328 to enhance the fight against smuggling, which strengthens the enforcement of and penalties for customs tax fraud.	Approved in 2015 and came into force in 2016.
Fiscal	Laws 9388, 9380, 9381 and 9383 to reform the pension regime to limit pension inheritance and curb excessive increases.	Approved in 2016 and came into force in 2017.
Monetary	Bill amending Art. 17 of Law 7558 (Organic Law of the Central Bank) seeking to strengthen the independence of the Central Bank by delinking the appointing of the President of the Central Bank from the political cycle.	Draft bill is ready to be sent to Congress. It has been consulted and agreed internally by the Central Bank and the Ministry of Finance.
Financial stability	Bill 17.776 establishing a deposit insurance scheme and bank resolution regime covering all financial entities supervised by SUGEF.	A new text that incorporates the recommendations and best practices of the OECD is ready to be sent to Congress.
Competition	Bill 19.996 establishing the National Competition Council (CONACOM) to provide a strengthened competition authority with greater independence and resourcing.	A substitute text was presented to the Legislative Assembly on 25 April 2017; and designated by the Executive as a priority bill. A second round of consultations was conducted and finalised. Hearings were also held during 2017. As part of the process, there have been negotiations with the sectors involved. A new substitutive text is being negotiated with the sectors in order to be presented to the Legislative Commission of Government and Administration for discussion and approval.
Informality	Bill 19.805 proposes a 5.05 percentage point of gross payroll decrease in employer social security contributions related to IMAS and Asignaciones Familiares for new, small businesses for the first four years of operation.	Presented to the Legislative Assembly in November 2015.
Labour	Law 9343 to modernise labour legislation, including reforms to individual labour law governing the employer-employee relationship, collective bargaining and labour dispute procedures, and strengthening of the labour inspectorate.	Approved by the Legislative Assembly in December 2015 and came into force in July 2017.
Labour	Bill 19.130 to grant labour inspectors the right to impose sanctions directly on employers.	Initiated in 2014 and presented to the Legislative Assembly in 2015.
Social	Bill 19.960 to transform the current Ministry of Human Development and Social Inclusion by granting it resources and staff to enable it to fulfil its current mandate as the social sector co-ordinator.	Presented to the Legislative Assembly in May 2016.

Table A1. **Recent and ongoing legislative initiatives of relevance to the 2018 *Economic Survey of Costa Rica*** *(cont.)*

Policy area	Bill/Law description	Status
Education	Bill 19.378 to establish an apprenticeship educational track and regulate the contractual situation of students in the workplace.	Presented to the Legislative Assembly in October 2014.
Education	Bill 19.549 to make accreditation of all teaching programmes in private universities mandatory.	Presented to the Legislative Assembly in April 2015.
Corporate governance of SOEs	Draft bill to strengthen the corporate governance of SOEs.	Bill is currently being drafted.
Innovation	Bill 19.822 to concentrate funds and responsibilities relating to firm innovation and development in one entity (FOMPRODUCE).	Presented to the Legislative Assembly in November 2015 but subsequently withdrawn in April 2016. This proposal has stalled.
Insolvency	Draft bill to create a unified regulatory framework and streamlined procedures for insolvency.	Bill has been drafted but has not yet been submitted to the Legislative Assembly.
Productivity	Bill 20.331 to institutionalise the Presidential Council on Competitiveness and Innovation, including the Productivity Commission.	Presented to the Legislative Assembly in April 2017, under the revision of the Commission of Economic Affairs. In the meantime, the Commission has been put in place through Executive Decree 40.227.

Thematic chapters

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Chapter 1

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

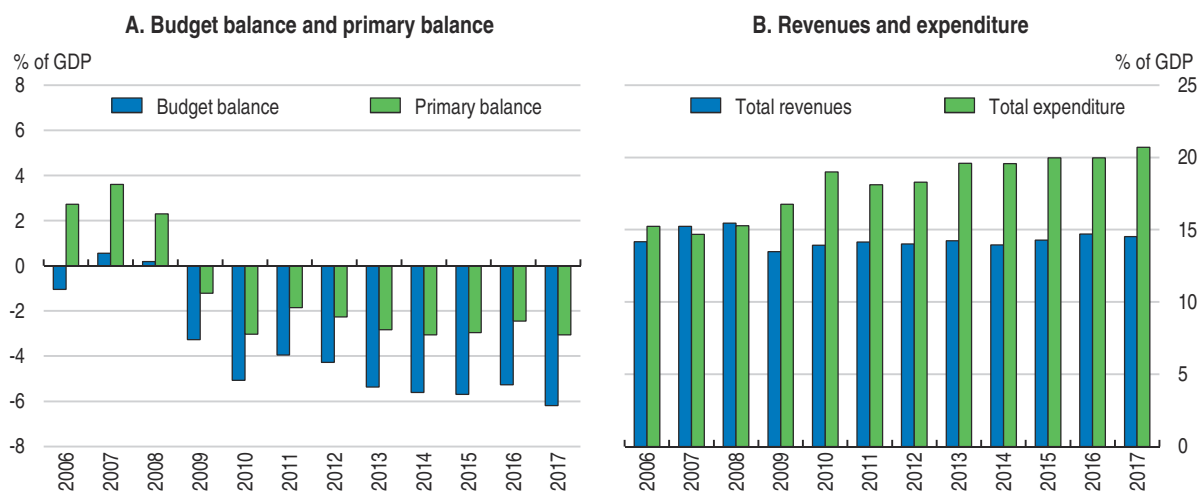
Consecutive years of primary deficits have led to mounting public debt of almost 50% of GDP, one of the fastest increases in Latin America over the last decade. Government attempts to restore fiscal health have been undermined by a gridlocked Congress. While only minor reforms have been enacted to contain 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.

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 1.1, 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% of 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.

Figure 1.1. **Budgetary imbalances are mounting**

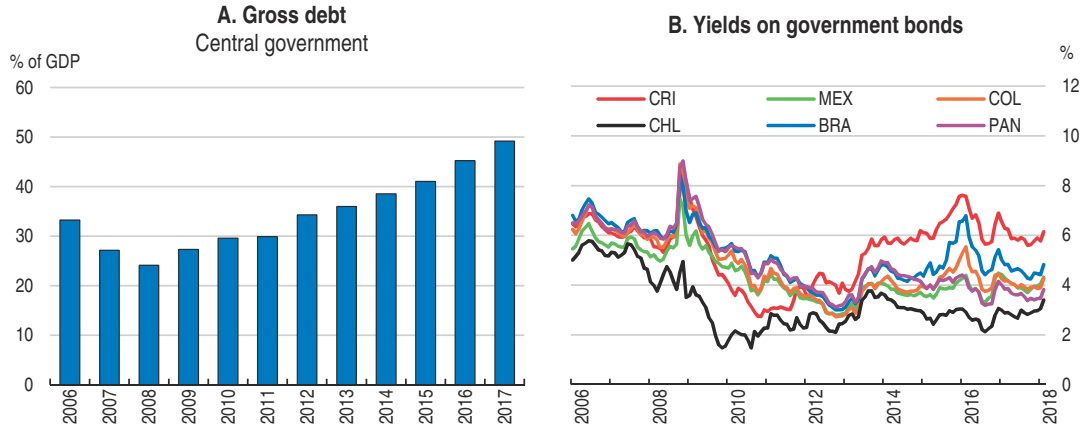


Note: Data refer to the central government only.
Source: Ministerio de Hacienda.

StatLink http://dx.doi.org/10.1787/888933702098

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 1.2 Panel A and Figure 1.3), 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

Figure 1.2. **Public debt is rising fast**



Source: Ministerio de Hacienda and Thomson Reuters Datastream.

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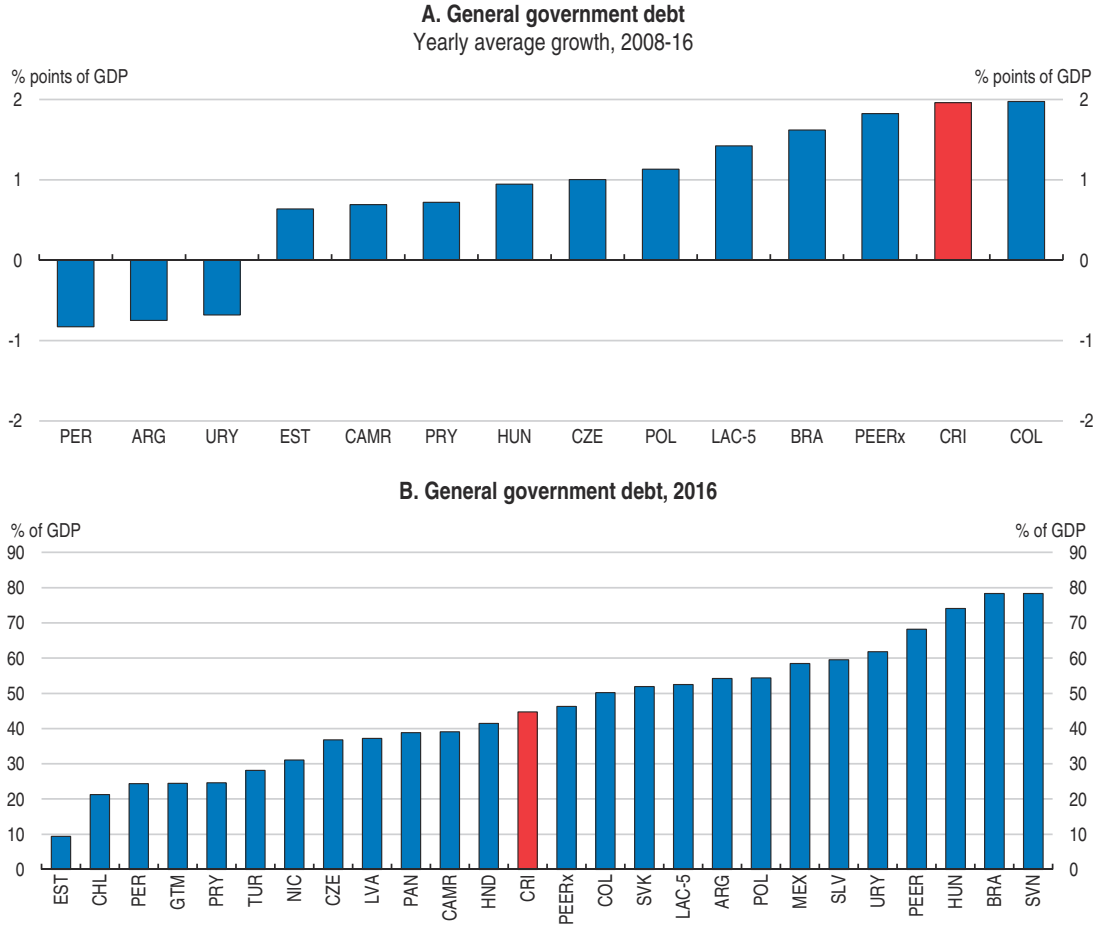
Figure 1.3. **Costa Rica's public debt dynamics has deteriorated faster than those of peers**



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.

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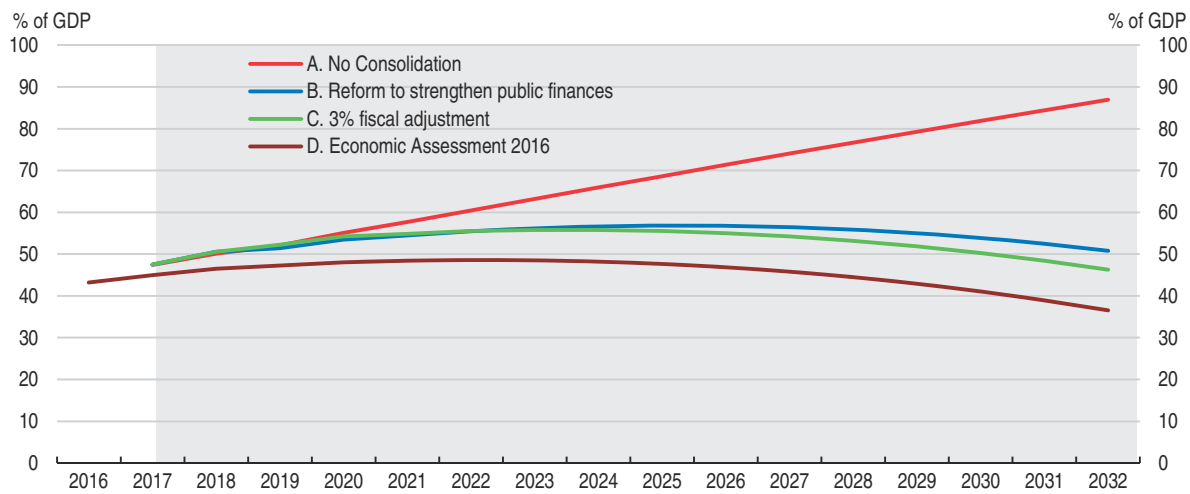
yields now among the highest in the region (Figure 1.2, Panel B). In January 2018, one rating agency changed the outlook of Costa Rica's long-term debt from stable to negative, reflecting the country's inability to correct its fiscal imbalance, putting additional upwards pressure on the cost of financing.

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).

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 1.4, 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 1.4, D. "Economic Assessment 2016").

Figure 1.4. **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 Públicas 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. For more details, see Box 1.1.
Source: OECD calculations based on data from Ministerio de Hacienda.

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Box 1.1. **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. This model uses a short-term fiscal multiplier of 0.3 as in IMF (2015). 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 1.2).

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 1.2).

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 servicing costs. 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

Box 1.2. **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 (about 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 their parent's pension for life, 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

Box 1.2. **Measures enacted by the government to contain fiscal imbalances during 2016-18** *(cont.)*

surpluses reported at the end of a year. Surpluses will have to be spent according to the National Development 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.

spending has not slowed 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% of GDP, the 2018 budget, approved in Congress on November 23 2017, includes a hiring freeze and tighter control over the spending of 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 even further relative to 2017, 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.

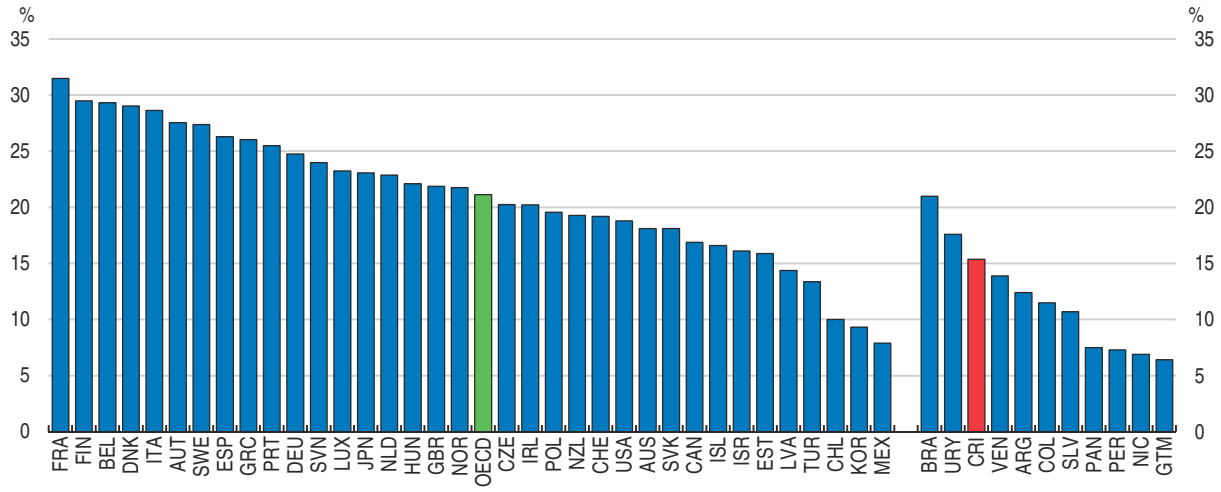
Prolonged fiscal imbalances also constrain the scope for counter-cyclical policies. Furthermore, Costa Rica's fiscal position also makes the country particularly vulnerable to sudden stops and capital flow reversals. While stronger fiscal positions do not insulate emerging markets from sudden stops (Eichengreen 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 1.5; 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.

Figure 1.5. **Social spending is relatively high in Costa Rica**

Social expenditure as a percentage of GDP, 2015 or latest available year



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

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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 increase 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 (Chapter 2).

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 to 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 1.1). 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 1.1).

Table 1.1. **Evolution of the public sector in Costa Rica**

Number of entities created

Entity	Before 1900	1900-39	1940-49	1950-59	1960-69	1970-79	1980-89	1990-99	2000-09	2010-16	**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.

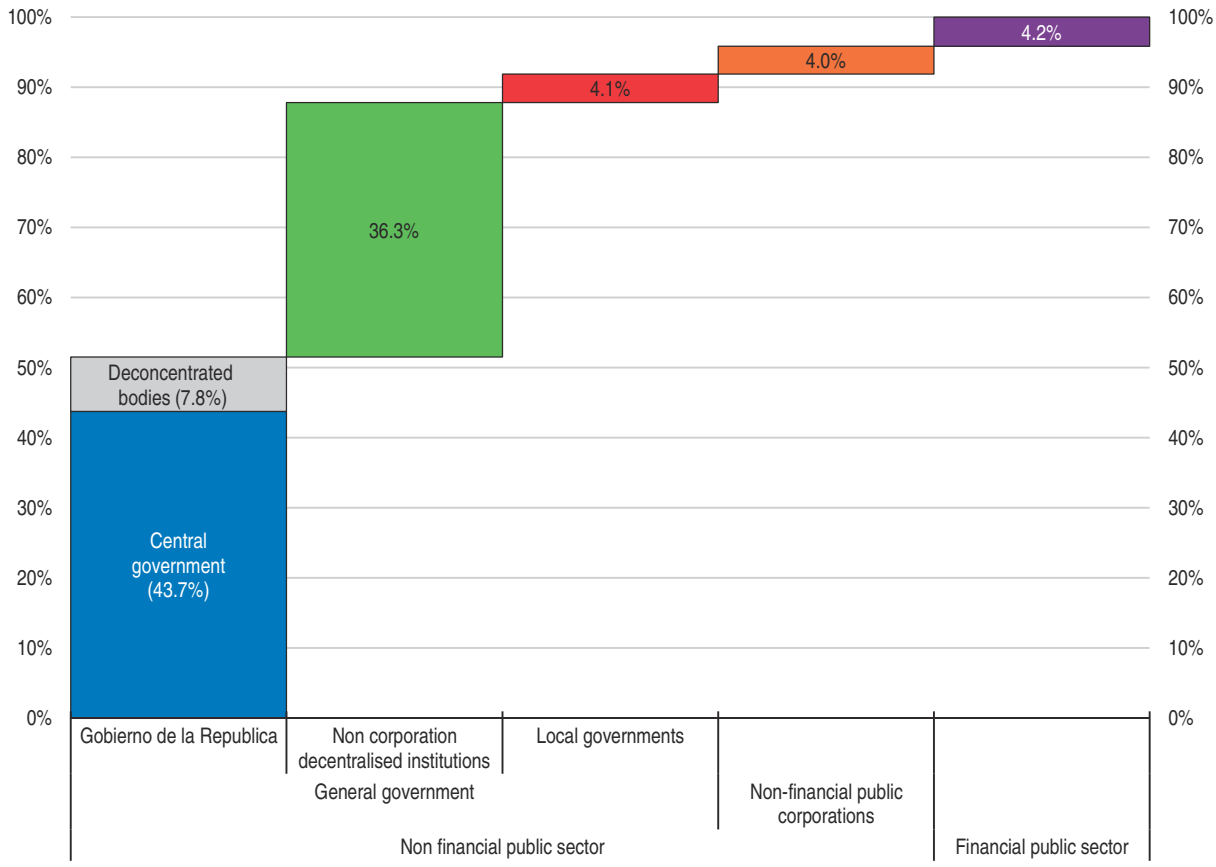
The existence of a large decentralised sector is also not associated with strong co-operation mechanisms neither between the different institutions of the decentralised sector, nor with the relevant ministries. Concurring with this outcome is that fact that the Centre of Government, formed by the Presidency, 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 co-ordination (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 co-ordinate 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 1.6). 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 re-allocated 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.

Figure 1.6. **Only half of the government budget is under the budgetary process headed by the Ministry of Finance**

As a share of total public sector expenditure, 2016



Source: Ministerio de Hacienda.

StatLink http://dx.doi.org/10.1787/888933702193

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, co-ordination and steering.

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 1.2). A worrying trend is that the share of discretionary spending has been declining over time.

Table 1.2. **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	32.0
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.

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.

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 policy 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 nor effective 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 the 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 1.4, B. "Reform to strengthen public finances"). The government estimates that the total fiscal impact of this bill amounts to 1.92% of GDP (Table 1.3). Its implementation in 2018 is still feasible as the Legislative Assembly approved a fast-track approval procedure for the *Ley de Fortalecimiento de las Finanzas Públicas* at the end of February 2018.

Table 1.3. **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**	**1.60**
Compensation of public sector workers	0.02	0.02
Fiscal Rule	0.50	0.50
Cut mandated spending	-	1.08
Total	**1.92**	**3.00**

An additional consolidation effort of one percentage point of GDP in a third consecutive year could stabilise debt four years earlier (Figure 1.4, 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

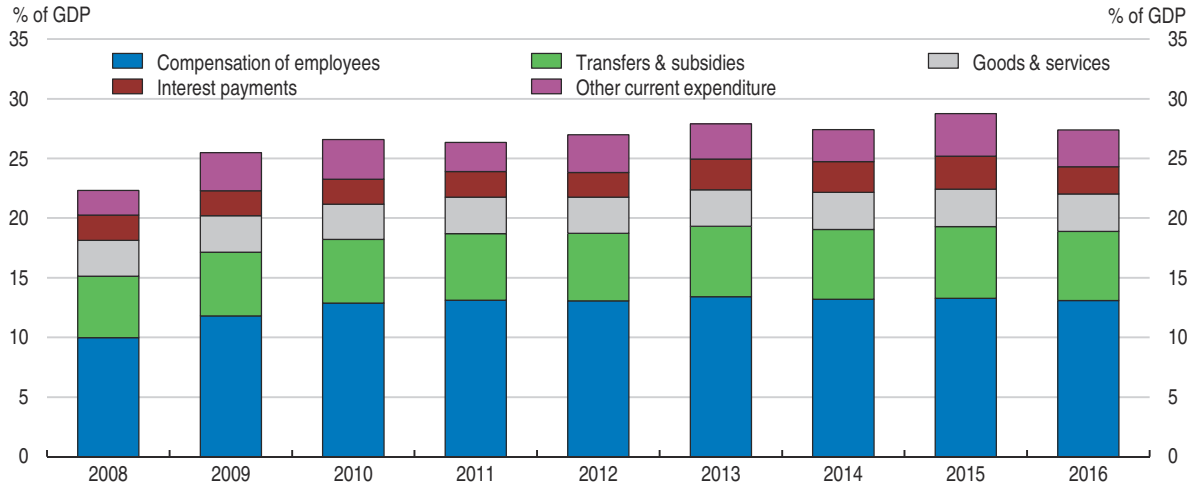
multiplier, it appears to be substantially less than unity, and low in international comparisons (Estevão and Samake, 2013). This suggests that the short-term costs of fiscal consolidation, measured by output losses, would be low and that the long-term benefits of putting the fiscal accounts back on 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).

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 below 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 1.7; Chapter 2). 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 and mandated spending demanded by the Constitution (notably in education) should be enforced.

Figure 1.7. **Compensation of public-sector employees accounts for an increasing share of spending**

General government; decomposition of current expenditure



Source: IMF Government Finance Statistics database.

StatLink http://dx.doi.org/10.1787/888933702212

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). This bill was approved in February 2018 and its implementation is now pending. This is a step in the right direction even though it only concerns less than 8% of public expenditure (Figure 1.6). 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.

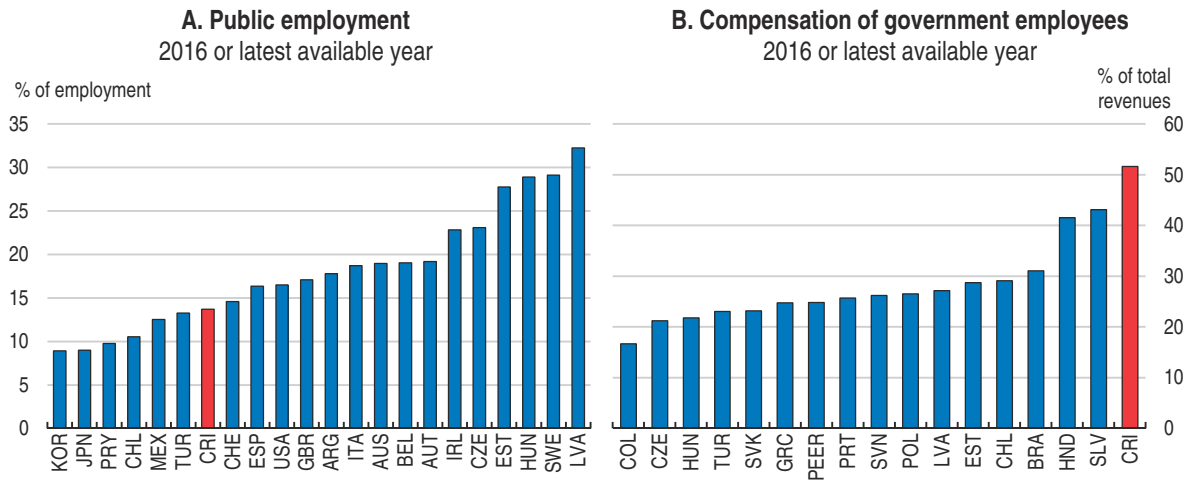
An interesting example of a successful fiscal consolidation episode that could be useful for Costa Rica is the one enacted in Sweden after the financial crisis of 1990-91. While Sweden's level of development and the economic circumstances in which public debt became unsustainable are very different, 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 revenue, is higher than in OECD countries, even though public employment is much lower than in OECD countries (Figure 1.8). 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 1.8. **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.

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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 on 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 co-ordinated 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).

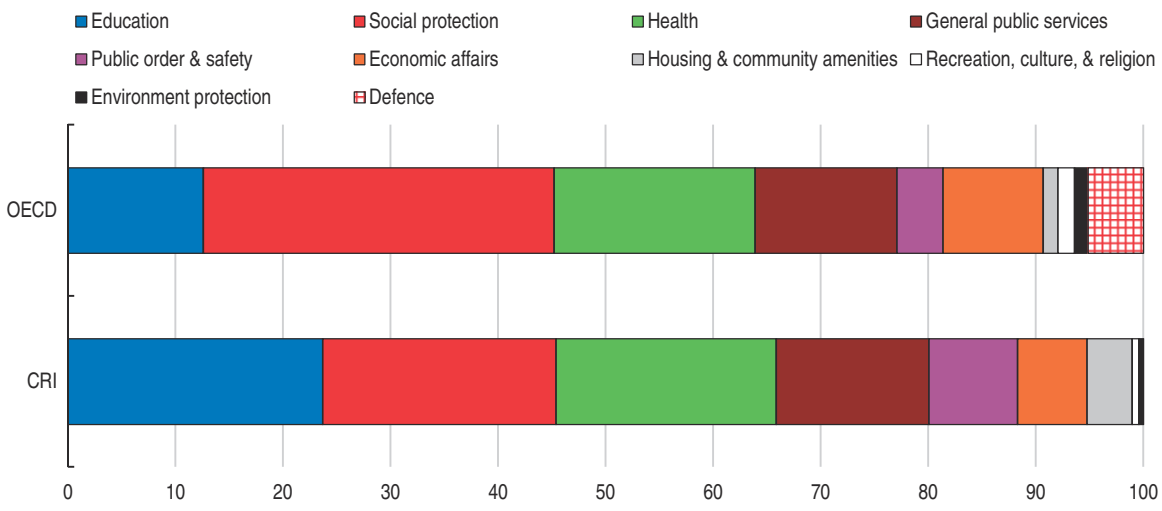
Ongoing reform efforts are led by the National Employment Commission, which gathers high level representatives from the Ministry of Labour and Social Affairs, MIDEPLAN, the Ministry of Finance, the Civil Service and the Ministry of the Presidency. The Commission has drafted bills that promote equal pay 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.[1]

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 1.9) 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.

Figure 1.9. **General government expenditure by function**

% of total, 2015



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

StatLink http://dx.doi.org/10.1787/888933702250

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

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 co-ordination.

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 co-ordination 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 Chapter 2). 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.

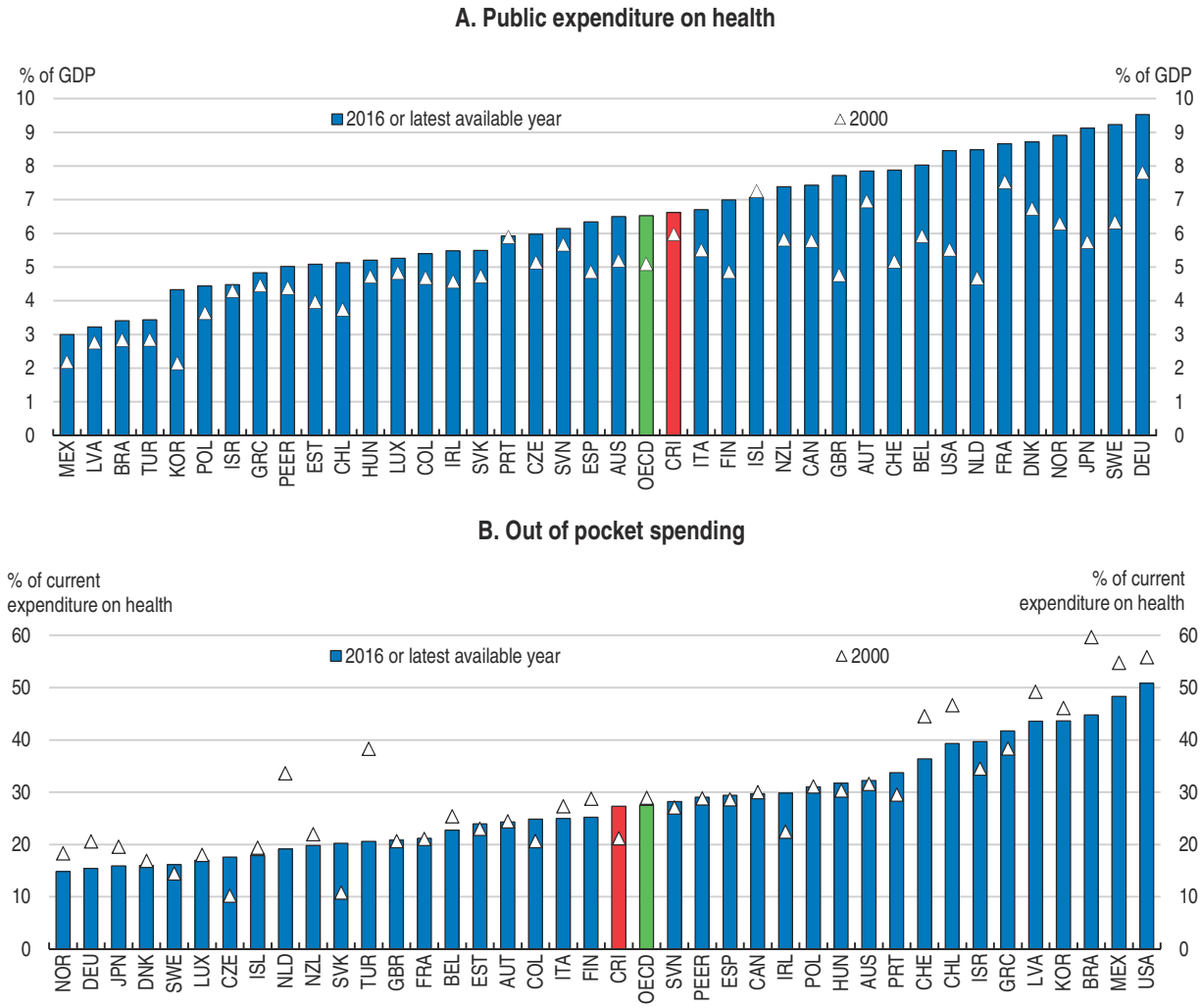
However, recent spending increases have been driven mostly by increases in medical salaries and have not benefited patients through a higher provision of health care (OECD 2017fg; World Bank, 2015). While public health spending as a percentage of GDP is now above the OECD average and continues to increase, the average daily hospital production or the number of outpatient visits per professional have declined, with users facing excessively long waiting times (Figure 1.10). 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).

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

Figure 1.10. **Public expenditure on health**



Note: 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.
Source: OECD, *Global Health Expenditure Database.*

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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 (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.

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 – Figure 1.11 sum of Panels A and B) 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 and one third of those who remain in school lack core competencies (OECD, 2017e). Costa Rican students score low in OECD PISA tests, pointing to quality issues. Moreover, 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.

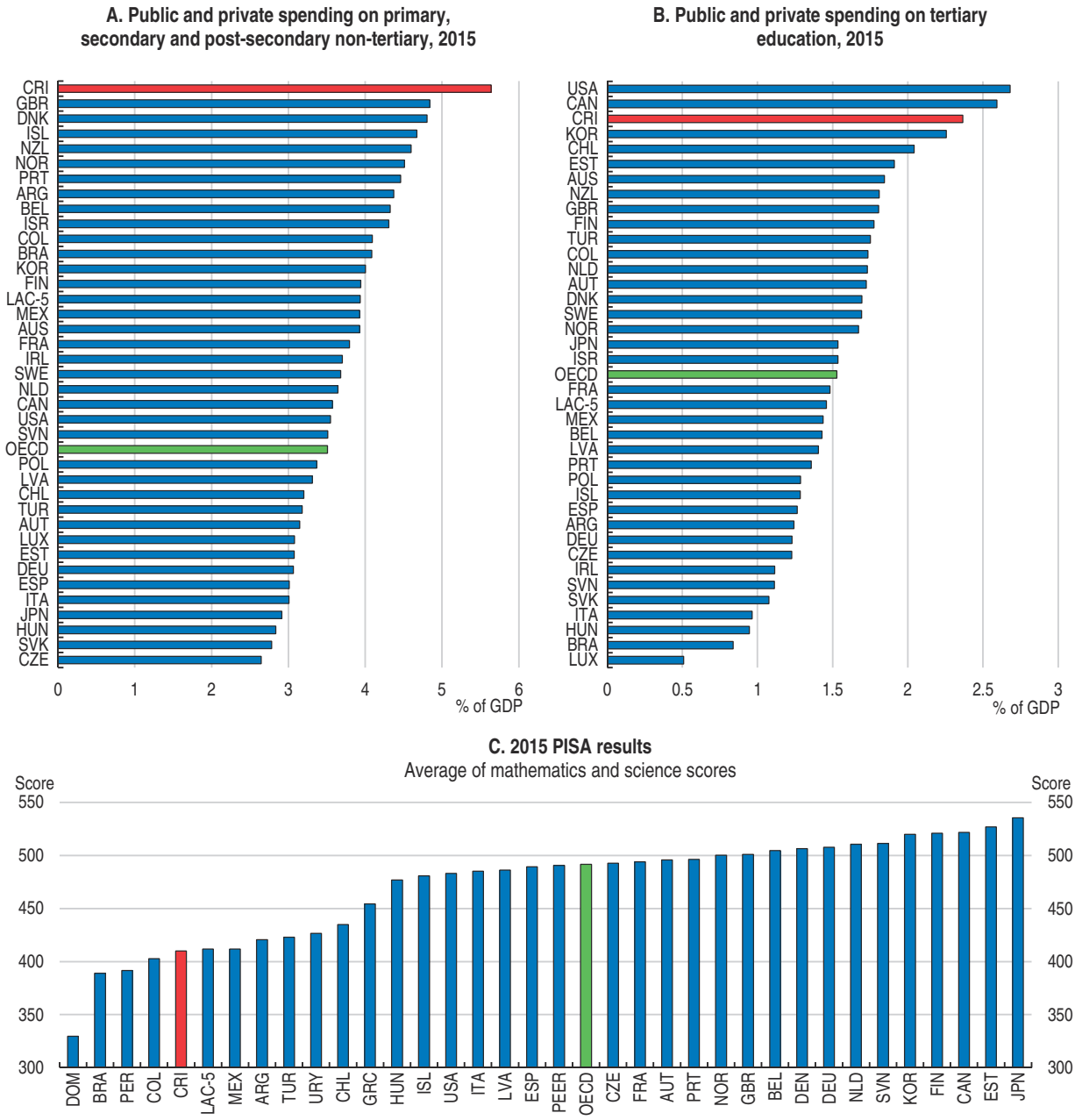
While public spending on education of 8% of GDP is unwarranted in the current fiscal context, access to good quality education not only enhances growth and well-being in the long-run, it also ensures that all citizens are able to fulfil their potential. Also, there seems to be a consensus in society 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

Figure 1.11. **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*.

StatLink http://dx.doi.org/10.1787/888933702288

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 into 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 Chapter 2).

- 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.

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 Social*, 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 were increased by one percentage point of salaries in June 2017, broader proposals to address the sustainability of the pension system are still needed and are

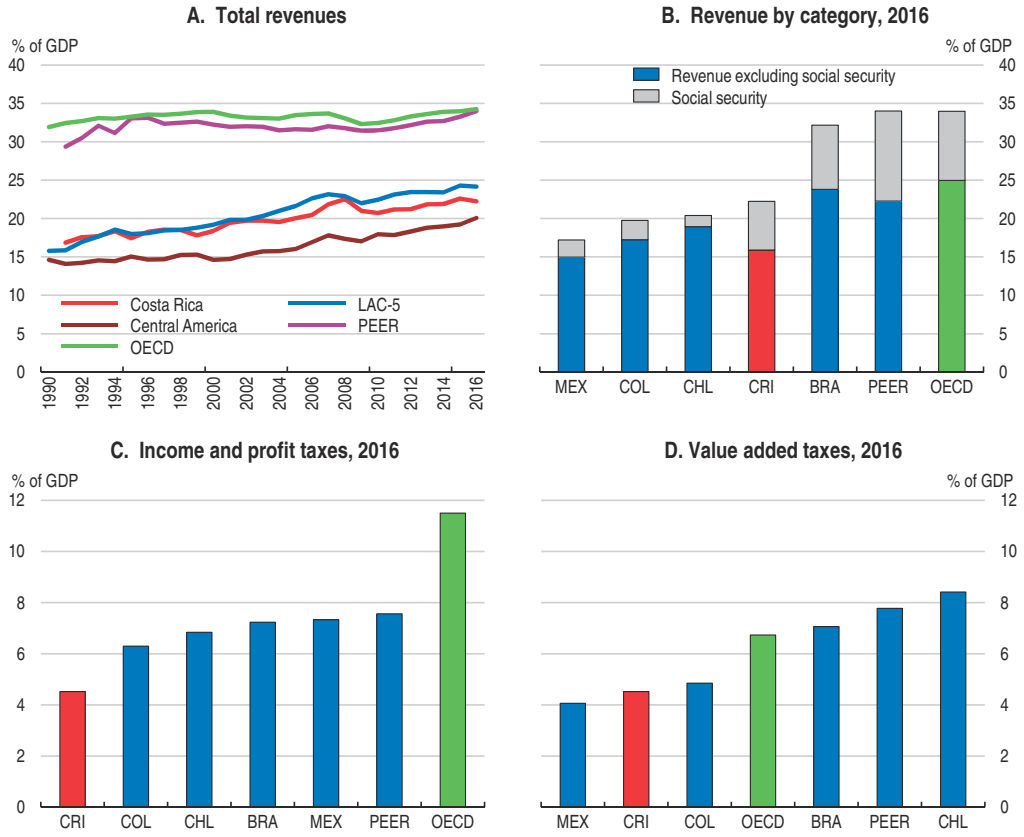
currently under discussion, following the findings and recommendations of the actuarial study of the sustainability of the pension system by Arias López et al. (2016). Reform efforts should focus on indexing pension entitlement parameters, such as benefits or the statutory retirement age, to changes 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 1.12). 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.

Figure 1.12. **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).

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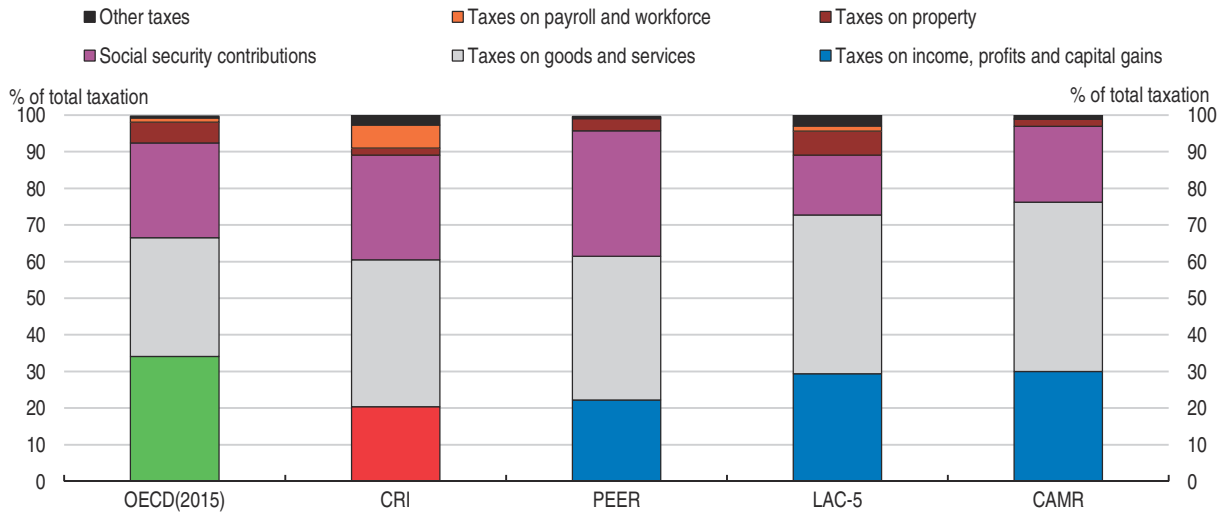
Authorities estimate that tax evasion and avoidance represented 8.22% of GDP in 2013. Tax exemptions, which amount to 5% of GDP, continue to be granted, further lowering tax revenue collection (Estado de la Nacíon, 2017). They reduce the redistributive ability of the tax system and also generate distortions 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.

Costa Rica's tax mix differs markedly from either the OECD or the LAC regional averages (Figure 1.13). 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 1.15).[2]

Figure 1.13. **Costa Rica's tax structure relies heavily on social security contributions**

2016



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 2015 data.

Source: OECD, Revenue Statistics – Latin American Countries and OECD members.

StatLink http://dx.doi.org/10.1787/888933702326

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 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 system.

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 had also submitted a VAT reform, intending to increase the tax rate from 13% to 15% and enlargen 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 was well designed to avoid negative impacts on poorer households and is consistent with the view that zero or reduced 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.

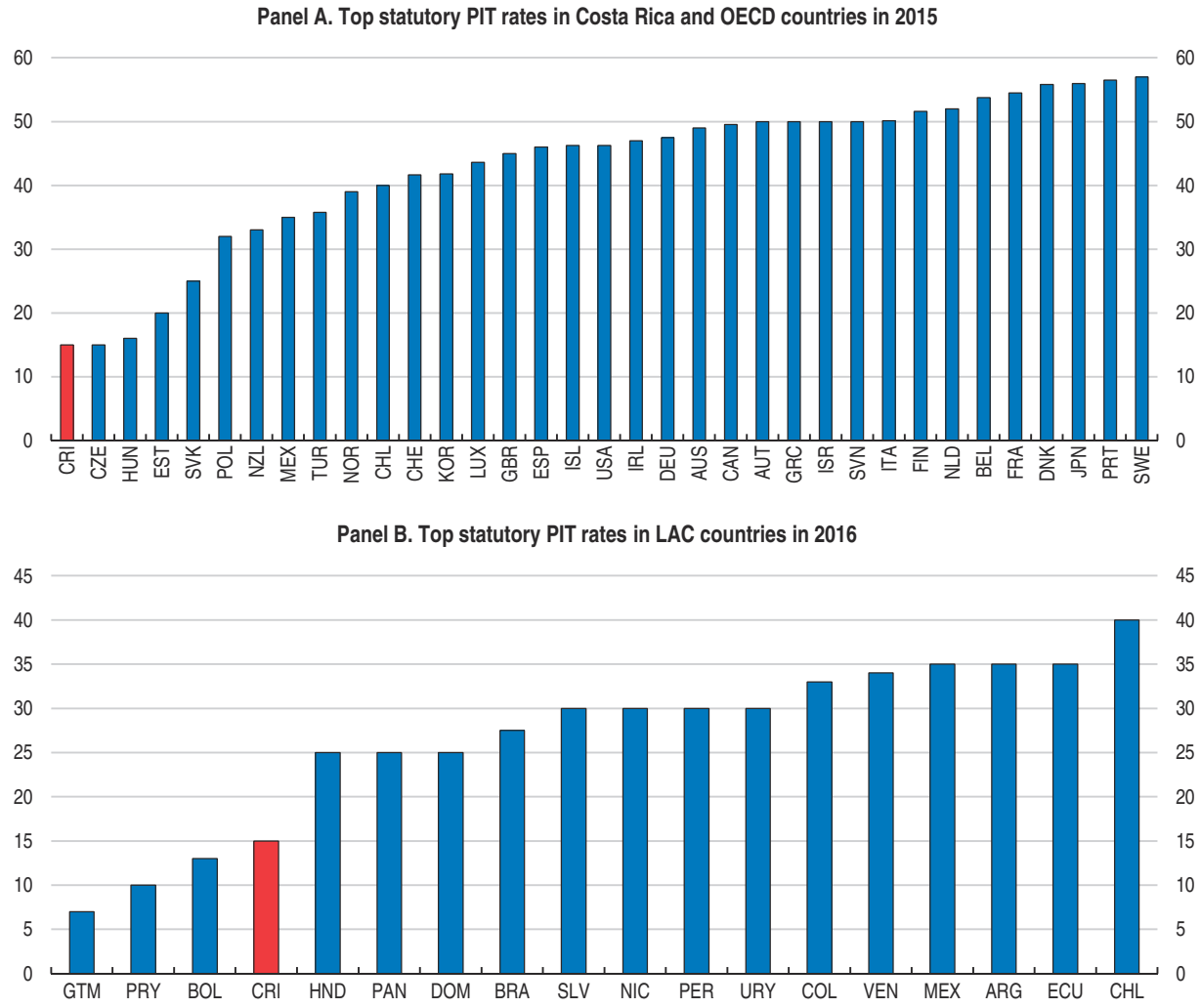
As part of the comprehensive fiscal sustainability package (*Ley de Fortalecimiento de las Finanzas Públicas*), the current tax reform proposal has been modified from the original proposal, but still contemplates transforming the current sales tax into a fully-fledged VAT tax, extended to services, thereby 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 1.3) 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 1.14). 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

Figure 1.14. **There is space to raise additional revenues from PIT**



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

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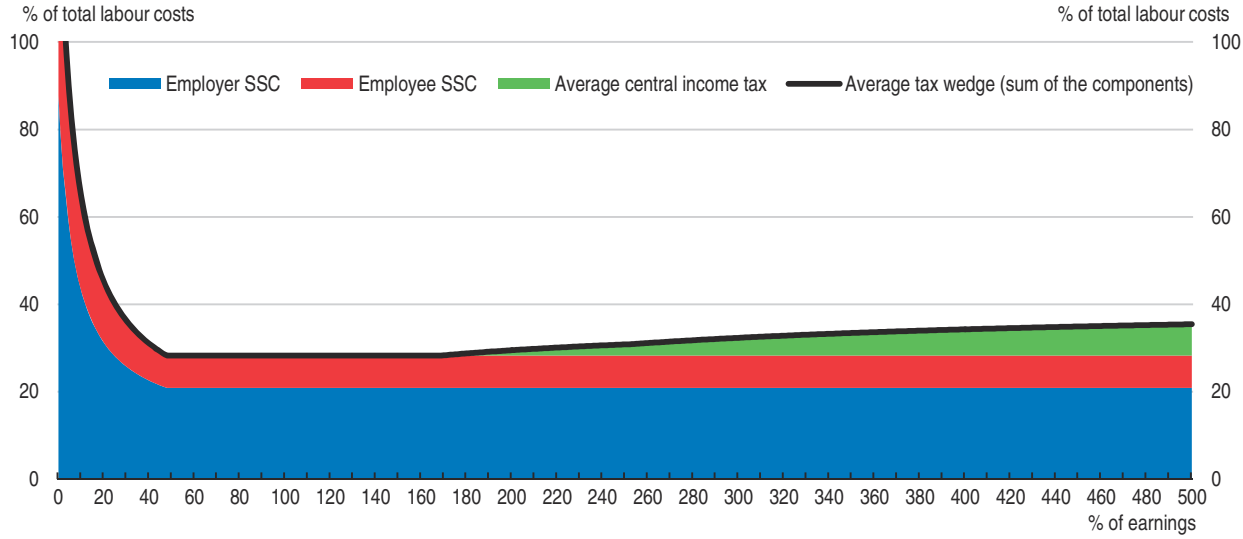
higher share of fiscal revenues than in Latin American countries or OECD countries. However, these taxes are regressive; they increase labour costs and harm employment, especially for the low skilled, and feed informality (Figure 1.15). Moreover, the strong reliance on social security contributions, 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 1.15. **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*.

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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 forecasts 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 a fiscal expenditure 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).[3] 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 it 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 the 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 the 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 the 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 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% of countries) or in the legislature (34% of 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, CCSS (which administers the contributory pension fund) and the state-owned insurance company (where insurances also benefit from a state guarantee) hold large amounts of public debt in their portfolios. 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 IFIs improve the public's understanding of the quality of fiscal policy and 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 co-ordinating 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's debt is issued domestically (Figure 1.21). 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 co-ordination 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 duplicate 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 co-ordination 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 co-ordination 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, and 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, an 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 practice 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 1.3. **Fiscal policy recommendations**

(Key recommendations included in the Executive Summary are bolded)

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.

Box 1.3. **Fiscal policy recommendations** *(cont.)*

(Key recommendations included in the Executive Summary are bolded)

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.

Notes

1. 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.
2. 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).
3. 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.

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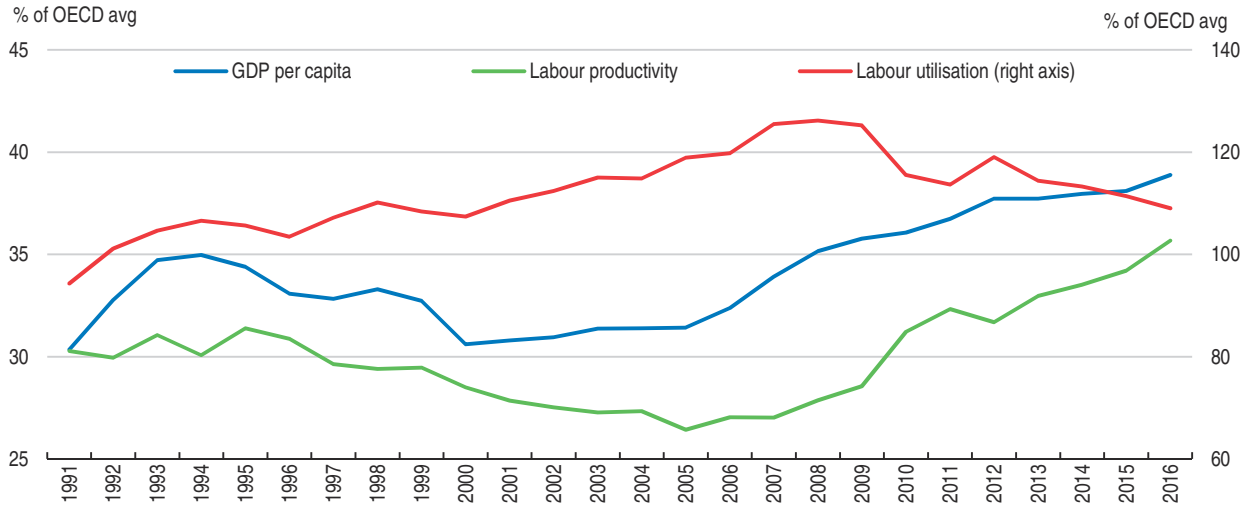
Chapter 2

Structural policies to boost productivity and inclusion

Owing to past structural reforms, Costa Rica has enjoyed robust GDP growth and productivity levels are gradually converging towards the OECD average. However, large GDP per capita and productivity gaps persist. In addition, not everyone has benefited from this growth. Inequality has increased and labour market conditions are a concern. Costa Rica has a lower share of employed workers in the population than almost all OECD countries, unemployment remains well above its pre-global-financial-crisis level, labour market participation has decreased and the share of informal jobs is high. Recognising these challenges, Costa Rica has accelerated its structural reform momentum recently, with policy reforms underway or planned in several areas that present win-win opportunities to boost both productivity and inclusion. These include efforts to tackle labour market informality, simplify the minimum wage structure, increase competition and reduce regulatory burdens. In addition to further reforms in these priority areas, structural policy improvements are also needed to increase outcomes and reduce inequalities in education and address significant transport infrastructure gaps.

While Costa Rica's economic and social achievements have been significant, greater productivity growth and inclusiveness are needed to improve living standards further and distribute the benefits of progress more widely. The recovery in output growth after the global financial crisis was rapid and robust, with GDP growth of above 4% in most years since 2010. In addition, after many years of sluggish productivity growth, performance has improved since the mid-2000s and is now driving convergence towards the OECD average (Monge-González, 2016; Escobar and Meehan, 2018). Average annual labour productivity growth has picked up from 0.6% between 1993 and 2005 to 3.7% between 2006 and 2016, and similarly, multi-factor productivity (MFP) growth has gone from 0.5% to 2.9% (Figure 2.1 and Figure 2.2). This acceleration has been broad based, with most industries experiencing a structural break towards higher productivity growth (Escobar and Meehan, 2018). However, significant scope for further convergence remains. GDP per capita is 39% of the OECD average and remains below that of Mexico and Chile (Figure 2.3). This gap reflects low labour productivity, which stands at 36% of the OECD average, while labour utilisation is above the OECD average (Figure 2.1). Furthermore, even at the faster growth rate experienced over the last decade of 3.7% a year, it will take almost 30 years to reach the current OECD average labour productivity level. Boosting productivity will therefore be key to raising living standards.

Figure 2.1. **GDP per capita and labour productivity are converging, but remain at low levels**

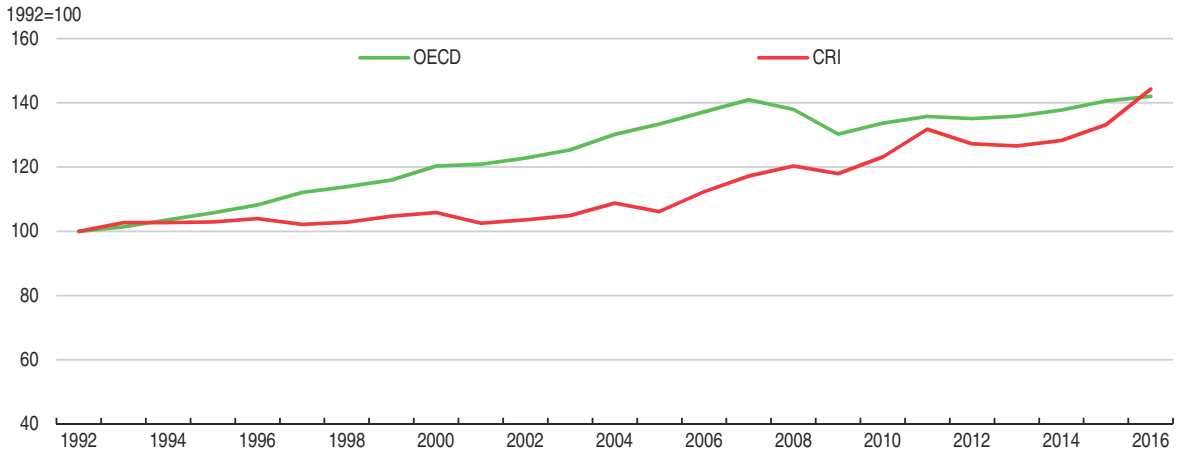


Source: OECD Productivity Database.

StatLink http://dx.doi.org/10.1787/888933702383

Moreover, in order for economic growth to improve the lives of all Costa Ricans, its benefits need to be more widely spread. Inequality is high relative to OECD countries, and in contrast to other Latin American countries, has been increasing (González Pandiella and Gabriel, 2017). This income inequality is tempered by the public provision of health care and education, which has been a key component of Costa Rica's social progress. Indeed,

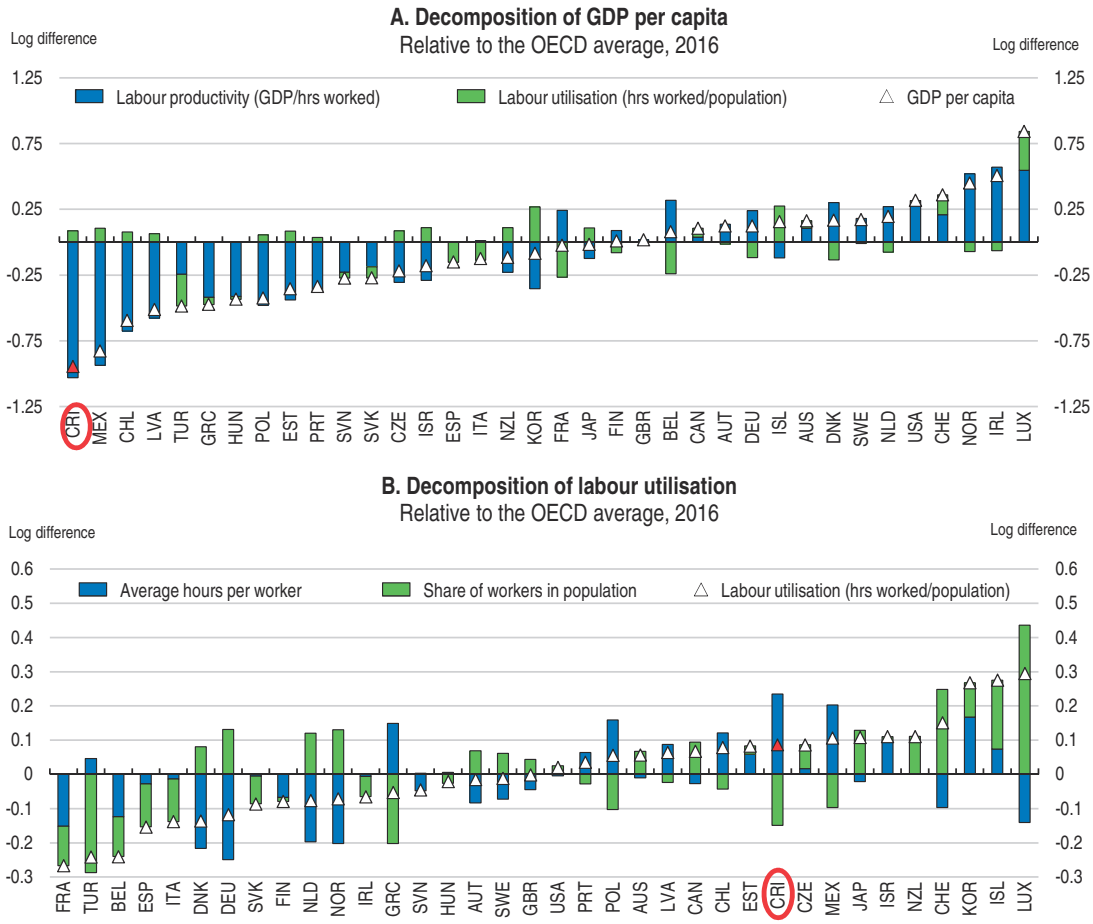
Figure 2.2. **Multi-factor productivity growth has picked up**



Note: OECD is a simple average of OECD member countries' MFP growth rates.
Source: *OECD Economic Outlook Database.*

StatLink http://dx.doi.org/10.1787/888933702402

Figure 2.3. **The GDP per capita gap reflects low productivity and employment, but long working hours**



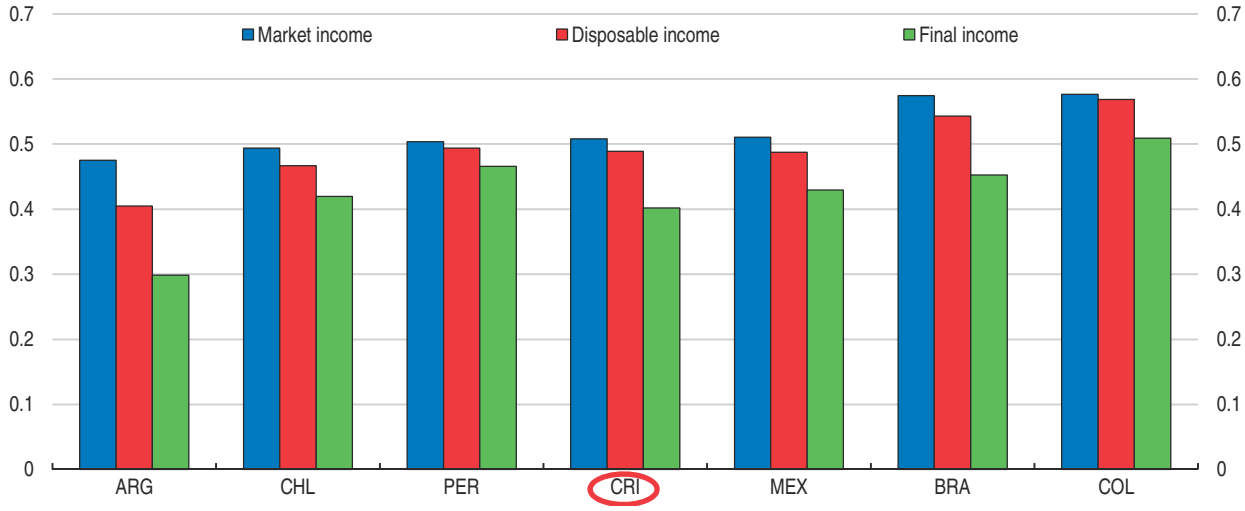
Source: *OECD Productivity Database.*

StatLink http://dx.doi.org/10.1787/888933702421

while market and disposable income inequality is similar to that of Peru and Mexico, the distribution of final income is more equal due to these in-kind benefits (Figure 2.4). However, there is evidence that Costa Ricans are becoming increasing dissatisfied with the quality of these public services and out-of-pocket spending on health care has been increasing (Estado de la Nación, 2016; Estado de la Nación 2017; OECD, 2017a; Chapter 1).

Figure 2.4. **In-kind benefits moderate high market- and disposable-income inequality**

Gini coefficient, 2010[1]



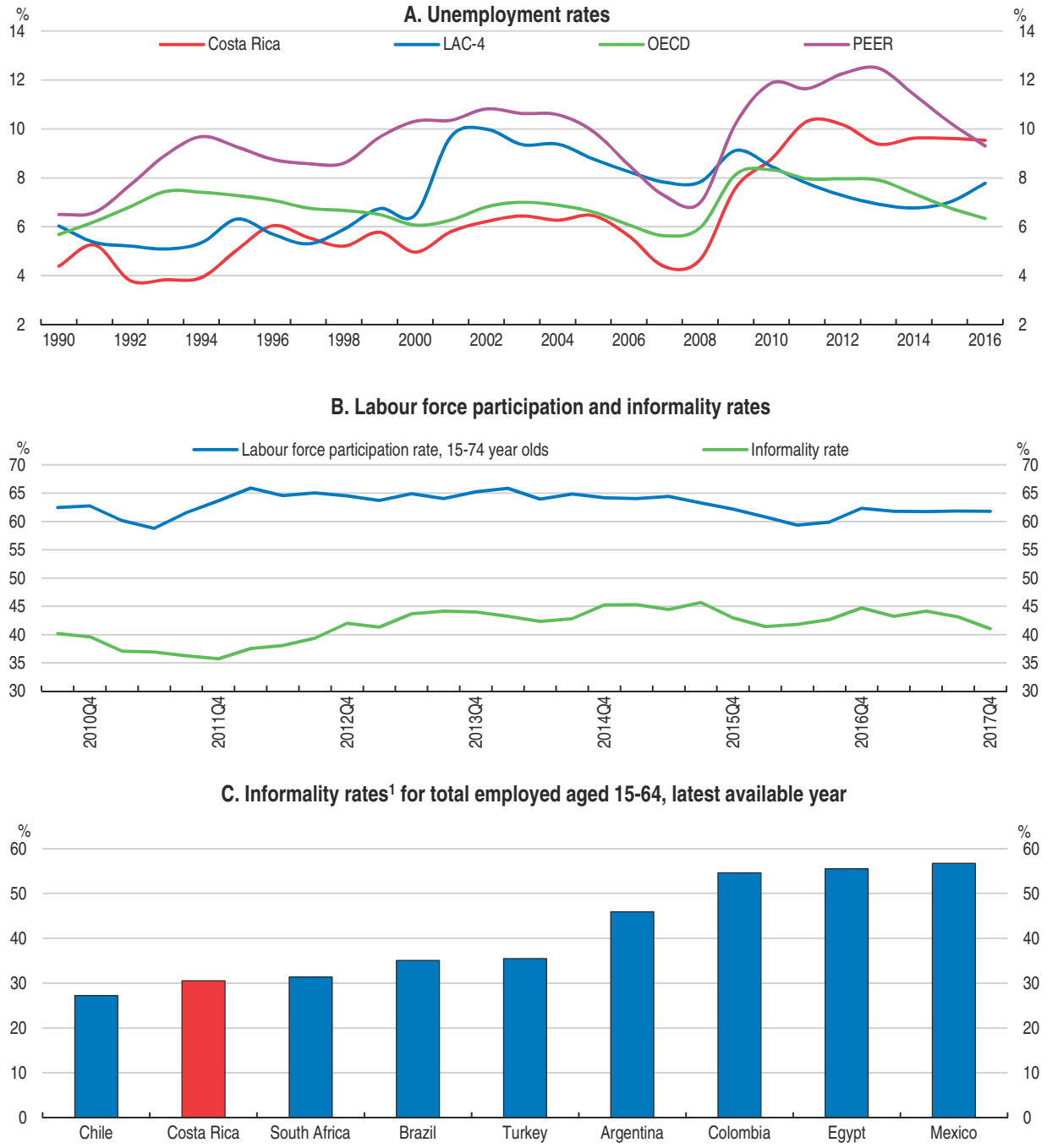
1. Reference year is 2013 for Chile and 2009 for Peru and Brazil.
Source: Lustig (2017).

StatLink http://dx.doi.org/10.1787/888933702440

Strong economic growth has also failed to translate into positive labour market outcomes. While Costa Rica's labour utilisation (hours worked per capita) is above the OECD average, this reflects working hours among the employed that are longer than all OECD countries, but below-average employment rates (workers as a share of the total population) due to high unemployment and low labour force participation (Figure 2.3, Panel B; Figure 2.5, Panels A and B). Indeed, the share of employed workers in the population is lower than all OECD countries except Greece and Turkey (Figure 2.3, Panel B). Unemployment has remained elevated since the global financial crisis, with much of this increase due to structural change as industries which traditionally absorbed low-skilled labour have grown more slowly than high-skilled manufacturing and service sectors (Banco Central de Costa Rica, 2016; OECD, 2017b; Sandoval et al., 2017). This is reflected in the increase in long-term unemployment – in 2016, 16.7% of unemployed had been out of work for more than a year compared with 9.8% in 2012 – which, combined with falling labour market participation rates, suggests that many workers have become discouraged (Estado de la Nación, 2017; Figure 2.5).

In addition, while the share of workers in informal jobs is lower than other countries in the region, such as Colombia, Brazil and Mexico, it is high by OECD standards (Figure 2.5, Panel C). The share of workers holding informal jobs has also increased in the recent past and now remains stubbornly high at around 41% (Figure 2.5, Panel B). This contrasts with other Latin American countries where informality has been falling (OECD, 2017b; Box 2.2.). The negative impact of these developments is mostly keenly felt by disadvantaged groups and those who are less equipped to adapt to the higher skill levels demanded by the labour

Figure 2.5. **Labour market conditions remain a concern**



1. Informality is defined to include i) employees who do not pay social security contributions, and ii) self-employed who do not pay social security contributions (Chile, Costa Rica and Turkey), or whose business is not registered (Argentina, Brazil, Colombia, Egypt, Mexico, Peru and South Africa). The informality rate for Costa Rica differs from the official measure of informality from INEC presented in Panel B in order to facilitate cross-country comparisons (see OECD, 2017b).

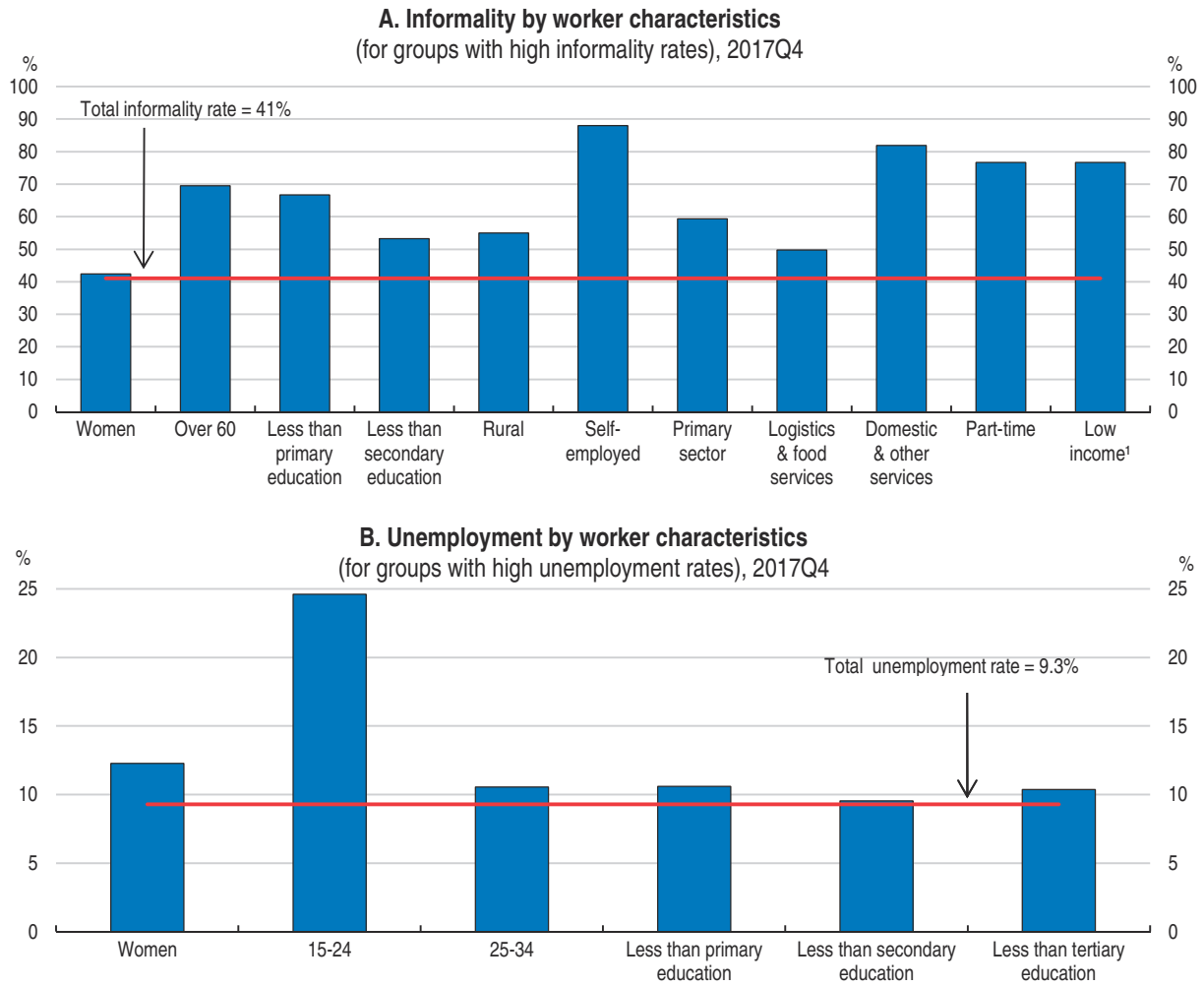
Note: LAC-4 is a simple average of Brazil, Colombia, Chile and Mexico. PEER is the 10 non-Latin American OECD countries with the lowest GDP per capita: Czech Republic, Estonia, Greece, Hungary, Latvia, Poland, Portugal, Slovak Republic, Slovenia and Turkey.

Source: *OECD Economic Outlook* 102; INEC Encuesta Continua de Empleo; OECD (2017b).

StatLink http://dx.doi.org/10.1787/888933702459

market, including those with low education levels, the young, women and those living in rural areas (Figure 2.6). This mismatch between the skills demanded and supplied is also evident in the increasing earnings premium for skilled workers, which is further contributing to rising inequality (González Pandiella and Gabriel, 2017).

Figure 2.6. **Labour market outcomes are particularly poor among disadvantaged groups**



1. Panel A: Low income refers to hourly earnings of less than the lowest minimum wage.
Source: INEC, Encuesta Continua de Empleo.

StatLink http://dx.doi.org/10.1787/888933702478

Structural policy reforms are needed to avoid poverty traps whereby individuals with low skills and poor access to opportunities are confined to low-productivity and low-wage jobs, which in turn reduces aggregate productivity and further worsens inequality (Ferreira et al., 2014; OECD, 2016a). Setting in motion a "virtuous cycle" will require co-ordinated and concerted reforms across a range of policy areas that provide win-win opportunities to boost both productivity and inclusion (OECD, 2016a). This chapter first discusses policies to boost inclusion that will help individuals fulfil their potential and lay the foundations for stronger future productivity growth, including measures to make labour markets more inclusive and enhance education. It then discusses policies to increase productivity growth and help firms fulfil their potential that will also level the playing field and reduce

economic inequalities, including reforms to strengthen competition, promote innovation and address transport infrastructure gaps.

Recognising the twin challenges of boosting productivity and inclusion, Costa Rica has accelerated its structural reform momentum recently, with initiatives to improve policy design across a number of areas. Examples of areas where legislative changes have been made and/or other initiatives are well advanced include an overhaul of the labour laws to improve worker protection that came into force in July 2017, the roll-out of a modernised school curriculum that is due to be completed in 2018, modifications to social security contributions aimed at increasing coverage among target groups of workers and a reduction in the number of minimum wage categories. Effectively implementing reforms still poses a significant challenge in some of these areas, particularly given the high degree of institutional fragmentation and lack of co-ordination, steering and accountability mechanisms across many areas of the public sector (OECD, 2015a; OECD, 2016b; OECD, 2017a; OECD, 2017b; OECD, 2017c; OECD, 2017d; OECD, 2017e; Chapter 1). For example, greater teacher training is needed to successfully implement the new school curriculum, with half of surveyed teachers unable to explain the difference between the new and old curricula (OECD, 2017c). Other positive initiatives are currently in the planning or consultation stage. Examples include a bill to increase the independence and resources of the competition authority, the development of a bill to unify and streamline the regulatory framework for business insolvency, and the establishment of a national strategy to transition to a formal economy. Greater reform efforts are needed in some important areas, such as shifting the focus of education to outcome targets and strengthening competition. However, many initiatives aimed at adopting the 2016 OECD Economic Assessment recommendations are underway.

The breadth and depth of possible structural policy improvements highlighted in the 2016 Economic Assessment and several recent in-depth OECD policy reviews of Costa Rica also underscore the importance of directing immediate reform efforts to areas that are likely to bring large gains and/or that set the framework conditions necessary to fully realise the benefits of future reforms. Based on available research quantifying the potential gains of reforms (see Box 2.1) and the experiences of other countries, reforms to reduce labour market informality, improve educational outcomes, strengthen competition and address transport infrastructure gaps are highlighted as important areas. In labour markets and education, priority actions include expanding early childhood education and care, refocusing spending to pre-tertiary education and further progressing towards a simpler minimum wage. To boost productivity, reforms should focus on enhancing competition, including by adopting and implementing the bill reinforcing the powers, independence and funding of the competition authority. Other priorities include restricting the scope for anti-trust exemptions from competition, and reducing burdensome regulation that limits firm entry and exit and business formalisation.

Box 2.1. **The potential impact of structural reforms**

The quantification of the impact of structural reforms on GDP provides insights into the potential size of the payoff, which is a useful input into prioritisation decisions. Table 2.1 summarises relevant estimates of the effects of structural reforms. While differences in measurement and methodology make it difficult to compare across the various reform areas and the effects are not additive, these estimates provide an indication of the sizeable effect that improvements in labour market, education, product market, insolvency and transport infrastructure policies may have.

Box 2.1. **The potential impact of structural reforms** *(cont.)*

Table 2.1. **Potential impact of structural reforms**

Structural policy area	Description and magnitude of improvement	Estimated impact	Source
Inclusive labour markets			
Reduce gender gaps in labour market participation	Eliminate gender gaps in labour market participation and opportunities (i.e. choice to become an entrepreneur and choice of job)	Gender gaps in Costa Rica result in a 22% total loss in long-run income	Cuberes and Teignier (2016)
Education and skills			
Improve skill levels	Achieve universal basic skills (i.e. universal secondary school enrolment for 15 year olds and PISA scores of 420 or above)	Increase in GDP growth of 0.65 percentage points a year	OECD(2015b)
Product market regulation			
Improve the governance of state-owned enterprises (SOEs)	SOEs no longer have access to financing that is not available to private companies. Establish an ownership unit within the Ministry of the Presidency to manage the government's equity in SOEs.	1.1% long-run increase in GDP per capita levels[1]	Égert (2017); Égert and Gal (2017)
Streamline the licences and permits system	Establish one-stop shops implemented at the local level with information available online.	1.6% long-run increase in GDP per capita levels[1]	Égert (2017); Égert and Gal (2017)
Reduce administrative barriers for firms	Procedures that are currently done by the entrepreneur (e.g. registering with the social security agency) are done by a one-stop shop. The number of days to register a business reduces to 20, and the number of bodies to contact in order to register falls to 1.	0.9% long-run increase in GDP per capita levels[1]	Égert (2017); Égert and Gal (2017)
Remove anti-trust exemptions	Anti-trust exemptions are removed.	0.5% long-run increase in GDP per capita levels[1]	Égert (2017); Égert and Gal (2017)
Improve trade facilitation through better communication	Regulations are communicated in an accessible manner at the international level.	0.9% long-run increase in GDP per capita levels[1]	Égert (2017); Égert and Gal (2017)
World Bank Doing Business			
Improve insolvency procedures[2]	Reduce the time to insolvency from 3 years to 2.5 years.	5.4% long-run increase in GDP per capita levels[1]	Égert (2017); Égert and Gal (2017)
Transport infrastructure			
Improve road infrastructure quality	Increase the quality of Costa Rica's roads to the median for Latin American countries, based on the World Economic Forum Global Competitiveness Report quality measure.	Increase in GDP growth of 0.14 percentage points	Lanau (2017)
Expand the road network	1% increase in the number of kilometres of road.	Increase in GDP growth of 0.18 percentage points	Lanau (2017)

1. The change in GDP per capita is calculated using Equation 5 of Égert and Gal (2017) and assumes a labour force to working-age population ratio in 2013 of 56.4% for Costa Rica.
2. Due to estimation differences, the magnitude of the impact of a change in the World Bank Doing Business insolvency measure is not directly comparable to the OECD PMR results in Égert (2017).

Box 2.1. **The potential impact of structural reforms** *(cont.)*

For example, recent OECD research estimates the effect of reforms on GDP per capita levels using simulations based on historical and cross-country relationships between reforms and growth in OECD and non-OECD countries (Égert, 2017). Taken together, the proposed product market regulation (PMR) measures could boost GDP per capita by 5.1% in the long term. These gains are sizeable despite the fact that even if all of these product market reforms were implemented, the stringency of regulations in Costa Rica would remain significantly above the OECD average, and be at a similar level to Greece or Slovenia and slightly better than Colombia. Reducing the time it takes to resolve corporate insolvency from the current 3 to 2.5 years could boost GDP per capita by 5.4%. However, it is important to note that the magnitude of the insolvency estimate is not directly comparable to the PMR results due to methodological differences. In particular, the PMR estimates are based on average time (within) effects, whereas the insolvency estimate uses cross-country (between) effects. This makes a large difference to the results – for example, using PMR estimates based on cross-country effects would yield much larger estimates, in the range of a 24% boost to GDP per capita. It should also be noted that improvement measures are often only proxies. For example, increasing the road network is a proxy for the quantity of infrastructure in Lanau (2017), and furthermore, increasing the road network will only bring benefits if investment decisions are based on sound selection and prioritisation of projects via cost-benefit analysis.

There are some other important policy areas that have not yet been quantified for Costa Rica, although estimates for other countries provide a general indication of the potential impact of reforms. For example, for Mexico it is estimated that resource misallocation is much higher among informal firms and every Mexican peso of capital and labour that is allocated to an informal firm would be worth 28% more if allocated to a formal firm. While estimates for Costa Rica are not available, this suggests that informality has a large negative impact on aggregate productivity and GDP (Busso et al., 2012). In aggregate, improving resource allocation could increase GDP in Mexico by 125%, with informal firms accounting for 35 percentage points of this gain (IMF, 2017).

Likewise, estimates of skill mismatches for Costa Rica based on the OECD Survey of Adult Skills data are not available. However, eliminating skill mismatches in a country where about a third of workers are either under- or over-skilled for their jobs (such as in Italy) could increase productivity levels by 10% (Adalet McGowan and Andrews, 2015).

Making labour markets more inclusive

Lifting the quantity and quality of jobs is a priority for achieving inclusive growth in Costa Rica. The share of workers in the Costa Rican population is lower than almost all OECD countries (Figure 2.3, Panel B). This is despite the fact that, at 66.1%, the share of the population that is of working age (15-64 years old) is similar to the OECD average (66.7%), reflecting a higher share of children but a lower share of those aged 65 and over in Costa Rica. Thus, there is significant scope to increase the level of labour market activity, particularly among women and young people, and to reduce labour market segmentation by addressing barriers to formalisation.

Costa Rica has a flexible labour market, with employment protection legislation for permanent workers that is less stringent than most OECD countries, and limited differences between the regulations relating to temporary and permanent employees (OECD, 2017b). Despite this, there is significant labour market segmentation, which is largely driven by cost differences between formal and informal employment. This high and increasing level of informality is hindering worker mobility, productivity-enhancing resource allocation and workers' access to quality jobs (López-Calva and Lustig, 2010; Busso et al., 2012; Hoeller et al., 2012; Hsieh, 2015; OECD, 2016a; OECD and IDB, 2016). For example, improving resource allocation could increase GDP in Mexico by 125%, with informal firms accounting for

35 percentage points of this gain (IMF, 2017; Box 2.1). While the estimated gains are likely to be smaller for Costa Rica as its informal sector is smaller than Mexico's (Figure 2.5, Panel C), these gains are still significant.

The total labour market participation among 15-64 year olds in Costa Rica was 65% in 2016, which is lower than the OECD average of 71.7% (Table 2.2). This lower participation as well as higher unemployment rates are reflected in the employment rate, which was 58.7%, for 15-64 year olds compared with the OECD average of 67.0%. In addition, despite an increase over time, at 50.4% in 2016, the participation of working-age women in the labour market is lower than all OECD countries except Mexico and Turkey (Figure 2.7). In 2016, just 44.3% of working-age Costa Rican women were in employment compared with 59.4% across OECD countries. A large gender gap also persists, as the male participation (79.2%) and employment rates (72.8%) are much higher, and the unemployment rate among men is lower (8.1% versus 12.2% for women) (Table 2.2). These disparities exist despite better school performance by girls than boys in Costa Rica, slightly higher levels of education among working-aged women than men, and a gender-wage gap that is lower than in any OECD country (1.8% of the male median wage in 2016) (Carrillo et al., 2014; OECD, 2016b; OECD, 2017c). Traditional gender roles remain strong and care responsibilities are one of the main barriers limiting higher participation by women, particularly for low-income women (Figure 2.8). Overall, many women are not fully using and developing their skills, which not only exacerbates socio-economic inequalities, but also limits aggregate productivity and income growth (Ruhm and Waldfogel, 2011; Mateo-Diaz and Rodriguez-Chamussy, 2013; Gal and Theising, 2015). It is estimated that the long-run income loss due to gender gaps in labour market participation and opportunities in terms of job and entrepreneurial choices is 22% in Costa Rica, compared to an average of 15.4% for OECD countries (Cuberes and Teignier, 2016; Box 2.1).

Table 2.2. **Labour market outcomes are below the OECD average**

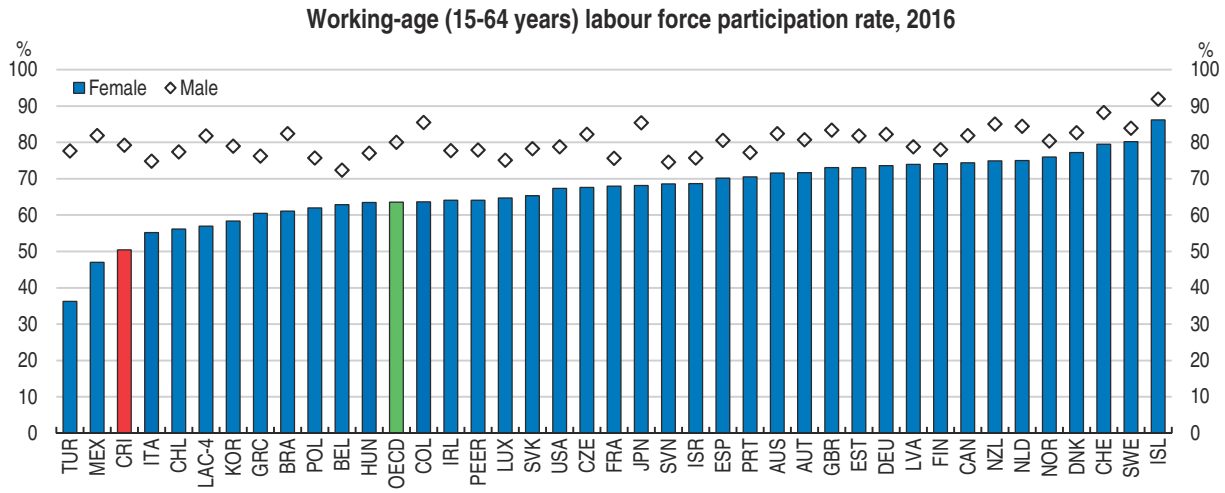
	Employment rate (%)		Labour force participation rate (%)		Unemployment rate (%)	
	Costa Rica	OECD average	Costa Rica	OECD average	Costa Rica	OECD average
Total	58.7	67.0	65.0	71.7	9.7	6.5
Men	72.8	74.8	79.2	80.0	8.1	6.4
Women	44.3	59.4	50.4	63.6	12.2	6.6

Note: For the working-aged population (15-64 years). Reference year is 2016.
Source: OECD Labour Force Statistics.

Like in many OECD countries, unemployment and inactivity among young workers is high. In 2007, unemployment among those aged 15-24 years old was below the OECD average (10.8% versus 12.1%), but has increased significantly and is now above the OECD average (23.1% versus 12.9% in 2016). About a quarter of youth aged 18-24 years old are not in employment, education nor training (NEET) compared with an OECD average of 15.3%, with higher rates among women (33.3% versus an OECD average of 16.4%) and those from low-income families (Estado de la Nación, 2016). This is particularly problematic for Costa Rica as its relatively young population means that employment difficulties among youth will be especially detrimental to future skill levels, productivity and social cohesion (Bell and Blanchflower, 2011).

The high unemployment rate, particularly among youth, coupled with skill shortages highlights that the education system is not equipping people with skills that are demanded

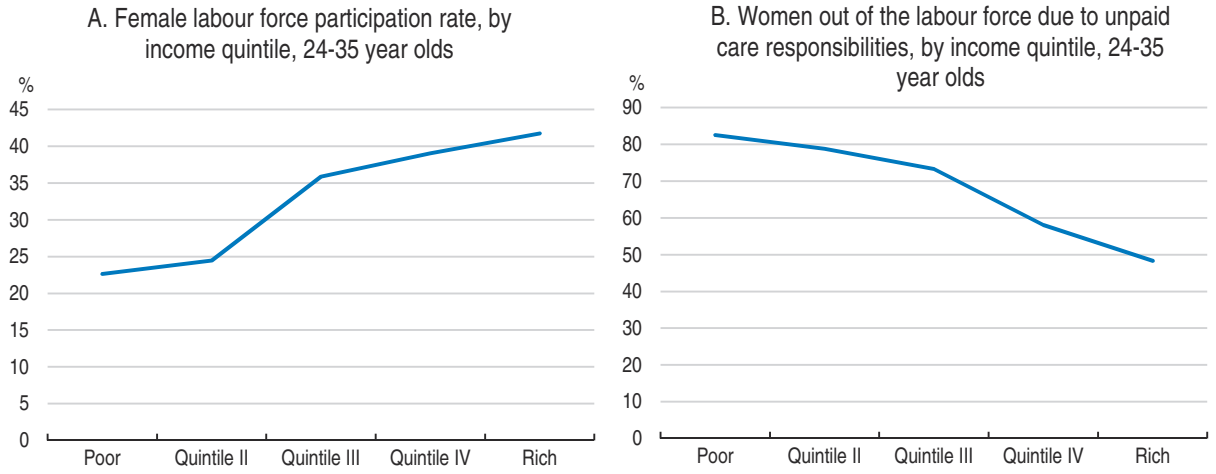
Figure 2.7. **Female labour market participation lags behind most OECD and Latin American countries**



Note: Data for Brazil is 2015. LAC-4 is a simple average of Brazil, Colombia, Chile and Mexico. PEER is a simple average of 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.
Source: *OECD Labour Force Statistics Database.*

StatLink http://dx.doi.org/10.1787/888933702497

Figure 2.8. **Care responsibilities are a barrier to women's labour market participation**



Source: INEC Encuesta Nacional de Hogares 2014.

StatLink http://dx.doi.org/10.1787/888933702516

by the labour market and the tools needed to adapt to structural and technological change. In addition, the difficulties faced by displaced workers in re-integrating into the labour market highlight the need for enhanced active labour market policies and life-long education and training opportunities.

Encouraging formal employment

The OECD has recommended the adoption of a comprehensive strategy to tackle informality in Costa Rica, including actions to reduce non-wage labour costs, simplify the minimum wage structure, strengthen enforcement, reduce barriers to entrepreneurship

and improve education and training (OECD, 2016b; OECD, 2017b). Other Latin American countries have had relative success with policies aimed at encouraging formalisation (OECD, 2017f; Box 2.2).

In response, the government launched a National Strategy to Transition to a Formal Economy (*Estrategia Nacional para la Transición a la Economía Formal*) in February 2018, with the overall goal of reducing informality by 10 percentage points compared with the 2012-16 average of 42.6% by 2025. Consistent with OECD recommendations, it includes policies aimed at improving education and training, enhancing social protection, reducing regulatory burdens and simplifying tax procedures. The design and implementation will be the responsibility of a tripartite technical council supported by a technical secretariat that will provide semi-annual progress reports and the strategy will be evaluated after 18 months.

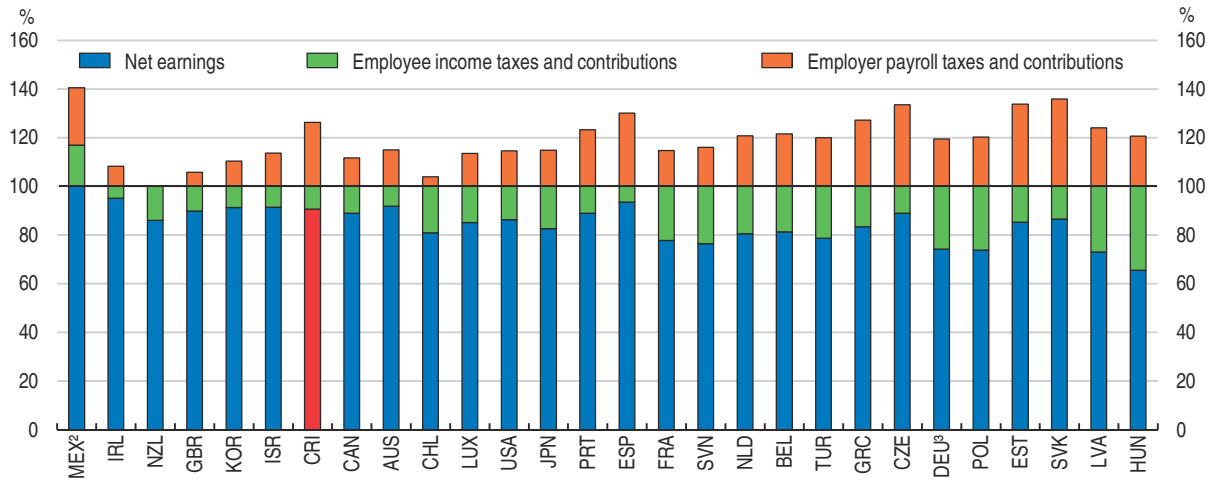
While the strategy is still in the early stages, it is a positive step. To address the next challenge of translating the high-level strategy into actionable steps, with clear lines of accountability, timeframes and assessment criteria, the authorities intend to establish detailed actions plans for each of the main areas of the strategy. Incorporating the strategy and associated action plans into the National Development Plan 2018-2022 would solidify it as a priority area going forward. In addition, it will be important for the technical council to have steering mechanisms to influence the work of the numerous relevant agencies that will be involved in the strategy's implementation. The experience of other tripartite councils in Costa Rica is that they have a marginal role in policy making (OECD, 2017b), and to successfully implement the Strategy, the council will need adequate tools to overcome the high degree of public sector fragmentation. The recently created National Council for Trade Facilitation could provide a useful example of a council with both public- and private-sector members that has the authority to make decisions that are binding on the relevant government agencies. An additional challenge is that some of the key actions (for example, part of the proposed reduction in social security contributions for new, small businesses, which is discussed below) will require legislative changes, and it is therefore uncertain whether and when these changes will occur.

Reforms to tax and social security payments have been at the centre of relatively successful policy efforts to reduce informality in other Latin American countries, and one of the main features of the Costa Rican strategy involves changes to social security contributions (SSCs) (Box 2.2). SSCs account for a high share of tax revenues in Costa Rica – 34% of total tax revenue compared with an average of 16.6% for LAC-5 and 26.1% for the OECD – and are a major barrier to formality (Ramírez Alfaro, 2010; ILO, 2014; OECD, 2017b; OECD, 2017g). The total SSC rate in Costa Rica is 36.5% of gross salary, with 26.33 percentage points levied on the employer and 9.34 percentage points on employees (OECD, 2017g). The large portion payable by employers drives Costa Rica's non-wage labour costs towards the top of the OECD rankings (OECD, 2017b; Figure 2.9). Unlike OECD countries, the state also pays a small share of SSCs (0.82% of gross salaries) (OECD, 2017g). In recognition of the need to contain non-wage labour costs, a proposal is currently being considered to make further inflation-adjusted annual state transfers to the contributory pension fund.

Unusually among OECD countries, a significant portion of the SSCs are not used for social security purposes. Out of the total contribution rate, 28 percentage points cover social security (old-age pensions, health care and unemployment insurance). The remaining contributions are used for other purposes, such as financing public banks and anti-poverty programmes. The payment rate is also particularly high relative to earnings

Figure 2.9. **High non-wage labour costs discourage formality**

Percentage of gross earnings for a single individual earning the minimum wage, 2013[1]



1. Tax burdens are calculated for a full-time worker in a single-person household earning a minimum wage at the standard (adult) rate. Full time refers to usual full-time hours in each country. Employer and employee social contributions also include any mandatory payments to private insurance for health, retirement pensions, etc.
2. Mexican low-wage earnings have negative income taxes because they receive a wage supplement in the form of a tax credit.
3. Minimum wage levels refer to 2015 for Germany.

Source: OECD (2017b).

StatLink http://dx.doi.org/10.1787/888933702535

Box 2.2. **Examples of policies to tackle informality**

Informality has decreased in several Latin American countries due to a combination of economic growth and specific policy interventions. For example, evidence suggests that policies to reduce the costs of formal employment in Brazil contributed to reducing the informality rate from over 60% in 2000 to under 50% in recent years (Filho and Veloso, 2016; OECD, 2017f). In particular, the 1996 SIMPLES law, which introduced an integrated tax and contribution payment system for micro and small enterprises, facilitated business registration and lowered the tax rate for microenterprises, contributed to the formalisation of nearly half a million microenterprises over five years. A more recent 2008 law aimed at sole-proprietor firms also reduced social security contributions and facilitated an increase in formalisation among the self-employed, although this appears to have had some perverse effects whereby firms have substituted regular employees for self-employed providers. Stricter enforcement mechanisms, including a performance pay system for inspectors, have also helped (OECD, 2013; OECD, 2017f).

In Mexico, two schemes were introduced in 2014 to provide incentives for small businesses to formalise. These involved reduced tax and social security obligations for the first ten years of operation. The measures also included incentives to help new formal firms expand through access to government-backed financing and training and a series of electronic tools to simplify tax compliance. Evidence suggests that this has induced 1.5 million informal firms to join the tax system. In addition, a comprehensive labour reform law in 2012 included initiatives to stimulate formal employment by reducing the uncertainty and costs for businesses, for instance, by limiting the cost of terminating employees (OECD, 2015c; OECD 2017f).

Colombia's 2013 tax reform reduced employer payroll contributions by 13.5 percentage points, which is estimated to have led to the creation of 213 000 formal jobs in the short run and reduced the informality rate by between 1.2 and 2.2 percentage points (Fernández and Villar, 2016; Morales and Medina, 2017; OECD, 2017h; OECD, 2017i).

for low-income and part-time workers because the minimum base contribution is the same regardless of working hours or earnings, which results in particularly high tax wedges at the bottom of the income distribution and discourages formality (OECD, 2017b; OECD, 2017g; Chapter 1).

The poor state of public finances does not currently allow for a significant reduction in contribution rates (see Chapter 1). However, the government is investigating options to increase coverage in selected sectors with high levels of informality. For domestic service workers, the minimum base contribution rate was lowered from July 2017 and a system to account for contributions from multiple employers established. In addition, a pilot scheme for coffee harvesters involving a reduced social security contribution rate of 15% to cover health insurance during the harvesting season is due to start in 2018. A special scheme for apprentices is also being considered. The Transition Strategy includes plans to implement similar schemes for at least two additional (yet to be identified) groups of workers.

The government has also proposed lowering the employer contribution rate for new, small businesses for the first four years of operation from approximately 25% of gross payroll to between 13.33% and 15.33%. It is expected that an agreement will be reached with the Costa Rican Social Security Agency (*Caja Costarricense de Seguro*, CCSS) in 2018 to allow the employer contributions to be reduced to between 18.83% and 20.83%. Furthermore, a proposed bill to reduce the rate by an additional 5.05 percentage points was presented to the Legislative Assembly in November 2015 (Bill 19.805). Evidence from other countries suggests that this scheme could contribute to increased formalisation and the proposal appears to be well designed (European Commission and OECD, 2015; OECD, 2017b; OECD, 2017f). For example, limiting the reduced rates to four years should minimise the fiscal impact and mitigate the risk that this size-contingent policy will act as a disincentive to firm growth (Braguinsky et al., 2011; Garicano et al., 2016). However, it will be important to consider the costs and benefits, ensuring that the policy is indeed contributing to formalisation, that the fiscal consequences are manageable and that there are no major unintended consequences. There are also plans to complement these measures with simplified tax procedures, including the integration of tax and social security payment systems. At this stage, it is unknown whether these changes will proceed and if they do, when they will occur.

Shifting the tax mix away from SSCs and towards less distortionary sources, including personal income, corporate and value-added taxes, would be a more far-reaching strategy to reduce barriers to formality. However, changes should be contingent on stabilising the fiscal situation since even a change which is revenue-neutral in principle would entail a higher level of uncertainty in the short run.

As part of this shift, the OECD has also recommended that contributions be used exclusively for social security purposes, with the funding for other institutions and programmes gradually moved to sources that are more progressive and/or less distortionary (OECD, 2016b; OECD, 2017b). Further consideration could be given to modifying the minimum contribution rate for all workers, particularly if the scheme for domestic service workers is successful. For example, the minimum base contribution rate could vary with working hours or contributions could be proportional to part-time incomes (OECD, 2017b). These changes will be particularly important given the changing nature of work that is occurring globally, including increases in part-time, casual and multi-employer workers. In addition, workers must currently contribute for at least 15 years to receive a reduced pension or 25 years to receive a full pension, which discourages workers

who are unlikely to reach 15 years of contributions from becoming formal. The minimum years to qualify for a pension could be reduced or eliminated and to avoid very low pension amounts, the non-contributory benefit could be progressively withdrawn as the contributory pension income increases (OECD, 2017b).

Additional measures that will also encourage formality are discussed below, including: improving education and training, imposing stricter enforcement, making it easier to register a business, reducing business compliance costs and simplifying the minimum wage.

Simplifying the minimum wage

The minimum wage in Costa Rica is set by the tripartite National Salary Council (*Consejo Nacional de Salarios*, CNS) and varies by skill, occupation and educational attainment. The number of minimum wage categories has decreased significantly over time, from 520 in 1987 to 23 currently. The most recent reduction from 25 to 23 categories came into effect in January 2018. In addition, market studies are currently underway to investigate options to further reduce the number of categories, with the intention of gradually moving to 10 categories by the end of 2019. However, given that the main goal of minimum wages is to reduce poverty among workers with the weakest bargaining power, differentiating on the basis of occupation and skill levels is unusual. While minimum wage practices across OECD countries vary, in general, most countries have a single statutory minimum wage, or a minimum wage that differs by age group (to recognise that the young are generally less experienced so the minimum wage is a greater hurdle to employment) and/or by region (to account for differences in living costs and local labour market conditions) (Box 2.3). In addition, the minimum wage for unskilled workers amounts to 70% of the median full-time wage in Costa Rica, which is higher than all OECD countries except Turkey (Figure 2.10).

Box 2.3. **Minimum wage settings in OECD countries**

The primary goal of minimum wages is to reduce poverty by improving the situation of workers with the least bargaining power in the labour market. Most OECD countries have statutory minimum wages and in the few (mainly Nordic) countries that do not have a statutory minimum, a large part of the workforce is covered by sector-level collective agreements which include wage floors. However, the level of the minimum wage, the institutional frameworks for setting minimum wages, the share of workers who earn the minimum wage, and the level of compliance vary across countries. Moreover, in some countries minimum wages are used in conjunction with collective wage bargaining, while in others, such as Costa Rica, they are the main institutional framework to increase the wage bargaining power of the most vulnerable workers.

While the practices across countries vary markedly, OECD (2015d) identifies some key policy principles for minimum wages:

1. Improve coverage of and compliance with minimum wage legislation, especially in countries where collective bargaining is weak or declining.
2. Ensure that minimum wages are revised regularly, based on accurate, up-to-date and impartial information and advice that carefully considers current labour market conditions and the views of social partners.
3. Where necessary, allow minimum wages to vary by age group (to reflect differences in productivity or employment barriers) and/or by region (to reflect differences in economic conditions) – bearing in mind that simple minimum wage systems are most likely to achieve high compliance.
4. Make minimum wages pay while avoiding that they price low-skilled workers out of jobs, by carefully considering their interactions with the tax-benefit system.

Box 2.3. **Minimum wage settings in OECD countries** *(cont.)*

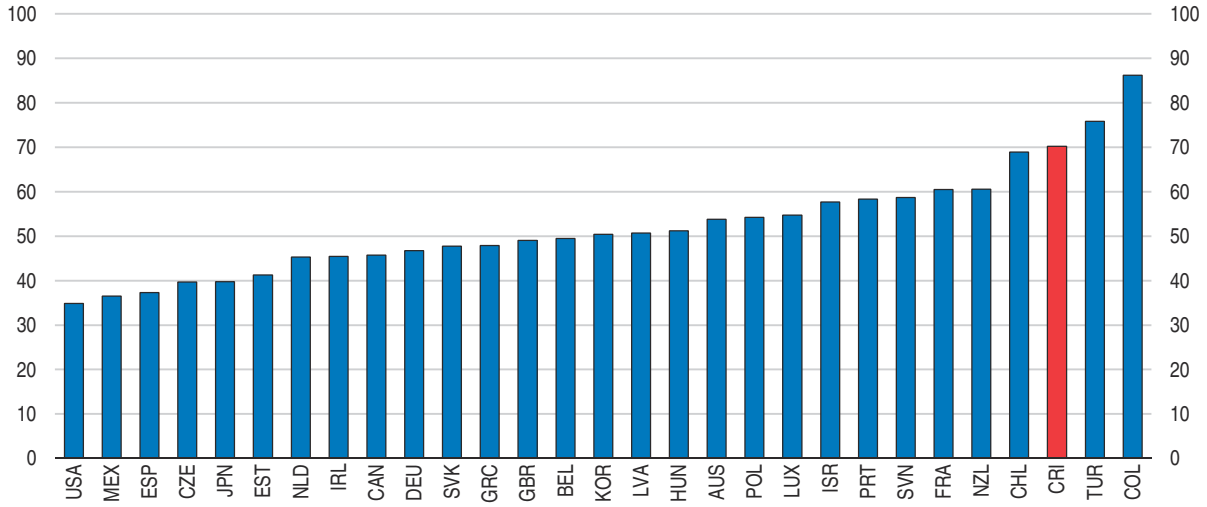
5. Use minimum wages as a tool to raise wages at the bottom of the wage ladder, but accompany them with other tax and benefit measures to effectively fight poverty in and out of work.

There is ongoing debate about the impact of the minimum wage on employment. Overall, empirical evidence suggests that the negative impact of minimum wage increases on employment tend to be small, but the effects are greater for more vulnerable groups such as the young or the long-term unemployed, or if the starting level of the minimum wage is high (Broecke et al., 2017). For emerging economies, the evidence suggests that minimum wages have only a small negative effect on employment and informality, but in countries where minimum wages are set at a high level, negative employment effects are more evident (ILO, 2013; Broecke et al., 2017). Country-specific analysis for Costa Rica suggests that a 10% increase in the real value of the minimum wage reduces formal private-sector employment by about 1% and working hours by 6% (Gindling and Terrell, 2007). Since labour market conditions are less favourable than when this analysis was undertaken, it is also possible that the effect is now larger. Moreover, despite the multiple minimum wages in Costa Rica, the largest impact on wages and employment of formal workers is in the lower end of the distribution (Gindling and Terrell, 2007). This suggests that there are important trade-offs between supporting those in relatively stable formal-sector jobs and alleviating poverty among struggling working families (OECD, 2017b).

In setting minimum wage levels, there is also often a trade-off between achieving simplicity (which encourages compliance) and allowing minimum wages to vary by region and/or sub-groups. Around half of OECD countries have lower minimum wages for youth, which can be justified on the grounds that labour market entrants typically have lower productivity than more experienced workers, and that this can help facilitate the transition of young people into the workforce. Regional differences to reflect variation in economic conditions are also fairly common. Some countries also have lower rates for apprentices and workers with disabilities. A few countries also differentiate the minimum by sector/occupation or level of seniority, but this is rare (OECD, 2015d).

Figure 2.10. **Costa Rica's minimum wage is high**

Minimum wage as a percentage of the median wages of full-time workers, 2016



Note: For Costa Rica, the calculations use the minimum wage for unskilled workers.
Source: *OECD Labour Force Statistics Database.*

StatLink http://dx.doi.org/10.1787/888933702554

The complex structure of the minimum wage in Costa Rica imposes a heavy administrative burden on firms and contributes to the low levels of compliance. About a third of workers are paid below the relevant minimum wage and about a quarter of workers below the lowest minimum wage (Estado de la Nación 2014; OECD, 2017b). Furthermore, those earning less than the minimum wage are disproportionately young, part-time workers, workers in rural areas, immigrants and workers in agriculture, construction and domestic service sectors (OECD, 2017b). As a result, the current minimum wage structure is not very effective at protecting disadvantaged workers. Moreover, minimum wages can hinder formal employment, particularly among low-income workers, if the floor is set at a high level, as is the case in Costa Rica (Box 2.3). For Costa Rica, it is estimated that a 10% increase in the minimum wage reduces formal employment by about 1% and working hours by 6% (Gindling and Terrell, 2007). This highlights the existence of trade-offs between protecting those in relatively stable formal sector jobs and alleviating poverty among the most vulnerable workers.

There are also trade-offs involved in differentiating the minimum wage categories on the basis of occupation, skill and qualification levels. The goal of this system is to encourage people to acquire skills. However, this is unlikely to be necessary as the high and increasing skills premium in Costa Rica signals that the market already rewards skills (González Pandiella and Gabriel, 2017). Moreover, the potential effect on skills acquisition is likely to be outweighed by the cost of discouraging formality and limiting worker mobility.

While current efforts to reduce the number of categories are welcome, it is recommended that Costa Rica moves to a small number of minimum wages that differ by age group and/or location and that are set at a more modest level. Differentiating on this basis should be informed by analysis of regional economic conditions and the impact of the minimum wage on formal employment opportunities and education decisions of young people. But, for example, it could involve a higher minimum wage in San José to account for higher living costs and a lower rate for young workers to recognise that the minimum wage is a greater hurdle to employment for those with less experience. This should also be accompanied by stronger enforcement (discussed below). In addition, minimum wage reforms could be complemented with measures to increase the social dialogue given the strong reliance on minimum wage provisions in Costa Rica and the current marginal role of tripartite bodies in policy making. For example, the 2003 proposal to create an Economic and Social Council could be re-visited (OECD, 2017b).

Strengthening the enforcement of labour regulations

Tackling high informality and increasing minimum wage compliance hinges upon the ability to monitor, investigate and sanction breaches. The OECD has highlighted the need to strengthen labour inspection services in Costa Rica as inspectors lack basic resources and sparse information means that they are often limited to large firms (OECD, 2017b).

To address these issues, Costa Rica has made a number of changes to labour inspections and further improvements are planned. In 2016, the National Inspection Directorate (*Dirección Nacional de Inspección del Trabajo*, DNI) changed its inspection approach, granting inspectors more scope to make qualitative assessments, focussing on serious infractions, and making better use of information to target workplace inspections. In addition, the DNI's budget was increased by 20% and its staff numbers by 40%, resulting in a significant increase in the number of workers covered by inspections (from about 175 700 in 2014 and 146 100 in 2015 to about 200 600 in 2016). However, it is not clear whether this has resulted in a greater number of breaches being identified, nor if it has increased the deterrent effect. The National

Strategy to Transition to a Formal Economy includes additional actions to run at least one information campaign about employers' labour regulation obligations and plans to formulate a proposal to further improve the resourcing of the DNI.

An additional issue is that once violations of labour market regulations are referred to the labour tribunals, the process can be costly and time consuming, which discourages individuals from reporting breaches (Gindling and Trejos, 2010; OECD 2017b). The recent Labour Procedural Reform Law (Law 9343), which came into force in July 2017, aims to expedite the judicial process and reduce the cost for individuals by requiring decisions to be provided within six months, simplifying the structure of labour tribunals, creating Alternative Dispute Resolution Units throughout the country to provide arbitration services, and offering targeted legal aid. The current proposal to grant labour inspectors the right to impose sanctions directly on employers without going through the labour courts would also help accelerate the process and increase the deterrent effects (Bill 19.130). Going forward, the authorities should ensure that penalties imposed for breaches of labour regulations are high enough to act as a deterrent (OECD, 2016b).

Facilitating the labour market and social integration of immigrants

Unlike other countries in Central America, Costa Rica has net immigration, with immigrants representing about 11% of the adult population (OECD, 2017b). Most migrants come from Nicaragua, are of working age and have lower average education levels than the native population. Migrants are over-represented in low-skilled occupations and sectors with high rates of informality, such as construction, domestic services, hospitality and food services and agriculture (OECD, 2017b).

The 2010 Migration Law (Law 8764) and the subsequent Comprehensive Migration Policy provide a solid framework for migration, but implementation challenges remain (OECD, 2017b). Take-up of provisions for immigrants with irregular status to acquire legal residence has been lower than expected. Immigrants wishing to acquire legal status must leave the country, pay a fine at the border and remain outside the country for a time period equivalent to the amount of time they spent irregularly in Costa Rica. However, these requirements were lifted until the end of 2017 for workers in agriculture, construction and domestic services who were able to acquire a work permit upon proof of their employment contract. This low take-up rate reflects high rates of informality preventing irregular migrants from providing formal employment contracts, migrants being deterred by the requirement to leave the country, long processing times and high application fees. Efforts are currently underway to reduce processing times, for example, work on a new IT system is expected to begin in 2018. This new system will also include linkages to relevant government services offered to migrants, which should improve low coverage compared with the native-born population for programmes such as conditional cash transfers aimed at encouraging participation in education (OECD/FUNDEVI, 2017). Since 60% of coffee pickers are immigrants, mainly from Nicaragua and Panama, the special health insurance scheme described above that is due to begin in the 2018 harvest season will also contribute to the integration and well-being of immigrants. However, if the priority of regularisation is to identify those in the country and ensure that they are protected from exploitation, then the OECD has recommended that a one-off regularisation be considered without the requirement of a formal employment contract (OECD, 2017b).

Going forward, migration policy could be more responsive to labour market needs. While the Migration Law is comprehensive and views migration as a driver of development,

it lacks a strategic vision. Regular analysis of labour market supply and demand should be undertaken to better inform migration policy, and measures to attract skilled migrants in areas where there are labour shortages should be investigated (OECD, 2017b).

Enhancing the quality and efficiency of the education system

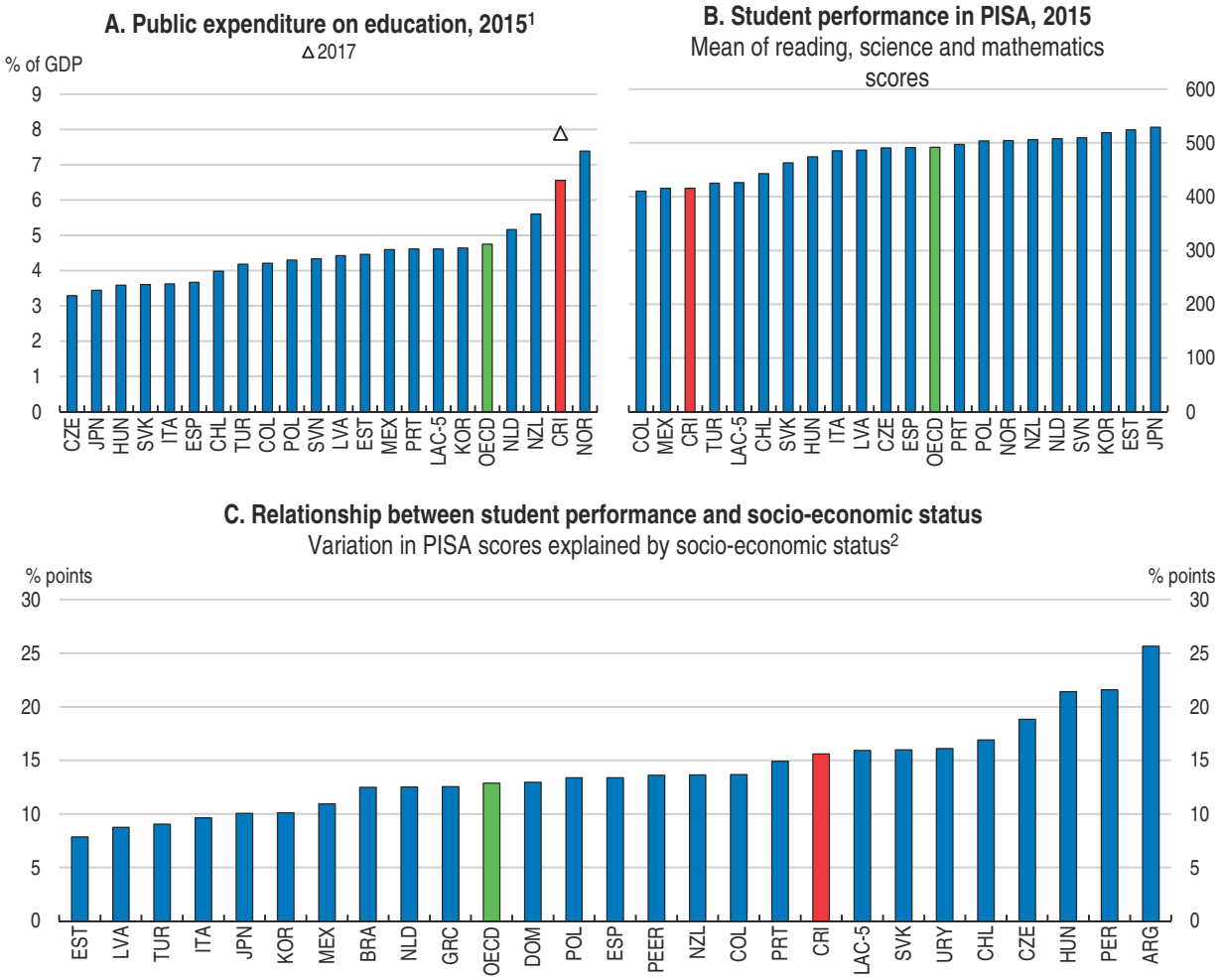
Providing quality education for all is a powerful lever for boosting inclusiveness and productivity (OECD, 2012a). Costa Rica has a strong commitment to education and government spending as a percentage of GDP is higher than all OECD countries and has increased significantly, from 5% of GDP in 2006 to 7.9% in 2017 (OECD, 2017c; Figure 2.11, Panel A). However, this high level of spending has not translated into strong outcomes. Although enrolment rates have increased across the board, they remain below the OECD average in all areas except primary education (OECD, 2017c). More than half of young people aged 25-34 have no secondary school qualification, compared with the OECD average of 17%. Grade repetition and drop-out rates have decreased in recent years, but remain elevated. By the age of 15, nearly a third of Costa Ricans have repeated at least one grade and 30% have dropped out of school (OECD, 2017c). About a third of those who remain in school lack core competencies, with Costa Rica's 15-year-olds performing around two years below their OECD peers according to the Programme for International Student Assessment (PISA) (Figure 2.11, Panel B).

Costa Rica could achieve better results with the resources it invests. For example, Croatia has a comparable level of GDP per capita and spends a similar amount per student, but by age 15, Croatian students are the equivalent of 1.5 school years ahead of those in Costa Rica. In addition, rapidly developing Latin American countries, such as Peru, have succeeded in simultaneously enrolling more children and improving average learning outcomes (OECD, 2017c). Moreover, outcomes have not increased in line with spending (Jiménez, 2014). For example, a significant portion (60%) of the rapid increase in spending in the last decade has been due to increases in the wage bill, but there is no evidence that the quality of teaching has improved as a result (OECD, 2017c). At the same time, there is a widespread and acute shortage of textbooks and other learning materials. About 38% of students are in schools with a shortage of educational materials, which is one of the largest proportions among PISA-participating countries (OECD, 2017c).

In addition, education inequalities remain large. Children from poor families with low levels of parental education, those living outside the capital, or belonging to an indigenous or migrant group are less likely to enrol in education at all levels and have lower educational outcomes (OECD, 2017c). PISA results are more strongly influenced by socio-economic status than in most OECD countries (Figure 2.11, Panel C). This inequality manifests itself most strongly at higher levels of education. Only 3.8% of young Costa Ricans from the lowest income quintile enrol in tertiary education compared with 57.8% of those from the wealthiest quintile, one of the largest differences in the Latin American region (Figure 2.12).

The allocation of funds raises efficiency and equity issues. Giving priority to the formative years helps overcome differences in family background and provides children with the foundational skills needed to achieve in later years. While countries need a high quality well-resourced tertiary education system, public expenditure on tertiary education tends to be regressive (OECD, 2007). In Costa Rica, investment in basic education is relatively low, with cumulative spending by the age of 15 around half of the OECD average. While spending per student on preschool education (4 and 5 year olds) has increased, it

Figure 2.11. **Low outcomes and inequities in education persist despite high levels of spending**



1. Data refer to expenditure on primary, secondary, post-secondary and tertiary education. Year of reference is 2015 or latest available year.
2. Measured as the average change in PISA scores associated with a one-unit change of the PISA index of economic, social and cultural status.

Note: OECD is a simple average of OECD member countries. LAC-5 is a simple average of Argentina, Brazil, Colombia, Chile and Mexico. PEER is a simple average of the 10 OECD countries with the lowest GDP per capita (excluding Latin American members): Czech Republic, Estonia, Greece, Hungary, Latvia, Poland, Portugal, Slovak Republic, Slovenia and Turkey. For Argentina, PISA data refer to Ciudad Autónoma de Buenos Aires only.

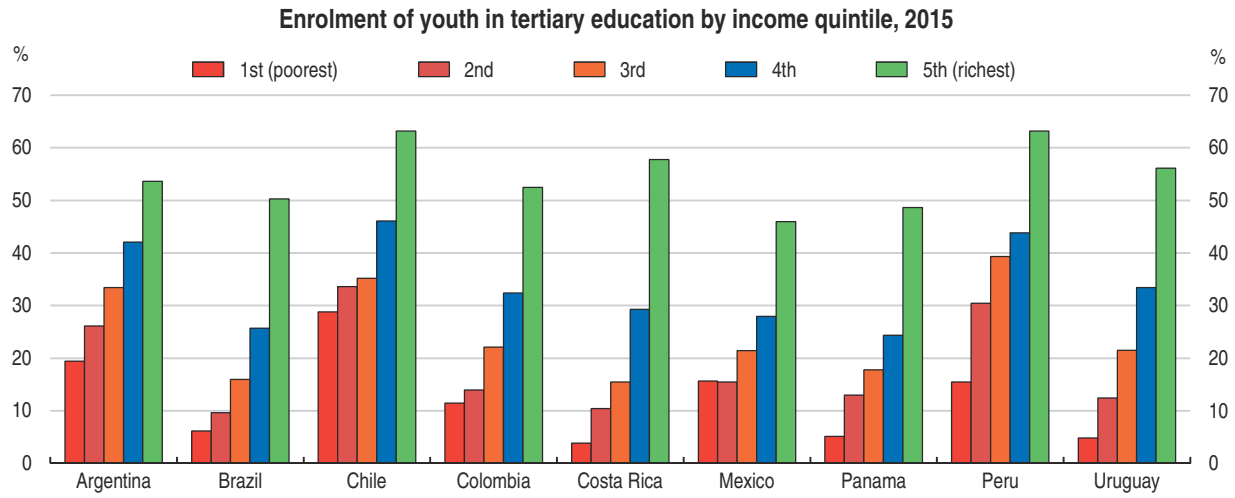
Source: *OECD Educational Finance Indicators* and Ministerio de Hacienda; *OECD PISA 2015 Database*; OECD (2016c).

StatLink *http://dx.doi.org/10.1787/888933702573*

remains below that of other emerging economies in Latin America and is just one-third of the average OECD expenditure (OECD, 2017c). In contrast, public spending per tertiary student is one of the highest among OECD and Latin American countries (OECD, 2017c). Moreover, spending on primary education has been increasing at a fast rate, accounting for 35% of additional expenditure, yet demographic trends mean that primary school enrolments have been decreasing while there are growing pressures at the secondary level.

Targeting resources toward the most disadvantaged students also improves efficiency and equity (OECD, 2007). Costa Rica has a number of positive initiatives in this area, including a range of programmes to promote access to school by providing meals, transport, scholarships and conditional cash transfers through the *Avancemos* and Bridge to Development (*Puente al Desarrollo*) schemes. In addition, the *Yo me Apunto* programme

Figure 2.12. **Socio-economic gaps in tertiary education enrolment are among the largest in Latin America**



Note: Data refers to 2014 for Mexico.
Source: CEDLAS and the World Bank, Net enrolment rate: Tertiary Education, Socio-Economic Database for Latin America and the Caribbean (SEDLAC).

StatLink http://dx.doi.org/10.1787/888933702592

was launched in 2015 and is aimed at disadvantaged students at risk of leaving education (discussed below). However, greater advances in this area could be made through more systematic targeting. For example, unlike in many OECD countries, there are no systematic mechanisms to redistribute resources to disadvantaged schools to ensure that at-risk students receive the necessary support (OECD, 2017c).

Making educational outcomes the main policy target and re-balancing the spending mix

There is a constitutional mandate to increase education spending to 8% of GDP in 2018. While education is a cornerstone of Costa Rica's successful social model, an education spending target that is inscribed in the constitution is unique among OECD countries. There is also no underlying rationale for this specific target, which represents a higher level of spending than in any OECD country. The focus needs to shift from inputs to outcomes in order to ensure that this high level of investment is matched by strong results (OECD, 2016b; OECD, 2017c). Overarching performance targets should be established and supported by strong evaluation arrangements. Clear and verifiable performance-based targeting should be established against which to measure the success of education policies. While improvements to data collection and management have been made (OECD, 2017c), better information on student and school performance is needed to allow the evaluation of outcomes, direct resources where they are most needed and make evidence-informed improvements (discussed below).

Re-balancing the spending mix away from tertiary education and towards the earlier years would also improve outcomes and better address inequalities. In particular, resources should be channelled to early childhood education and care and secondary education to address current deficiencies and to better reflect demographic patterns. This could be achieved while accommodating the anticipated future growth in tertiary education enrolments through reforms to the funding arrangements for universities (see below) (OECD, 2016b; OECD, 2017c).

Increasing access to quality early childhood education and care

Quality early childhood education and care (ECEC) reduces the impact of socio-economic background and improves skill accumulation, employment prospects and earnings later in life (Cunha et al., 2006; OECD, 2007; Almond and Currie, 2011; OECD, 2016b). Expanding ECEC services would also facilitate women's participation in the labour market, particularly given the high barrier that care responsibilities create for Costa Rican women (Figure 2.8).

ECEC remains underdeveloped, despite significant expansion in enrolments. In 2000, only 7% of 4 year olds and 83% of 5 year olds were enrolled. By 2014, this had grown to 63% of 4 year olds and 90% of 5 year olds. However, enrolment rates remain low by OECD standards, particularly among those aged 3 years and under. Just 6.5% of 3 year olds are enrolled in ECEC compared with over 40% in Brazil, Chile and Mexico and 70% across OECD countries. Moreover, enrolment rates are much lower for children living in rural areas and from low-income families and these disparities are growing (Estado de la Nación, 2015; OECD, 2016b; OECD, 2017c). Quality also needs to be improved, with many services focussed on basic care and nutrition with limited attention given to skills development (OECD, 2017c).

Costa Rican authorities recognise the importance of expanding ECEC. The current National Development Plan includes a goal to increase coverage of Interactive II (4 year olds) from 63% to 69.5% between 2015 and 2018, with expansion being prioritised in 75 target districts with low enrolment and high poverty rates (MIDEPLAN, 2014). In the first half of 2017, Interactive II coverage stood at 66.1%, and preliminary data suggest further advances have been made in the second half of 2017. While this expansion, including the focus on disadvantaged regions, is welcome, a more ambitious expansion plan with greater targeting of resources is needed to more effectively reach the most disadvantaged children and narrow the socio-economic divide (OECD, 2017c).

Actions to improve the quality of ECEC in Costa Rica have also been taken. In 2014, a new preschool curriculum was introduced to align programmes across the two years of preschool (Interactive II and the Transition phases, covering 4-5 year olds). It aims to better prepare children for primary school by taking a more holistic approach to development and placing greater emphasis on the development of early literacy skills. However, implementation has been a challenge due to the weak capacity of the teaching workforce, large class sizes and limited parental engagement. Stronger training and support are needed for teachers and parents so they are better placed to help children, particularly disadvantaged children, to develop their early literacy skills and successfully transition to primary school (OECD, 2017c). Greater efforts are also need to improve quality assurance and monitoring. While care services are subject to a set of minimum standards, the requirements are limited and monitoring is inadequate. A more comprehensive set of minimum standards should be established and enforced across all care centres (OECD, 2017c).

Another recent major initiative is the establishment and current implementation of a new early childhood policy, which aims to support the holistic development of children aged 0-8. Spanning the period to 2021, it includes plans to increase the provision of community-based care centres and create an overarching information management system to improve policy making and targeting (OECD, 2017c). In addition, with the aim of achieving universal preschool enrolment, the Higher Council for Education (*Consejo Superior de Educación*, CSE) recently established a policy to make the completion of preschool a requirement for children enrolling in primary school. While the preschool is already compulsory from the age of 4 and

the constitutional right of universal access to primary education will still take precedence, this policy is a potentially useful lever for encouraging preschool enrolment. This policy will be phased in over two years and to support its implementation, efforts to identify all children not enrolled in preschool are underway and preschool-aged children currently enrolled in the care system will also receive education services.

Lifting public funding for ECEC would facilitate further improvements in access and quality. As discussed, this should be achieved by re-balancing the current budget rather than increasing the already high levels of public spending on education. While preschool education is currently funded out of the education budget, it was assigned just 9.3% of funding in 2016 (OECD, 2017c). On the care side, it is hard to accurately estimate public funding, but it appears to be low (OECD, 2017c). Funding from the Social Development and Family Allowances Fund (FODESAF), which is the main source, amounted to roughly 0.2% of GDP in 2016, but there are also other sources, such as municipalities and private and civil society organisations. Classifying all spending on early childhood education and care under the constitutionally-mandated spending on education would facilitate the expansion of services.

Establishing a lead agency for the whole sector would also improve co-ordination. While Costa Rica is not unique in having several ministries and agencies involved in ECEC, it is unusual in having no institution with overall responsibility for delivering national policy. Leadership for the provision of preschool education is currently concentrated in the Ministry of Public Education (*Ministerio de Educación Pública*, MEP), but there is no lead agency for care services, with direction divided across three major government ministries/agencies: the Ministry of Health, the National Child Welfare Agency (*Patronato Nacional de la Infancia*, PANI) and the Joint Social Aid Institute (*Instituto Mixto de Ayuda Social,* IMAS). Each agency manages its own resources, sets its own standards and objectives and determines its own expansion plans. In 2014, the National Network for Childcare and Development (*Red Nacional de Cuido y Desarrollo Infantil,* REDCUDI) was established to improve co-ordination between the different public and private providers of care services; through the Consultation Commission of the Childhood Network[1] in charge of the inter-institutional competencies and the various types of childcare services, and aimed at recommending general policies and strategic directions to the care and child development system. This is a very positive reform and REDCUDI is well positioned to help advance co-ordination on the technical front. However, while improved articulation processes between the MEP and REDCUDI are being implemented with the aim of strengthening REDCUDI, it currently lacks the political influence, institutional capacity and mandate to affect the degree of transformation that is needed in the sector (OECD, 2017c). Vesting responsibility for the whole sector in one agency would strengthen leadership and create a clear champion for reform.

Costa Rica recognises the value of improving co-ordination in education, and the social sector more broadly. With the goal of improving co-ordination in the social sector, a bill was presented to the Legislative Assembly in May 2016 to strengthen the current Ministry of Human Development and Social Inclusion by granting it the resources and staff to enable it to fulfil its current mandate as the social sector coordinator (Bill 19.960). It would act as the coordinating agency across the Ministries of Health, Public Education, Labour and Social Development and PANI, with the aim of offering joined-up services. This could facilitate the development of a holistic approach to early childhood development and more effectively reduce inequalities by tackling the multiple barriers faced by disadvantaged children.

Costa Rica has already been moving towards this more targeted and joined up approach to social services in recent years, for example, by establishing the Bridge to Development (*Puente al Desarrollo*) Strategy in 2015 (OECD, 2017b). Led by IMAS, this programme unified 30-odd separate programmes into a single system. This strategy has several positive features. For example, it uses newly-developed information systems to actively target services to families most in need. This is more effective in reducing inequalities and improving spending efficiencies than the previous system where families had to identify and seek out entitlements themselves, resulting in many programmes largely benefiting middle- and high-income families (OECD, 2016b). The programme also involves more active participation of social workers, with assistance tailored to the individual needs of families, and made conditional on requirements that are relevant to their circumstances, such as participation in training programmes or children's school attendance. The data collected as part of the programme is already being used to improve service delivery. Going forward, these data will also assist in the systematic evaluation of these programmes. As highlighted in the 2016 Economic Assessment and Chapter 1, evaluation will allow further improvements to the programmes to be made, as well as facilitate improvements in spending efficiency by identifying and allowing resources to focus on the most effective interventions and ensuring that the programmes are reaching those most in need.

In ECEC, there are also initiatives underway to more effectively target the most disadvantaged children, however, greater efforts are still needed. The targeting of preschool expansion to 75 districts with low enrolment and high poverty rates as part of the National Development Plan is welcomed. In addition, the new early childhood policy includes plans to create an overarching information management system to improve policy making and targeting (OECD, 2017c). As a step towards this goal, a geo-referenced database of centres and child identifiers is expected to be ready in the first half of 2018. However, there is still limited information available on current and prospective demand to inform future expansion (OECD, 2017c). Initiatives are also underway to increase outreach in order to identify and enrol preschool-aged children who are not in the education system. For example, a door-to-door census in Heredia led to the identification of 160 preschool-aged children who were not in the education system, and the subsequent enrolment of 131 of them. As part of a programme with UNICEF, early childhood facilitators will be employed in 43 priority districts to identify children who are not enrolled in preschool.

There is room to continue with the current approach of expanding preschool through the existing network of primary schools. This network reaches the most remote parts of the country and many primary schools have spare capacity due to falling student numbers. Greater attention to delivering ECEC services through alternative approaches to the traditional centre-based model could also help reach the most disadvantaged communities. In 2014, around 1 500 children attended community-based care provided in the homes of "community mothers" and over 100 000 children benefited from the Nutrition and Education Centres – Child Integral Care's (*Centros de Educación y Nutrición Centros Infantiles de Atención Integral*, CEN-CINAI) home visit programme. However, unlike in other Latin American countries, such as Colombia, Bolivia and Mexico, community- and family-based programmes are not well developed. Enhancing such programmes could provide a cost-effective way to achieve wider coverage, particularly in remote areas, and could also help strengthen home learning environments.

The Costa Rican authorities are currently undertaking a feasibility study to explore options for, and ways to manage, alternative arrangements for the delivery and financing of

care services. Public care services are currently free-of-charge for all children. As a way to expand public care services in an equitable way, consideration could be given to introducing income-based fees. The majority of women in the first three income quintiles who are not in the labour force report that care responsibilities are a barrier to working (Figure 2.8). Often they do not have access to public care services, and are unlikely to be able to afford private care. Introducing income-based fees, similar to those in France or Norway, could enable parents to access care services at a lower cost while also increasing non-government revenue for the expansion of ECEC, but would need to be carefully managed to ensure that fees are based on the ability-to-pay and do not pose barriers to access (OECD, 2017c). In addition, partnerships with local governments and private providers should be encouraged as a means to improve access and quality. The involvement of municipalities in funding public care services is still limited. The Childhood Care and Development Centre (*Centro de Cuido y Desarrollo Infantil*, CECUDI) was created in 2010 to incentivise local investment, with the cost of the centre shared between the national government and municipalities. For example, in Curridabat the national government covers construction costs and the municipality provides the land and operates the services, with donations from other local participants. While this is a promising model, reducing administrative complexity would facilitate further expansion of partnerships between the central government, municipalities and private providers, as long delays in approval processes and operational procedures are currently a barrier (OECD, 2017c). In addition, clear and enforced minimum standards are needed to ensure that all services meet quality benchmarks regardless of the provider (discussed above).

Improving the quality of teachers and schools

Raising the quality of teachers and school leaders is the most important challenge for basic education in Costa Rica. Recent years have seen important steps to increase the level of qualification required to enter teaching and virtually all teachers now hold tertiary degrees. However, teachers and school leaders are poorly prepared, recruited and supported, and clear expectations and accountability are lacking. Moreover, the weak capacity to evaluate the school system constrains the development of policies that could raise educational outcomes and reduce inequalities by, for example, targeting assistance and resources where they are most needed (OECD, 2017c).

Teacher assessments reveal significant gaps in teachers' knowledge of core subjects and there is a wide-spread consensus that many initial teacher training programmes are very low quality (OECD, 2017c). The vast majority of teacher education programmes are not accredited and universities have full autonomy over the programmes. As part of efforts to raise the quality of initial teacher training, a welcome proposal is being discussed to make accreditation mandatory for all teaching programmes in private universities (Bill 19.549). The OECD has also recommended strengthening the initial teacher selection process and support for new teachers, by introducing an entrance examination, a probationary period, and a structured induction programme (OECD, 2017c).

Costa Rica also lacks an effective evaluation system for existing teachers. Appraisals are largely an administrative requirement, and virtually all teachers receive positive ratings (OECD, 2017c). There is also a lack of ongoing support and opportunities for professional development. The OECD has recommended that mechanisms to encourage and support teachers to learn and develop be introduced, including the establishment of a framework for evaluation and professional development (OECD, 2016b; OECD, 2017c).

Costa Rica has undertaken a series of initiatives over the last decade to strengthen schools and improve their quality. This includes a major initiative to modernise the curriculum which is due to be completed in 2018. This new curriculum emphasises critical thinking over rote memorisation, and has great promise as a means of engaging students as more active learners and ensuring that they gain skills that are more relevant to society and the labour market (OECD, 2017c). However, despite training, many teachers are not adequately prepared to deliver the new curriculum and weak pedagogical skills and a shortage of learning materials, such as textbooks, are significant obstacles to classroom implementation.

Additional efforts that have been made to improve the quality of schools include the establishment of a unit dedicated to quality management and evaluation within the MEP, the development of guidelines for school self-evaluations and reforms of the school supervision system. However, school evaluation policies and practices are still in the nascent stage. The OECD has recommended further strengthening school supervision by setting clearer standards for the evaluation of school quality and criteria to focus efforts on the schools that are most in need (OECD, 2017c). Establishing common indicators, shared data collection and a single information system would increase accountability and allow data to be used to make improvements. Costa Rica should consider creating a dedicated independent evaluation agency to promote more evidence-based and results-driven policies and support the development of a stronger culture of evaluation at all levels of the system (OECD, 2017c).

Costa Rica's growing awareness of the central role that schools play in improving education outcomes is reflected in the 2008 declaration of *Quality Schools as the Axis of Costa Rican Education*, in measures to improve leadership skills in schools, and in the 2010 reform to refocus the role of school supervision from external control to support for internal leadership. However, several obstacles need to be overcome to realise this vision of school-led improvement. School leaders continue to play a limited role as instructional leaders (e.g. through setting goals for improvement, undertaking classroom observation, and mentoring and motivating teachers). The OECD has therefore recommended that Costa Rica improves the relevance of initial and in-service leadership development programmes and establishes peer-learning schemes. The creation of instructional leadership positions within schools, with clear responsibility for the professional development of teachers, would improve pedagogical knowledge and teaching quality (OECD, 2017c).

Better information on student and school performance would allow resources and support to be targeted at underperforming schools. While Costa Rica has carried out national assessments involving a small sample of schools since 2007, it is primarily to inform policymakers about whether students are meeting national learning objectives, and it carries no stakes for schools, teachers or students. Costa Rica should consider applying the assessment to the school census so that the performance of individual schools can be benchmarked against national standards and similar schools, and the MEP has better data to inform policies and resource allocation (OECD, 2017c). In comparing school-level results, performance outcomes could be put into context to enable fair comparisons. For example, Brazil and Colombia use a multi-dimensional index that takes account of student performance, school progress, grade repetition and factors relating to the school environment (OECD, 2016d).

Reducing the high drop-out rate

Tackling the high drop-out rate requires a multi-faceted approach encompassing measures to equip teachers to provide high quality instruction and a relevant curriculum that keeps students engaged (as discussed above), in combination with more targeted

measures to identify and provide extra support to at-risk students. Costa Rica is already making progress in this area, particularly through the *Yo me Apunto* programme, which was launched in 2015. The programme aims to reduce the drop-out rate in 85 target secondary schools through early detection and intervention starting at primary school. High schools in the programme have reduced drop-out rates from 14.4% in 2013 to 9.2% in 2017. While it is early days for the programme, it has the potential to create the conditions for school success in the most disadvantaged communities (OECD, 2016b; OECD, 2017c). The OECD has therefore recommended that this programme be systematically evaluated, and if found to be successful, scaled up (OECD, 2016b).

In common with many countries, Costa Rica faces the challenge of transforming the focus of its upper secondary system from preparing a small elite for university to catering to a wider group of students, including those who will enter the workplace or pursue other training options. The growing skills divide, where low-skilled workers are confronted with an increasingly difficult labour market at the same time that the wage premium for skilled workers is growing, highlights the need for a more inclusive system. The OECD has therefore previously recommended developing a vocational education track in close conjunction with employers (OECD, 2016b; OECD, 2017c).

In developing a more inclusive system that better meets labour market needs, there is an increasing focus on technical schools. In Costa Rica, these technical schools include grades 6 to 9 as well as upper secondary levels, and students pursue technical and academic (*Bachillerato)* qualifications simultaneously. Just over a fifth of entrants to secondary school are in technical programmes, which is much lower than in OECD countries. However, this track has been growing and there are ambitious plans for further expansion. Outside of the formal education system, the National Training Institute (*Instituto Nacional del Aprendizaje*, INA) is funded through levies on employers and provides short vocational education and training (VET) courses. INA programmes serve as an alternative path to the labour market for students who have dropped out of secondary education, but a lack of co-ordination with the MEP makes it difficult for students to re-enter the formal school system (OECD, 2017c). However, ongoing work on the qualifications framework is also expected to make it easier for students to receive credit for their INA qualifications within the formal education system. In line with the OECD's recommendation to develop vocational education in close conjunction with employers (OECD, 2016b), partnerships with employers are also being developed and both INA and MEP are establishing programmes which include more hands-on experience in the workplace. In December 2016, the government approved a new apprenticeship track in upper secondary education and in early 2017 started a small-scale pilot programme involving four technical schools which prepare students in the automobile sector. Students who opt for this apprenticeship track must have completed lower secondary school, and will divide their time between the classroom and workplace. After completing the programme at end of the 12th grade, students will receive a diploma of mid-level technical skills and the *Bachiller*. In parallel, the Legislative Assembly is discussing a reform to establish an apprenticeship track which also regulates the contractual situation of students in the workplace (Bill 19.378). It is recommended that these pilot programmes are monitored and evaluated and avenues to increase vocational education continue to be explored.

Despite these efforts, some institutional features are holding back the attractiveness of technical schools and the expansion of the vocational education system. Costa Rica lacks the kind of dedicated vocational upper secondary colleges that are found in many countries, which can be a focus for developing technical skills, employer engagement and work-based

learning opportunities while also postponing the choice of career until the upper secondary level. Instead, in Costa Rica, most technical schools are, in practice, largely academic institutions since they include grades 6 to 9 as well as the upper secondary grades and all senior students pursue both the final *Bachillerato* and a technical qualification. In contrast, many countries maintain a comprehensive curriculum through lower secondary school and then introduce a vocational track in upper secondary school. To accommodate the different tracks, lower and upper secondary schools are separated. This has the advantage of postponing students' choices of vocational specialisation until upper secondary school, facilitating better career choices. It also postpones the time when students must travel far or live away from home to pursue specialist upper secondary education. The OECD has therefore recommended that Costa Rica considers gradually moving towards separate lower and upper secondary schools (OECD, 2017c). This would allow specialised technical colleges to develop with a central mission of teaching technical skills, and including greater links with employers and the labour market. This could also include moving towards the dual systems that countries such as Austria, Germany and Switzerland have, where students in the apprenticeship route do not have the equivalent of Costa Rica's *Bachillerato*, but normally have the option of studying for examinations which would allow them to subsequently gain university entrance. This could be pursued in conjunction with reforms to the current *Bachillerato* qualification system (discussed below).

In addition to making vocational education a more attractive option, reforming the senior secondary school assessment system (*Bachillerato*) could also reduce the drop-out rate. *Bachillerato* has a binary-pass criterion, so the third of students who stay in school until the final year but fail *Bachillerato* have nothing to show for their efforts, limiting the attractiveness of upper secondary studies for many (OECD, 2017c). The OECD has recommended that the current binary-pass criterion be replaced with a pass threshold for each of the six individual subjects to better recognise partial achievement and that further consideration be given to adopting a more flexible qualification system, as has been done in other countries such as Australia and New Zealand (OECD, 2017c).

Addressing skill shortages

The education system has not kept pace with ongoing structural transformation towards high technological- and skill-content sectors, resulting in skills shortages despite the high levels of unemployment. Skill mismatches harm productivity growth, and a lack of qualified personnel is one of the main self-reported barriers to innovation among Costa Rican firms and the majority of employers do not think the education system is meeting the economy's needs (UCCAEP, 2011; Adalet McGowan and Andrews, 2015; MICITT, 2016). Increasing basic skills would significantly raise inclusive growth, and initiatives such as the new school curriculum and further developing vocational education should better prepare students for higher education or the workplace.

The OECD has also highlighted the need for significant tertiary education reforms (OECD 2017c). Costa Rican universities have a high level of autonomy and few incentives to respond to labour market needs. While university autonomy is a well-respected principle across OECD countries, this is usually matched by strong steering and accountability mechanisms to ensure that tertiary institutions meet basic standards of quality and serve societal purposes. In Costa Rica, such accountability mechanisms are very limited, and there is no permanent co-ordination body or long-term plan to steer the sector towards common goals (OECD, 2017c).

Public spending on tertiary education has roughly doubled as a proportion of GDP since 2000 and currently amounts to 1.5% of GDP (OECD, 2017c). The vast bulk of funding (around 90%) for public universities comes from the government's Special Fund for Higher Education (FEES). Despite its size, it does not have an attached steering, monitoring and evaluation framework and it creates incentives to increase places in courses that are less expensive to deliver, resulting in a bias towards social sciences. The small number of STEM (science, technology, engineering and mathematics) graduates and post-graduates in all subjects poses a significant obstacle to Costa Rica's ambition of developing a more high-technology, knowledge-intensive economy (OECD, 2016b; OECD, 2017c). It is recommended that Costa Rica introduces funding mechanisms to enhance labour market relevance and outcomes, such as performance-based funding whereby a portion of funding is conditional on meeting targets such as the number of graduates in specific fields, or the employment and earning outcomes of graduates (OECD, 2016b; OECD, 2017j). While authorities recognise the issue, proposals to reform the FEES system have met with considerable resistance from stakeholders and to date, have not been progressed.

Public universities heavily subsidise tuition and provide scholarships so that students whose school results are good enough to gain entry to a public university face few financial barriers, enabling young people from disadvantaged backgrounds to attend university. However, over half of Costa Rican students enrol in private institutions, which are excluded from the system of generous public subsidies (OECD, 2017c). These funding arrangements are unsustainable as tertiary education spending has roughly doubled as a share of GDP since 2000 and further growth in enrolments is anticipated, which will contribute to Costa Rica's continued economic development. These arrangements are also inequitable as the majority of students who benefit from public universities are from wealthier backgrounds. In 2015, 3.8% of young people from the lowest income quintile enrolled in tertiary education (Figure 2.12). While the majority (70.1%) of these low-income young people enrolled in public universities, this means that just 2.7% of young people in the lowest income quintile attended a public university. In contrast, while only 41.8% of those from the highest income quintile who enrolled in tertiary education attended a public university, the much higher enrolment rate (57.8%) among this group means that almost a quarter of those from high income families benefited from public universities. Indeed, students who can afford to attend a private secondary school are twice as likely to gain entry to a public university as those who attend a public secondary school. Conversely, students in private universities have almost no access to scholarships, although they face larger fees, resulting in just 1.1% of youth from the lowest income quintile enrolling in private tertiary education, versus over a third of those from the highest income quintile.

A new tertiary funding and student support system needs to be developed to allow more effective and equitable cost sharing between the government and the students who benefit from tertiary education (OECD, 2017c). This new arrangement should target financial support to students on the basis of need and their ability to benefit. This should include a regulated but substantial increase in fees in public universities (OECD, 2017c). Scholarships and government-backed loans should be offered to students pursuing quality programmes in either public or private universities, replacing the current arrangements which primarily benefits public university students through subsidised tuition and scholarships (OECD, 2017c).

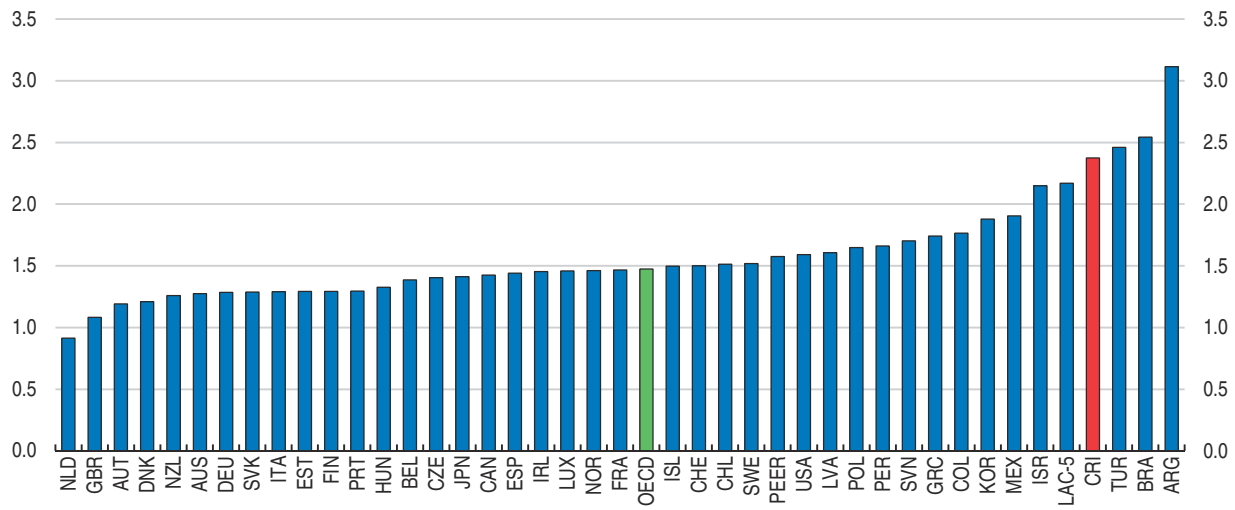
Strengthening competition

Weak competition in Costa Rica is holding back convergence to higher-income countries. Regulations which restrict competition can hinder efficiency gains, innovation and productivity-enhancing resource allocation and contribute to inequality by raising consumer prices and increasing the distribution of wages (Nicoletti and Scarpetta, 2003; Aghion and Griffith, 2005; Conway et al., 2006; Song et al., 2015; Denk, 2016; Ennis et al., 2017). Competition plays a key role in allowing resources to flow to their most productive uses. Estimates suggests that more efficient resource allocation could increase Costa Rica's MFP by more than 50%, which is similar to other Latin American countries, but higher than more developed countries, such as the United States (Alfaro Ureña and Garita, 2018).

Product market regulations in Costa Rica are more restrictive than in any OECD country except Turkey and they also compare poorly with other Latin American countries, including Chile, Colombia and Mexico (Figure 2.13). State controls are particularly restrictive, with large government involvement in network sectors, price controls and poor governance of state-owned enterprises (SOEs) (Figure 2.14, Panel A). Barriers to entrepreneurship in Costa Rica are also high due to the licence and permits system, administrative burdens on small firms, anti-trust exemptions and restrictions in network sectors (Figure 2.14, Panel B).

Figure 2.13. **Product market regulations are stringent**

Overall PMR score, index scale 0-6 from least to most restrictive



Note: Data refer to 2013. OECD is a simple average of OECD countries. LAC-5 is a simple average of Argentina, Brazil, Chile, Colombia and Mexico. PEER is a simple average of the 10 OECD lowest GDP per capital countries excluding Latin American countries.
Source: *OECD-WBG Product Market Regulation Database* for all LAC countries except Brazil, Chile and Mexico; *OECD Product Market Regulation Database*.

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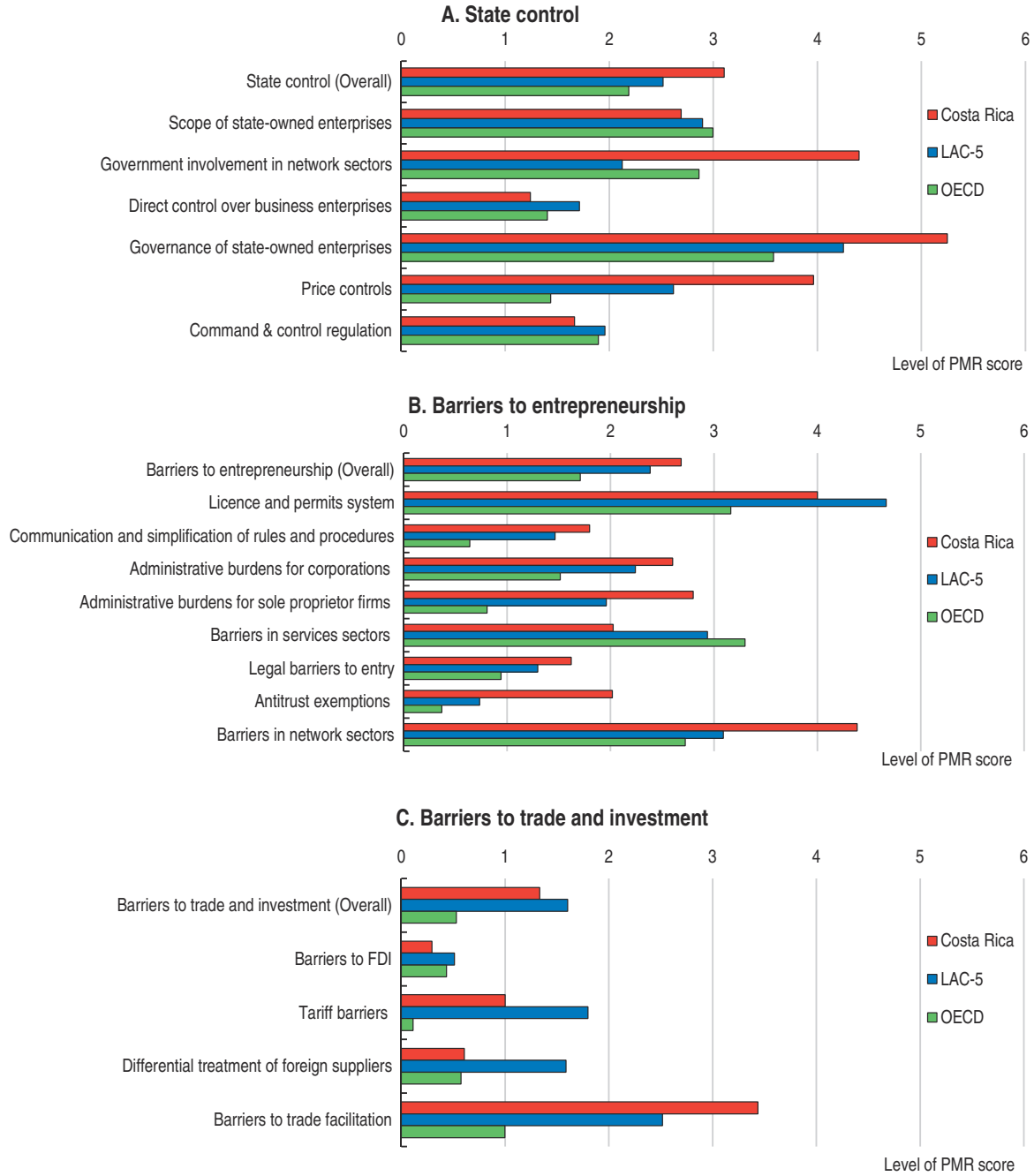
Granting the competition authority more independence and resources

Implementation issues are hampering the effectiveness of competition policy in Costa Rica. The main enforcement agency, COPROCOM (*Comisión para Promover la Competencia*), is an agency of the Ministry of Economy, Industry and Commerce (MEIC) and does not have administrative and budgetary independence. Staff of the Commission's Technical Support Unit are employed by MEIC and COPROCOM does not have its own legal personality and is reliant on the Attorney General to defend its decisions in court. COPROCOM is also under-

Figure 2.14. **State controls and barriers to entrepreneurship restrict competition**



Note: Data refer to 2013. OECD is a simple average of OECD member countries. LAC-5 is a simple average of Argentina, Brazil, Chile, Colombia and Mexico.

Source: *OECD-WBG Product Market Regulation Database* for all LAC countries except Brazil, Chile and Mexico; *OECD Product Market Regulation Database*.

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resourced – the Commission's Technical Support Unit is understaffed and its budget is low compared with other economic regulators in Costa Rica and similar competition agencies in the region (OECD, 2016b). In addition, Commissioners work part-time for negligible pay, and have a main job elsewhere, raising potential conflict of interest issues.

Costa Rica recognises these issues, and a bill to address them is being considered by Congress and may be adopted in 2018 (Bill 19.996). The bill creates a new National Council of Competition (Conacom) supported by a Secretariat General of Competition. Conacom will be a body of "maximum de-concentration" attached to MEIC but with functional, administrative and financial independence, as well as its own legal personality (OECD, 2016e). The proposed reform also includes measures to improve the process for appointments to the competition authority's board, reduce conflict of interest issues, increase the level of resourcing, and improve flexibility over staff selection and the setting of work conditions and pay. In line with 2016 Economic Assessment recommendations, the bill also grants Conacom the power to conduct market studies and to create a leniency programme for whistle-blowers. It also establishes a new sanction system, with fines determined by the level of the infraction's severity. However, the sanctions may still not be high enough to pose a sufficient deterrent effect in some industries (OECD, 2016e). This bill should be adopted and implemented as a matter of priority.

Assessing and removing unjustified anti-trust exemptions

Many sectors in Costa Rica are exempt from competition law and although it is unclear what share of the economy this represents, a rough estimate suggests that it may be a third of the economy (OECD, 2016e). These sectors include electricity, fuel transportation/distribution, alcohol distillation, sugar, rice, professional services and maritime transport. As several of these sectors are upstream suppliers, the share of the economy indirectly affected by these exemptions is much greater, which impacts on incentives to improve productivity downstream, decreases international competitiveness and reduces economic resilience (Bourlès et al., 2013; Monteiro et al., 2017).

In most cases, there seems to be no economic justification for the exemptions, and in a number of cases, notably concerning rice, COPROCOM has argued repeatedly that existing exemptions should be eliminated. The OECD has recommended that Costa Rica remove all unjustified exemptions (OECD, 2016b; OECD, 2016e). This could increase GDP per capita by 0.08% (Box 2.1).

In response, Costa Rica is undertaking in-depth reviews of 25 sectors exempt from competition law between 2017 and 2020 (a review timetable is provided in Table 2.3.). As of January 2018, two studies had been completed but are awaiting approval, and it is not yet

Table 2.3. **Costa Rica is reviewing sectors exempt from competition law**

Timetable for Costa Rica's in-depth sector reviews

Sector	Review year	Sector	Review year
1. Alcohol	2017-18	14. Public works concessions	2019
2. Professional associations	2017-18	15. Coffee sector	2019
3. Notary services	2017-18	16. Aqueducts and sewage	2019
4. Vehicle inspections	2017-18	17. Lotteries and bingo	2019
5. Gas stations	2017-18	18. Importation and production of fuels	2019
6. Postal services	2017-18	19. Transportation of fuels	2020
7. Ports	2018	20. Liquid gas	2020
8. Stevedoring services	2018	21. Electricity generation	2020
9. Maritime transport	2018	22. Electricity distribution	2020
10. International air transport	2018	23. Sugar sector	2020
11. Bus transport	2018	24. Rice sector	2020
12. Rail transport	2018	25. Social security services	2020
13. Taxi transport	2018		

known if they will be released publicly. A further three studies are underway and are expected to be completed in first quarter of 2018. While these reviews are a positive first step, removing exemptions is likely to be a controversial and lengthy process. For example, international trade negotiations were the catalyst for liberalisation of the Costa Rican telecommunications sector, and even then, the reforms were only approved following a very close referendum (OECD, 2016b). It is therefore recommended that next steps are mapped out to clarify how these studies will be used to spur concrete action. The review timetable should also be reconsidered, and sectors that are large and/or upstream suppliers (such as electricity) should be reviewed earlier.

Improving the governance of state-owned enterprises

There is a high degree of state control in the Costa Rican economy (Figure 2.14, Panel A), which restricts competition and leads to operational and allocative inefficiencies and lowers productivity (Hsieh and Klenow, 2009). SOEs play a dominant role in many key sectors, such as electricity, transport infrastructure, banking, insurance and petroleum products (OECD, 2016b; OECD, 2017k; OECD, 2017l). Even liberalised sectors, such as telecommunications and insurance, retain a dominant incumbent SOE. Several of these sectors will be reviewed as part of the in-depth sector studies mentioned above, providing an opportunity to assess not only whether state involvement is justified, but also whether the form of state involvement (including the presence of SOEs) is appropriate.

The governance of SOEs is also an issue. Most SOEs have been created by specific laws, resulting in a lack of uniformity in reporting and operational regulations. Improving SOE governance could have a sizeable impact on growth, boosting GDP per capita by 1.1% in the long term (Box 2.1). Recent high-profile cases involving two public banks (the cessation of intermediation activities at Bancrédito and investigations into the business practices of Banco de Costa Rica) have also raised public awareness about the importance of good governance.

To improve governance, the OECD has made a number of recommendations to align practices with the OECD *Guidelines on Corporate Governance of State-owned Enterprises* (OECD, 2015e; OECD, 2016b; OECD, 2017m). In response, the government launched an SOE Action Plan in July 2017, which is expected to be rolled out by the end of 2018. It includes actions to establish an ownership coordinating entity, develop an ownership policy, improve the composition of SOE boards, improve the corporate governance of SOEs, promote the adoption of international financial reporting standards, and enhance the monitoring and disclosure of SOE performance.

Several actions are already underway. An ownership unit was created as a legal entity in October 2017. A draft decree has also been developed that aims to align board member nomination processes with the OECD *Guidelines* by establishing a clear and transparent nomination policy for SOE board members and chief executives. Authorities are aiming to have the ownership entity operational and the nomination process established before the next round of board nominations takes place after the new administration takes office in May 2018. There are also ongoing efforts to address outstanding issues that have been raised by the OECD. For example, concerns have been raised that the ownership entity will not only be responsible for SOEs, but also other autonomous bodies such as the Regulatory Authority for Public Services (ARESEP) (OECD, 2017m). To address this, in its first two years of operation, the ownership entity will only be responsible for SOEs and after this time, a separate division will be created to oversee the other autonomous bodies. The level of resourcing of the ownership entity has also been raised as a potential issue, as the number of planned staff

appears to be small relative to other ownership entities in OECD countries and to the number of SOEs that it will monitor (OECD, 2017m). The Ministry of the Presidency plans to assess the level of staffing after two years, and make adjustments if necessary.

An additional issue is that many SOEs are established under their own legislation, and in some cases, these laws may need to be changed to avoid conflict with the draft decree. While authorities plan to address this issue through administrative measures initially, legal reform would bring greater stability. It is also expected that a Corporate Governance Bill will be submitted to the Legislative Assembly in 2018. The content of this bill is not yet clear as it is currently being drafted, but in general terms, it aims to provide cohesion to the public policy on corporate governance and complement the administrative actions that are already underway.

However, the Action Plan does not address level playing field concerns. SOEs often enjoy government-granted revenue streams. For example, the public bank Bancrédito had traditionally relied on state-sanctioned monopolies on the collection of airport exit taxes and the management of a state development fund (OECD, 2017m). Public banks also have the advantage over private banks of a full government guarantee on deposits. On the other hand, public banks must make para-fiscal transfers out of their net income (discussed in Chapter 1). These transfers do not pass through the national budget and are made directly to government agencies, such as the National Institute of Cooperative Development, the National Commission on Education Loans, the National Commission of Risk Prevention and Emergency Response and the Regime for Disability, Old Age and Death (OECD, 2017n).

Opening entry to FinTech start-ups and innovation would be a way to boost competition and reduce the high costs of financial intermediation. Technology-driven innovation in financial services has the potential to increase competition in the financial sector, improve access to credit, boost financial inclusion and reduce the cost of cross-border transactions. Several governments have therefore implemented, or are considering options for, FinTech regulatory frameworks. By providing greater certainty to innovating businesses and allowing space for experimentation, these aim to facilitate the development of FinTech while ensuring consumer protection and financial stability. For example, the UK launched a regulatory sandbox in May 2016 to provide a testing ground for new FinTech services, allowing for innovation under equal conditions for all players, while containing any consequences of failure. Several other governments have since created regulatory sandboxes, such as Singapore and Hong Kong. Mexico has also recently approved a bill to create a regulatory framework for FinTech and the European Commission is considering regulatory options as well.

In Costa Rica, to foster competition in the financial sector, where high transactions costs prevail, the central bank has updated its "Regulations for the Payments System" so that FinTech companies can register with and use the "National System of Electronic Payments", managed by the central bank, and widely used by the population. Building on this positive step, to further facilitate the development of FinTech the Costa Rican authorities should explore options and implement an appropriate regulatory framework.

Reducing barriers to entrepreneurship and streamlining regulatory procedures

Costa Rica's high barriers to entrepreneurship are reflected in Costa Rica's low level of business dynamism and high rates of informality. Product market regulations are particularly stringent due to the licence and permits system and high administrative burdens for small firms (Figure 2.14, Panel B). Reducing administration burdens for firms

could increase GDP per capita by 1.6%, and streamlining the licences and permits system could add 0.9% (Box 2.1).

According to the World Bank's *Doing Business* indicators, Costa Rica's distance-to-the-frontier score is 81.7 out of a possible 100, which is lower than all OECD countries. It takes 22.5 days to start a business, about 2.7 times longer than the OECD average, costs about 2.2 times as much, and involves 9 procedures. Costa Rica introduced an online platform for business registration in 2012, which significantly reduced the amount of time involved. However, it still takes considerable more time to start a business than in some other countries in the region (World Bank, 2017). Moreover, a mapping of the necessary processes by the Costa Rican authorities suggests that the time to operation (which includes not only business registration, but also obtaining necessary construction, environmental and other permits) is often much longer, taking about six months in an optimistic scenario, and involving 17 processes and 14 public agencies.

The government is working to reduce these business compliance costs. The majority of the 22.5 days it takes to start a business according to the World Bank measure is accounted for by the issuing of a business licence by the local municipality. Therefore, the Ministry of Economy, Industry and Commerce (MEIC) is working with several municipalities to reduce the time and paperwork involved, including by establishing one-stop shops in the Brunca, Central Pacific and Chorotega regions. In addition, MEIC and PROCOMER (Costa Rica's export promotion agency) started a joint project in 2016 to extend the sub-national initiatives to simplify and digitalise business processes, not only for the business registration phase, but also to obtain other licences and permits (such as construction, health and environmental permits). The digital platform has now been rolled out to firms within free trade zones, and is currently being extended to all firms. The project aims to reduce the current establishment time from 5-18 months to three months for manufacturing firms, from six months to 30-45 days for service firms, and from 1.5-2 years to six months for agro-industry firms. Areas that are slated for improvement include reducing the time to register foreign employees, obtain sanitation and environmental permits, undergo customs inspections and obtain free trade zone approvals.

These are positive steps, and if the current project is successfully implemented, it could set the stage for even further improvements in the future. Currently, the project involves improving processes within the current legal framework, which may limit what improvements are possible. Second, some of the procedures, such as obtaining a business licence and environmental permits, are the responsibility of local municipalities. Since municipalities have a high degree of autonomy, improving these processes requires consultation and co-ordination with municipalities on a case-by-case basis. Despite these limitations, authorities should continue these positive initiatives, with a view to establishing one-stop shops implemented at the local level, with clear and measurable objectives against which performance, including municipality performance, is benchmarked. As an example of what could be achieved, the number of procedures that an entrepreneur needs to undertake to start a business could be reduced from nine to one if these tasks were instead performed by a one-stop shop, as is the case in the best performing countries according to *Doing Business*, such as New Zealand.

Other efforts to reduce red tape are also underway. Regulations relating to registering low-risk food products and cosmetics were simplified in 2016. A new online application system for water permits has been introduced (OECD, 2017d). A new method for approving agrochemicals came into force in 2017, which is expected to reduce the approval time from

four years to as little as six months, although it is too early to assess its impact. Authorities should continue with their ongoing efforts to lower regulatory burdens.

Costa Rica's Law for the Protection of Citizens against Excessive Administrative Requirements and Procedures (Law 8220) has allowed for "silence is consent" since 2012. If permits and licences are not issued within the statutory time limit, the activity is deemed to be approved. However, "silence is consent" covers only permits, licences and authorisations, and excludes those relating to health, animal health, phytosanitary and environmental issues. There is also an onus on applicants to request "silence is consent", which involves submitting an application which confirms that all the necessary paperwork had been filed and the statutory response time has elapsed. The administration then has three days to either certify that "silence is consent" is granted or provide reasons why it does not apply. These exclusions and requirements may be limiting its use and effectiveness. Unfortunately, information on how often the "silence is consent" rule is applied in cases when the statutory time limit has elapsed is not available. It is recommended that this information be collected with a view to assessing the effectiveness of the "silence is consent" rule is in practice.

Improving the insolvency regime to facilitate the exit of "zombie" firms

At the other end of the firm lifecycle, facilitating the exit of unviable businesses frees resources to flow to more productive uses. According to OECD indicators of the design features of insolvency regimes, Costa Rica performs above the OECD average. This is largely due to Costa Rica achieving best-practice standards for restructuring tools, while systems for prevention and streamlining of the process could be improved (Adalet McGowan et al., 2017). However, Costa Rica's results according to the World Bank's *Doing Business* "resolving insolvency" indicator, which are based on a stylised case study and focuses more on implementation than the OECD indicators, are much less positive. According to the World Bank measure, Costa Rica's distance-to-the-frontier score is 34.4, which is lower than all OECD countries except Turkey and significantly below the OECD average of 74.8. This reflects a debt recovery rate (31 cents in the dollar) that is much lower than in OECD countries (75 cents) and countries such as Colombia (72 cents). The estimated time to resolution of three years is also high compared to the OECD average (1.8 years) and comparable countries such as Colombia (1.7 years) (World Bank, 2017).

Recognising these issues, a major overhaul of the insolvency regime is underway. Currently, the regulatory framework for insolvency is dispersed across several pieces of legislation. A draft bill that provides a unified regulatory framework for insolvency is expected to be ready shortly. The framework will follow World Bank recommendations and the model used in other countries, such as Mexico, Spain and Uruguay. It will provide for a re-structuring phase based on agreed solutions with creditors, providing the opportunity for the business to trade its way to viability. In the case that the business is not viable, it then provides for a liquidation phase. It aims to expedite this phase, which often takes three years or more currently, with an aim to reduce this to no more than one year. For example, processes will be streamlined by limiting the ability of creditors to appeal asset valuations and creating financial penalties for relatively trivial appeals. In addition, from February 2018, all insolvency cases will be heard in a specialist court.

Continuing efforts to increase the profile and co-ordination of productivity-related policies

Improving productivity and inclusive growth requires measures spanning many different policy areas, which poses a particular challenge for Costa Rica given the high

degree of public sector fragmentation (Cornick and Trejos, 2016). The Presidential Council on Competitiveness, Innovation and Human Talent, PCCI), modelled after productivity commissions in OECD countries such as Chile and Mexico, was established to raise the profile of productivity-related policies and to coordinate and align policy efforts.

While the PCCI has made positive steps to improve policy development and co-ordination, its effectiveness could be enhanced if it assumed a more strategic role, its three sub-councils were merged, and the technical unit was strengthened (OECD, 2016b; OECD, 2017e). To address these issues, a technical committee tasked with establishing an agenda of priorities for the PCCI's work has been created. Furthermore, a bill is being considered to institutionalise the PCCI to ensure its longevity, unify its three sub-councils, strengthen the technical secretariat and add a strategic advisory branch (Bill 20.331). While this is a positive development, it is not yet clear if and when this bill will be enacted and the changes implemented.

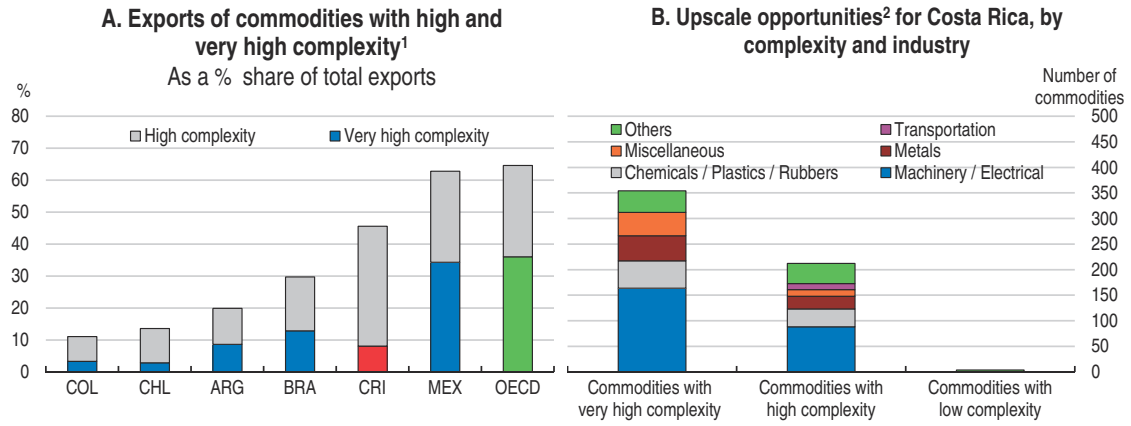
Promoting innovation, technological diffusion and integration into global value chains

The FDI- and export-led economic strategy that began in Costa Rica in the 1980s has contributed to a structural transformation from an agricultural-based economy to one with a more diversified structure that is integrated into global-value chains (GVCs), which has allowed for a sustained expansion of production since the mid-1980s (Rodriguez-Clare et al., 2001; Alfaro Ureña and Vindas, 2015). This evolving pattern of production is mirrored in the country's comparative advantage, which, similar to advanced OECD economies, shows an increasingly specialised and sophisticated export basket (OECD, 2017o; Figure 2.15, Panel A). Building on existing productive experiences and specialisation patterns, Costa Rica could benefit from upscaling opportunities in a number of medium- and high-technological industrial sectors (Araújo, Linares and Chalaux, 2018; Figure 2.15, Panel B). The service industry has also started to gain prominence, with an increase in the share of economic activity in knowledge-intensive service industries (OECD, 2017e). There has also been a rise in service exports, reflecting an increase in tourism and knowledge-intensive services (professional and business services, and telecommunication, computer and information services) (Figure 2.16). This diversification and transformation will contribute to economic resilience and spur productivity and income convergence to high-income countries. Although Costa Rica faces the challenge of spreading the benefits of this transformation more widely, it has the potential to improve the population's well-being by creating quality, higher paid formal jobs.

Costa Rica's strong foreign investment inflows have been facilitated by a friendly FDI regime (Figure 2.17). While regulatory barriers to FDI are lower than the OECD average, restrictions are still stringent in some sectors, including some key network sectors, such as electricity supply and maritime and surface transport (OECD, 2016b; OECD, 2017p). Moreover, Costa Rica restricts trade in many service sectors more than other countries, with particularly high restrictions in road freight transport, cargo-handling and storage and warehouse services (Figure 2.18). Logistics costs could be reduced and further trade and GVC integration facilitated if these restrictions were eased.

Despite its shift into more knowledge-intensive goods and services, Costa Rica does not score well on innovation input and outcome measures. On the input side, R&D spending as a share of GDP is on a par with other Latin American countries that have a similar level of

Figure 2.15. **Costa Rica is specialising in complex products**



1. "High" and "very high" complexity commodities are those with complexity scores in the 3rd and 4th quartiles of the distribution of the total set of commodities traded worldwide. These are calculated on the basis of the Product Complexity Index (PCI) which is a measure of the relative knowledge intensity of a commodity. An example of a product in the 4th quartile is "Ethylene dichloride", which ranked 10th in 2015 out of 4214 products listed in the Harmonized System 6 classification. A product in the 1st (lowest) quartile is "Cocoa paste wholly or partly defatted" ranked 4201st in 2015.
2. Upscale opportunities are those commodities currently exported with no comparative advantage, with a level of complexity (PCI) higher than the country's complexity index and which are closer to the country's specialisation pattern.

Source: Panel A: Araújo, Chalaux and Haugh (2018); Panel B: Araújo, Linares and Chalaux (2018).

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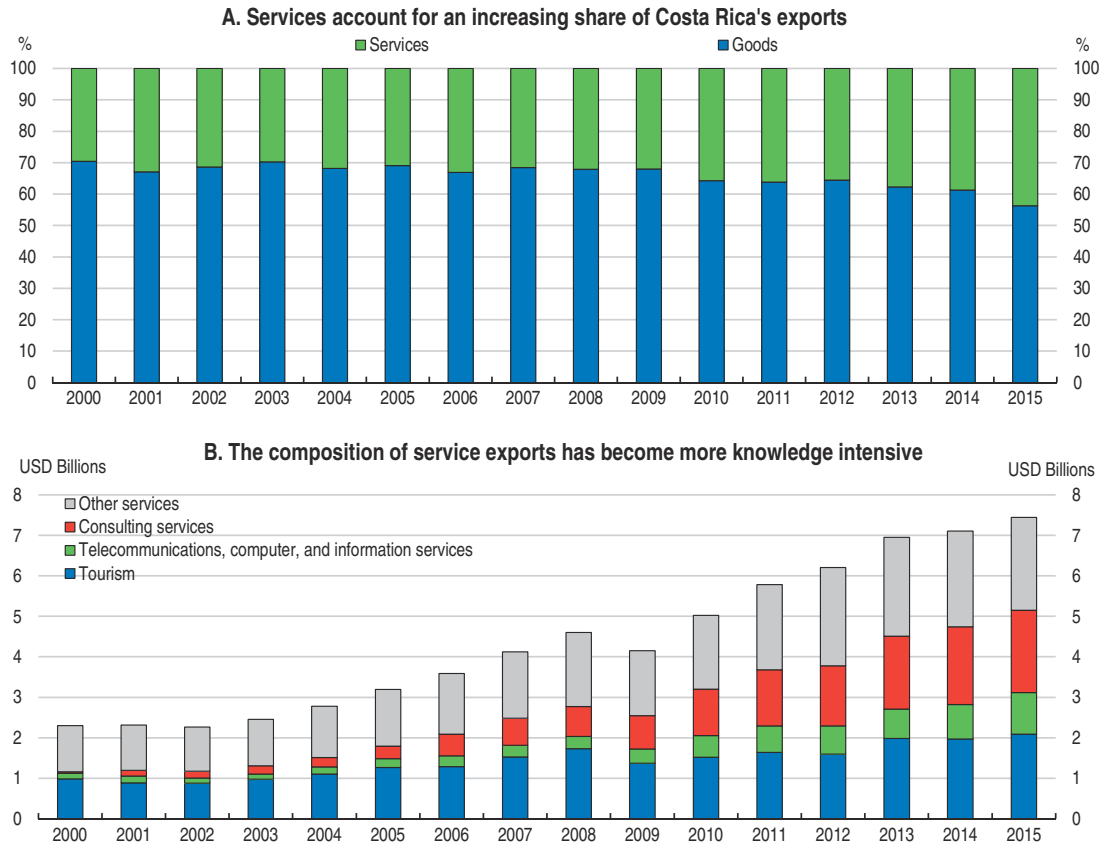
Figure 2.16. **Knowledge-intensive services are an increasingly important part of the economy**



Source: OECD Dataset: Bilateral Trade in Goods by Industry and End-use (BTDIxE), ISIC Rev.4. OECD Dataset: EBOPS 2010 – Trade in services by partner country.

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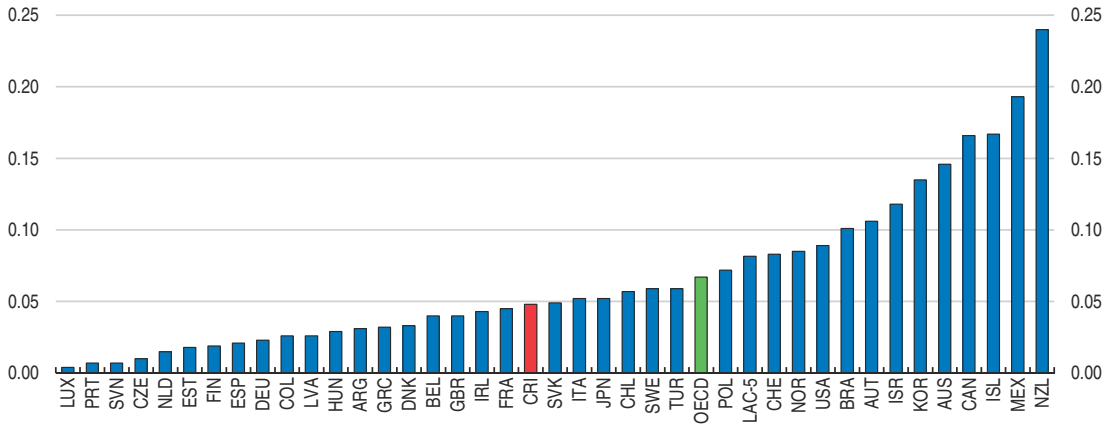
Figure 2.17. **FDI restrictions are relatively low overall**

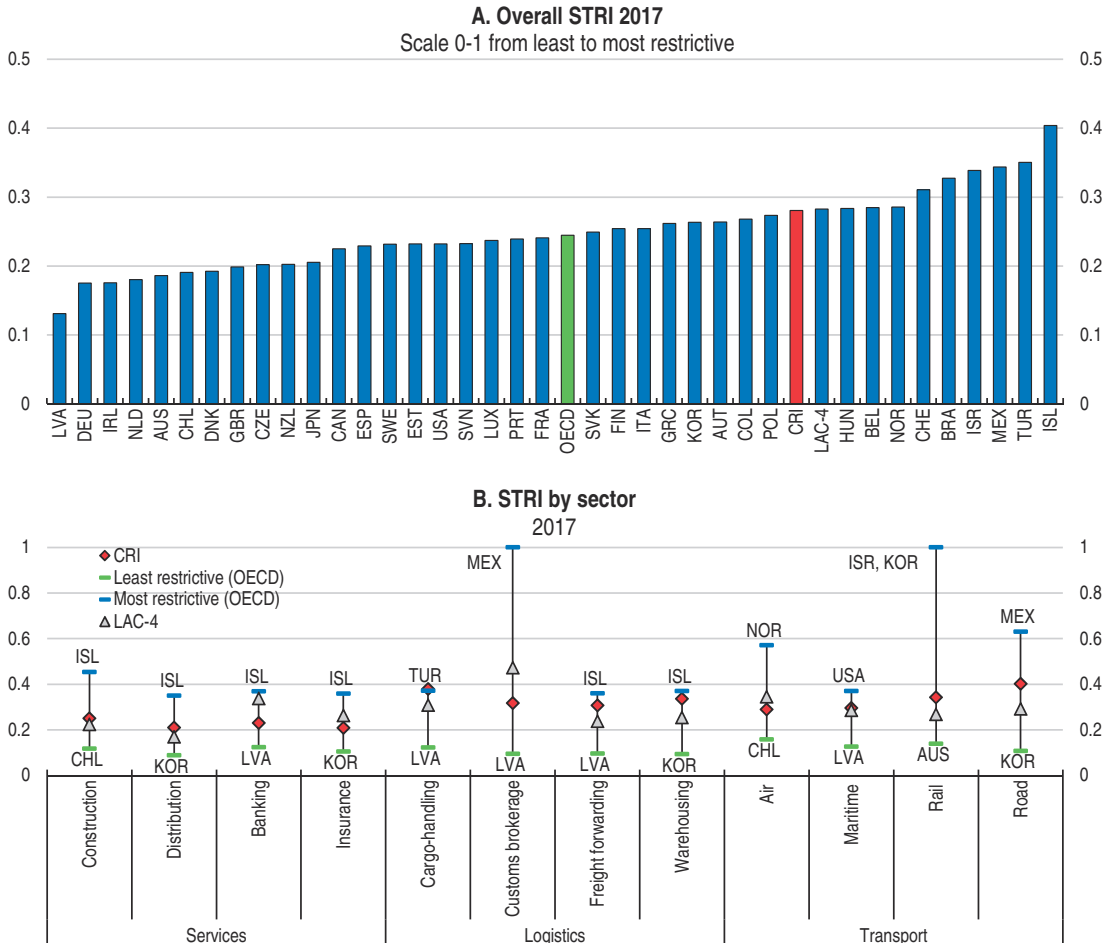
Total FDI Regulatory Restrictiveness, index scale 0-1 from open to closed, 2016



Note: OECD is a simple average of OECD countries. LAC-5 is a simple average of Argentina, Brazil, Colombia, Chile and Mexico.
Source: OECD FDI Restrictiveness Index.

StatLink http://dx.doi.org/10.1787/888933702687

Figure 2.18. **Services trade restrictions are high, particularly in transport and logistics**



Note: LAC-4 refers to a simple average of Brazil, Chile, Colombia and Mexico.
Source: OECD Services Trade Restrictiveness Index (STRI).

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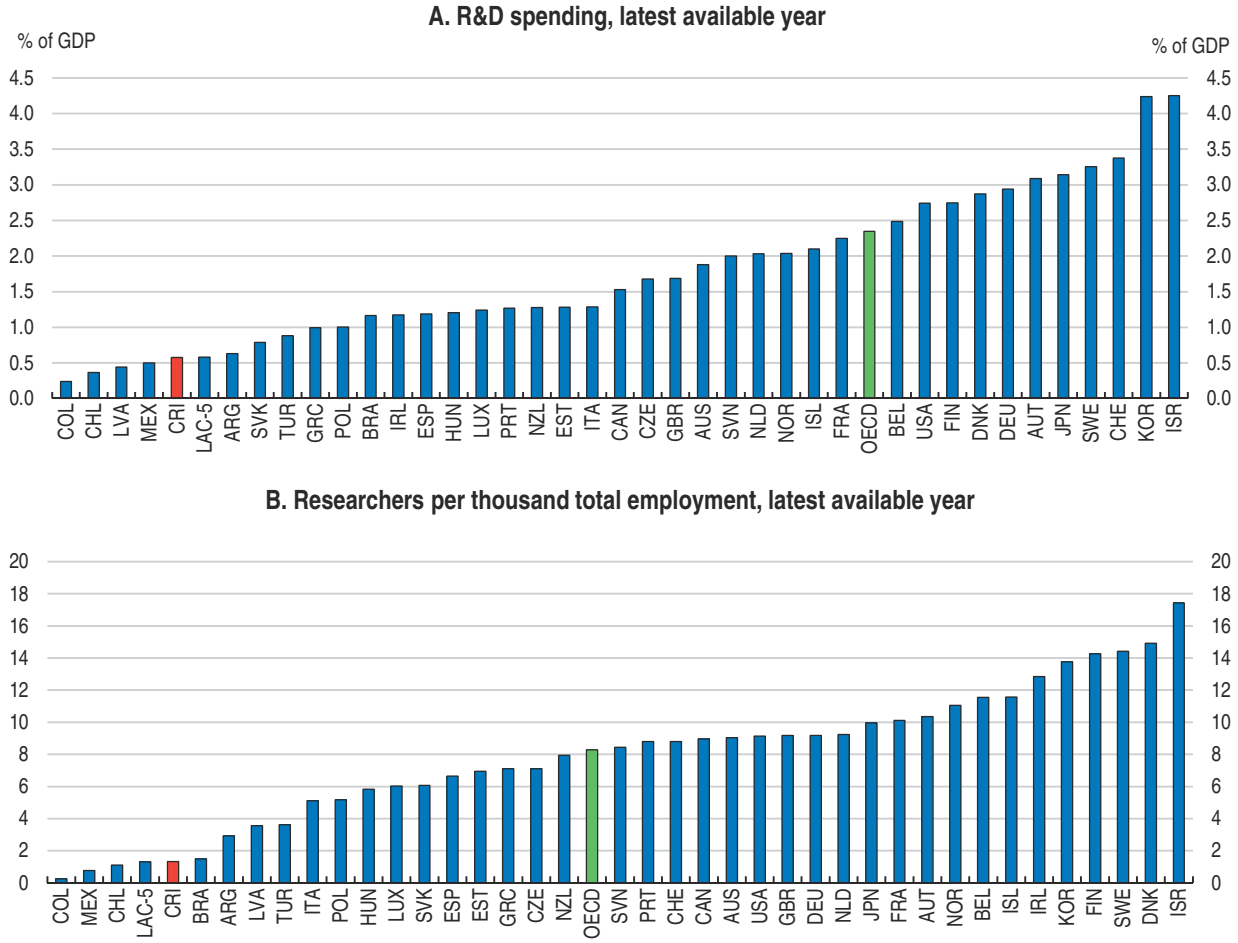
development, but it has stagnated in recent years and is well below the OECD average (Figure 2.19, Panel A). The private sector's contribution is weak, with a large and increasing share of R&D funded by the government (Figure 2.20), with limited knowledge transfer to businesses. Costa Rica is also well below the OECD average in terms of the share of researchers in total employment (Figure 2.19, Panel B). Investment in other key forms of intangibles for innovation such as ICT and software spending appear higher than in other Latin American countries (as a share of GDP), but are still several times lower than in OECD countries. On the outcomes side, Costa Rica has low performance in most knowledge and technological production indicators. Publication activity is lower than a number of comparable countries in the region and far below the OECD average. Indicators of intellectual production, such as patents and industrial designs, show that Costa Rica performs well below other Latin American and OECD countries. Costa Rica ranks better than most Latin America countries in terms of trademarks per person, but is still far behind the OECD average (OECD, 2017e).

Figure 2.19. **Investment in knowledge-based capital is lagging**

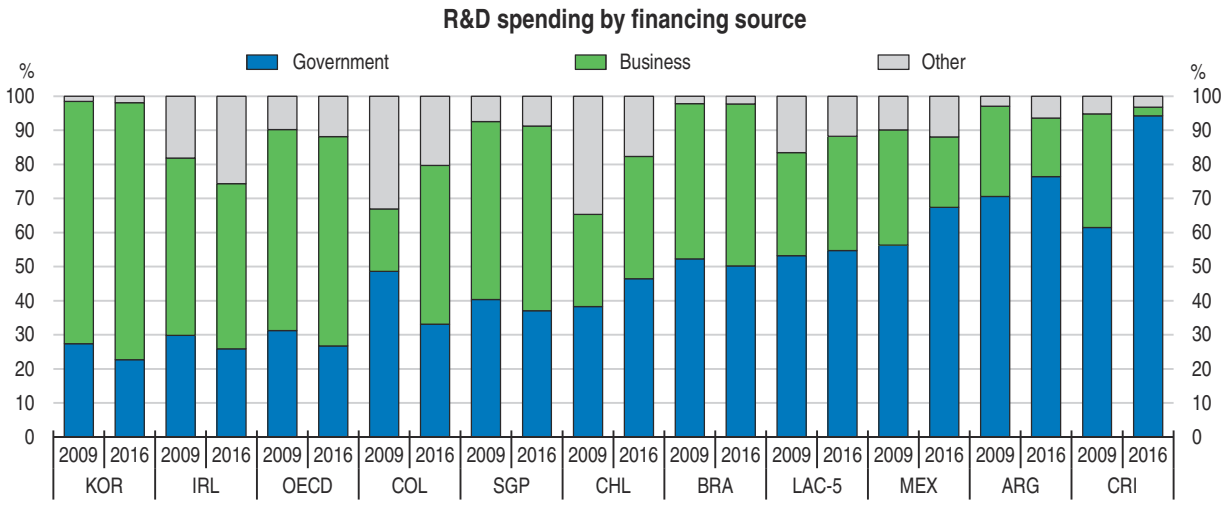


Note: R&D spending is measured as gross domestic expenditure on research and development. OECD is a simple average of OECD member countries. LAC-5 is a simple average of Argentina, Brazil, Chile, Colombia and Mexico.

Source: *OECD Main Science and Technology Indicators Database*. UNESCO Institute for Statistics.

StatLink http://dx.doi.org/10.1787/888933702725

Figure 2.20. **A large and increasing share of R&D is financed by the government**



Note: R&D spending is measured as gross domestic expenditure on research and development. OECD is a simple average of OECD member countries. LAC-5 is a simple average of Argentina, Brazil, Chile, Colombia and Mexico. First year of reference is 2009 except for Argentina (2008). Second year of reference is 2016 except for Argentina (2015), Ireland (2015), OECD (2015), Brazil (2015), Colombia (2015), Costa Rica (2014) and Singapore (2014).

Source: *OECD Main Science and Technology indicators* (database). Red de Indicadores de Ciencia y Tecnología RICYT, Indicadores de Insumo.

StatLink *http://dx.doi.org/10.1787/888933702744*

In addition, innovation and technology use is concentrated among firms in free-trade zones. These high-productivity firms co-exist with low-productivity domestic (including informal) firms. There is limited integration of local firms into the supply chains of multinational firms due to a mismatch between what foreign firms demand and the competencies of the local business sector (OECD, 2017e). As a result, local suppliers provide only 24% of inputs to multinational enterprises in Costa Rica, and this mostly consists of low value-added activities like packaging and cleaning services (OECD, 2017e). However, there is evidence of positive spillovers from FDI to domestic firms. In the manufacturing sector, firms that supply foreign-owned firms have, on average, 8% higher labour productivity than firms with similar characteristics that do not have business relations with foreign-owned firms. In the services sector, such firms have 6.4% higher labour productivity (Sandoval et al., 2018). Moreover, there is an increasingly dynamic services sector, with sophisticated business services and informatics accounting for 45% of the total sector (OECD, 2017e).

Strengthening co-ordination to increase firm linkages and the contribution of public research to innovation

The effectiveness of Costa Rica's innovation policy is hindered by fragmentation in policy execution and institutional settings, limiting coherence and direction in research and innovation policy by the Ministry of Science, Technology and Telecommunications (MICITT) and its agencies (OECD, 2017e). This fragmentation affects the delivery of business assistance programmes aimed at boosting innovation in local companies and deepening their links with foreign affiliates. These programmes include PROPYME – managed by MICITT to promote innovation and technological development in SMEs through grants – and Linkages (formerly *Costa Rica Provee*) – managed by PROCOMER to improve linkages between foreign and domestic companies by matching suppliers with buyers. Policy evaluation suggests that these programmes improve business performance, resulting in greater employment,

profitability and exports, with stronger effects for firms enrolled in both programmes (Monge González et al. 2010; Monge-González and Rodríguez-Álvarez, 2013).

Given these positive results, the 2016 Economic Assessment recommended scaling up PROPYME and Linkages and improving their co-ordination, as well as establishing a one-stop agency for related business assistance services (OECD, 2016b). A bill to create a new agency, FOMPRODUCE, to concentrate funds and responsibilities relating to firm innovation and development in one entity is consistent with this (Bill 19.822). However this proposal has stalled, although work continues to address stakeholder concerns and garner support for the bill.

The legal framework for intellectual property rights (IPR) in Costa Rica complies with international standards, however enforcement is weak, particularly in relation to copyright piracy and trademark counterfeiting, which may be discouraging the creation and diffusion of knowledge (OECD, 2016b). In order to address this concern, the Costa Rican authorities have taken steps to strengthen the prosecution of IPR infringements and improve border control measures, including through the law to enhance the fight against smuggling (Law 9328) that came into force in 2016, although its impact remains to be seen (OECD, 2017p).

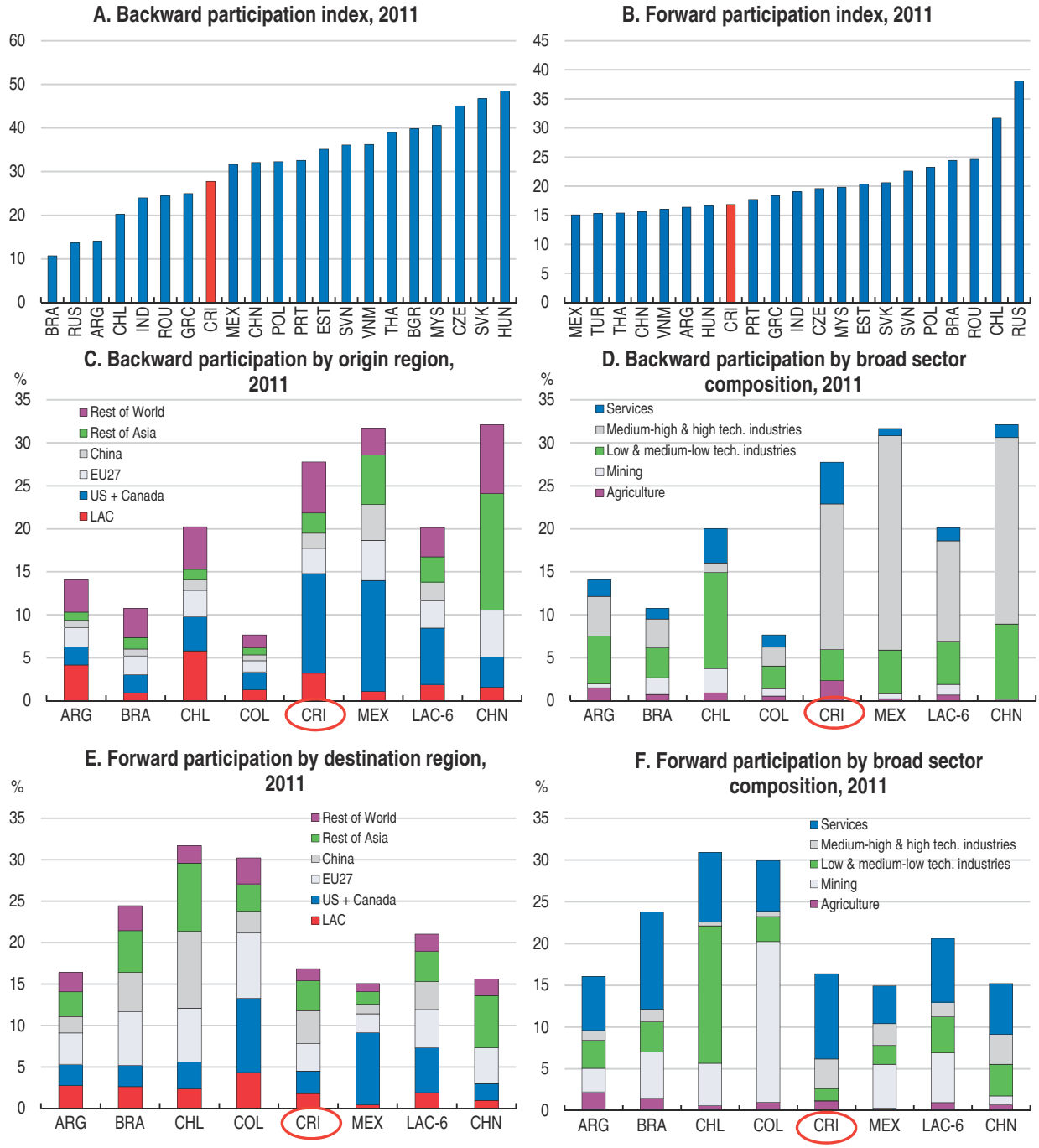
The high level of university autonomy is another aspect of the lack of a unified and concerted approach in the area of research and innovation. As discussed above in relation to improving education, the OECD has recommended that Costa Rica takes a more unified approach to university funding and that it reforms the FEES funding system by increasing the share of competitive funding to raise the quality of research and to incentivise linkages with the business sector (OECD, 2016b; OECD, 2017e). To date, this recommendation has not progressed due to considerable resistance from stakeholders.

Boosting regional integration through improved trade facilitation

Costa Rica is well integrated into global value chains (GVCs) from a backward participation perspective, with a share of foreign value added in gross exports that is similar to that of Mexico (Figure 2.21, Panel A). However, Costa Rica remains below peer countries regarding its forward participation in GVCs – that is, the share of Costa Rican value added embodied in foreign countries' exports is low (Figure 2.21, Panel B). Costa Rica's backward participation is concentrated in medium-high and high-technology industries (Figure 2.21, Panel D), while its forward participation is concentrated in services (Figure 2.21, Panel F). Costa Rica's backward participation is tilted towards the United States (Figure 2.21, Panel C), while its forward participation is oriented towards Asia, with only a small share of its GVC participation involving Latin American countries (Figure 2.21, Panel E). This mirrors the more general finding that intra-regional links in Latin America are weak, in contrast to the strong role of regional value chains in Asia, Europe and North America. For example, of the total foreign value added used for producing exports in Latin America, only 9% was sourced from within the region, compared with 49% in the EU and 40% in Southeast Asia (OECD and IDB, 2016).

Recognising the potential to boost intra-regional trade, a law to create a National Council of Trade Facilitation (*Consejo Nacional de Facilitación del Comercio*, CONAFAC) was passed in April 2017 (Law 9430), and the Council is expected to be fully operational in 2018. The Council has 12 members: seven vice-ministers whose functions relate to border control and five private-sector representatives. CONAFAC's decisions are binding on the relevant government agencies. It aims to reduce the transaction costs and increase the security of

Figure 2.21. **Costa Rica is well integrated into GVCs from a backward participation perspective**



Note: The backward participation index is defined as the share of foreign value added in a country's gross exports. Forward participation is defined as the share of domestic value added embodied in foreign countries' exports. For comparability reasons, most countries included are non-OECD peer countries, such as Brazil, Argentina, Indonesia, Romania, Vietnam, among others. According to the OECD technology classification for industries high tech industries include: Air and spacecraft and related machinery, pharmaceuticals, computer electronic and optical products, medical and dental instruments; medium-high tech industries refer to products such as motor vehicles, machinery and equipment, chemicals and chemical products, electrical equipment. LAC-6 refers to Argentina, Brazil, Chile, Colombia, Mexico and Peru.

Source: OECD-WTO Trade in Value Added Database.

StatLink http://dx.doi.org/10.1787/888933702763

cross-border commercial operations. CONAFAC is responsible for the implementation of free trade agreements as well as the modernisation and continuous improvement of all infrastructure relating to the cross-border movement of goods and people (it does not cover services). Examples of planned initiatives include standardisation and digitalisation of land border crossings in Central America as delays at border crossings are a significant contributor to slow land transport times.

According to the OECD's Trade Facilitation Indicators, Costa Rica's performance exceeds that of other countries in the region but remains below the OECD average. CONAFAC has the potential to improve Costa Rica's performance in a number of dimensions, including simplifying and harmonising documents, automation and streamlining of border procedures, and improving co-ordination of the relevant national agencies. Relatively modest changes in this area could have a significant impact on growth – for example, communicating regulations in an accessible manner at the international level could boost GDP per capita growth by 0.9% (Box 2.1).

Addressing transport infrastructure gaps

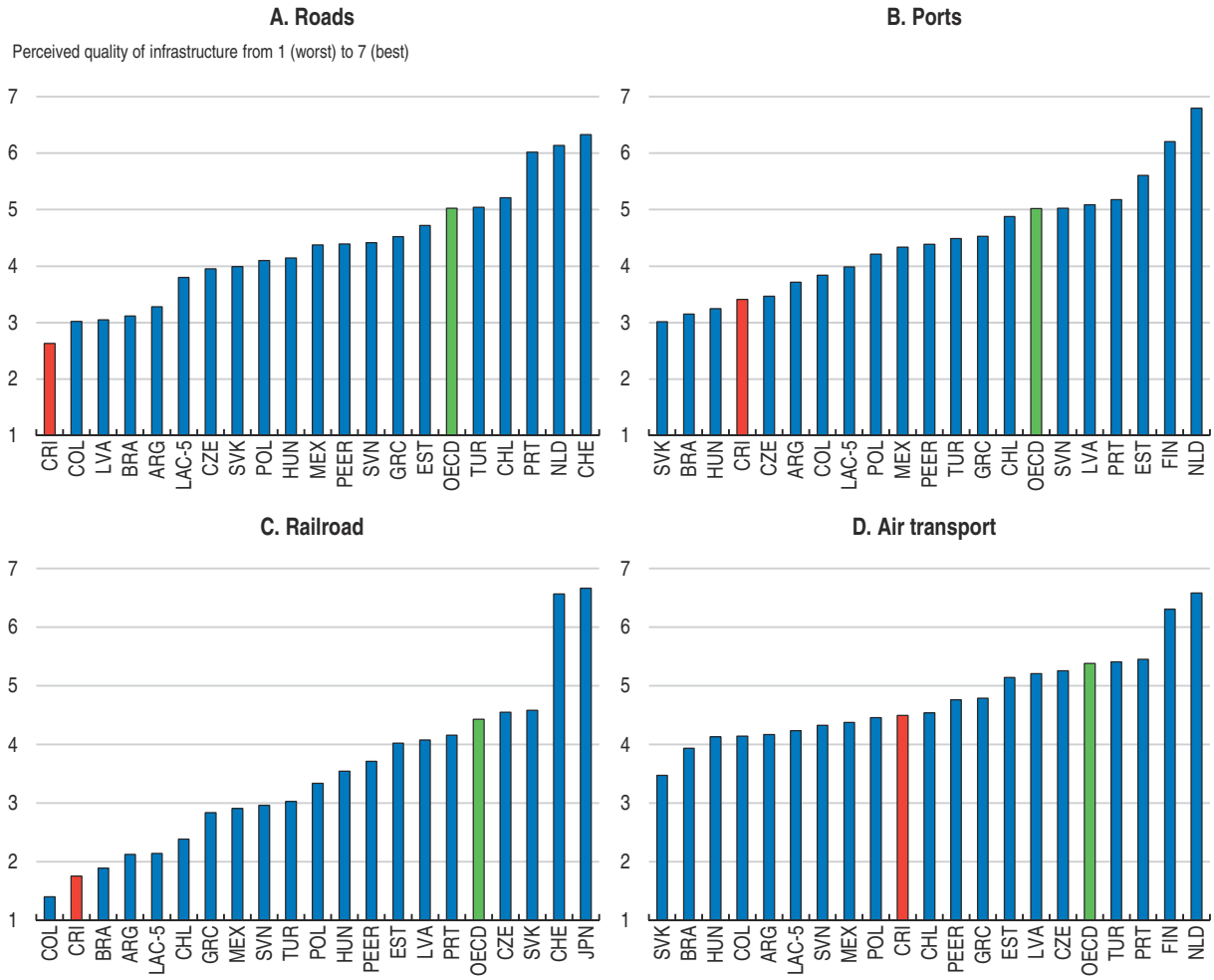
Costa Rica has significant infrastructure gaps, particularly in transport infrastructure, which are hindering productivity and environmentally-sustainable growth, as well as negatively affecting the population's well-being (Estado de la Nación, 2016; OECD and IDB, 2016; OECD, 2017d). Costa Rica ranks below the Latin American average for the perceived quality of roads, ports and railroads, but above the average for airports (Figure 2.22). These perceptions are supported by technical assessments, with only half of the roads considered to be in good condition (LANAMME, 2017). The potential gains from improving the quality and quantity of the road network are significant. Estimates suggest that GDP growth rates could increase by 0.14 percentage points if the quality of Costa Rica's roads was increased to the median for Latin American countries (Lanau, 2017; Box 2.1).

The low quality of transport infrastructure reflects consistent underspending in the past, deficient strategic planning, and poor project management and execution. Spending on infrastructure has been lower than the OECD average despite greater needs. The government is aware of the spending shortfall and the National Transport Plan 2011-35 projects annual infrastructure spending needs of almost 4% of GDP to 2035 (MOPT, 2011; OECD, 2016b). However, spending has been irregular as there is no multi-year budgeting process, making infrastructure investment vulnerable to cuts particularly in the context of limited fiscal space and a high level of earmarking for other areas of public spending (MOPT, 2011; OECD, 2016b).

Strategic planning and project management are also weak. This is typified by the well-publicised problems with the Alfredo González Flores Bridge. The bridge is part of the highway connecting San José with Alajuela province, and is the major route between the capital city and Juan Santamaría International Airport and carries about 90 000 cars a day. Yet, despite its importance and attempts by three successive governments to repair and expand it since 2009, this work was only completed in March 2017.

Another example is the need for a mass rapid transit system for the Great Metropolitan Area of San José (GMA) to reduce congestion and pollution, promote competition among firms and maximise the benefits of agglomeration economies (Ahrend, 2015; Atkin and Donaldson, 2015; Hsieh and Moretti, 2015). Despite long-standing plans, little progress has been made. Most recently, this planning has involved the creation of a committee consisting of representatives from the 21 GMA municipalities, the Ministry of Housing and Human

Figure 2.22. **Perceived quality of transport infrastructure is low**



Note: OECD is a simple average of OECD member countries; LAC-5 is a simple average of Argentina, Brazil, Chile, Colombia and Mexico; PEER is a simple average of the 10 non-Latin American OECD countries with the lowest GDP per capita. Road, port and air transport measures use the 2017-2018 Global Competitiveness Index edition. Rail uses 2016-2017 edition due to data availability for Costa Rica.
Source: World Economic Forum, The Global Competitiveness Index Historical Dataset 2007-2017.

StatLink http://dx.doi.org/10.1787/888933702782

Settlement, Ministry of Public Works (MOPT), and the Ministry of the Environment and Energy (MINAE). However, past planning exercises have failed to lead to concrete action, and it is not clear whether implementing the latest plan will prove more successful than past attempts, once again highlighting the issues arising from the high degree of institutional fragmentation.

Streamlining the institutional framework for transport infrastructure investment

The transport infrastructure planning processes are highly fragmented, involving several different ministries and government agencies with unclear and overlapping mandates, resulting in a lack of coherence and contributing to project delays (Pisu and Villalobos, 2016). The OECD has recommended that the institutional and legal framework of public-work agencies be streamlined and that a more strategic approach to long-term planning be taken, including by establishing a project pipeline to increase certainty (OECD, 2016b).

Costa Rica acknowledges these issues and some efforts have been made to improve the situation. A law to improve the financing and investment of the public institution responsible for train infrastructure (INCOFER) has been passed, a necessary but modest step towards the government's goal of establishing a rapid mass transport system for the GMA of San José. A bill to strengthen the Ministry of Public Works' (MOPT) stewardship of the sector and create a new, strengthened coordinating body for road infrastructure (the National Institute of Road Instructure) was proposed in 2016 but lacks political support (Bill 19.900). However, even if these measures are implemented, fragmentation issues will still be significant.

A necessary condition for a successful infrastructure programme is appropriate strategic planning that sets a long-term vision and prioritises investment (OECD, 2017q). While Costa Rica established the National Transport Plan 2011-2035 in response to the need to develop a long-term strategic view and investment priorities, it serves primarily as guidance for institutions involved in transport infrastructure and lacks legal enforcement mechanisms (Pisu and Villalobos, 2016). Different autonomous bodies are responsible for the numerous aspects of transport infrastructure and there are no mechanisms to coordinate and align incentives. For example, in road transport, the National Road Council (CONAVI) is responsible for extending and maintaining the national road network, municipalities are in charge of local roads, and the Public Transportation Council (CTP) is responsible for public road transportation (i.e. taxis, buses and coaches). The lack of co-ordination and strict budgetary separation, and in some cases (notably public transport) the absence of a budgetary line, means that there is no mechanism for making strategic trade-offs between different transport modes, for example, decisions such as whether to invest in public transport as an alternative to building more roads.

Co-ordination and accountability would be greatly improved by clarifying the mandates of the different agencies and granting authority and control of infrastructure management to a single institution. This lead agency could also be charged with long-term strategic planning and the development of a clear project pipeline, with project selection and prioritisation based on cost-benefit analysis (OECD, 2016b; Pisu and Villalobos, 2016; OECD, 2017q). Currently, these steps are overlooked, with more emphasis placed on concessions and project financing, which, while important, are secondary considerations to systematic prioritisation. Indeed, to ensure that projects are prioritised according to cost-effectiveness criteria, the OECD *Principles for the Public Governance of Public-Private Partnerships* highlight that best practice involves separating the project selection and delivery mode decisions (OECD, 2012b). After the prioritisation process has taken place, selected projects should then be evaluated on a case-by-case basis to identify the most appropriate delivery mode (e.g. PPP or direct public provision) (OECD, 2017q).

Reforming institutional settings to improve the governance of private sector investment

Costa Rica's National Transport Plan 2011-35 envisages that a third of the 4% of GDP spending on transport infrastructure will come from private sector investment (MOPT, 2011). However, Costa Rica has relatively little experience with PPPs and private involvement in infrastructure projects has been low and fraught. There have been only four PPP projects since the General Concession Law regulating private participation was passed in 1998, and these suffered from delays of up to 11 years before construction even began (OECD 2016b; Pisu and Villalobos, 2016; OECD, 2017r).

While there are a number of legitimate reasons for seeking the involvement of the private sector in the provision of infrastructure investment, PPPs are sometimes used inappropriately to disguise pressure on public finances. In such cases, investment decisions – by precluding appropriate alternative investment arrangements – will lead to suboptimal outcomes. This underscores the importance of separating the decision to invest in a project from the decision about how to procure and finance the investment. Moreover, the use of PPPs should be accompanied by proper and transparent assessment of their expected long-term impact on public finances (Araújo and Sutherland, 2010; OECD, 2012b). A stark example occurred in Hungary with major PPPs for motorways recorded off-budget in 2005 and 2006, despite the partnership involving a state-owned enterprise (Araújo and Sutherland, 2010).

Private participation in infrastructure in Costa Rica is governed by a fragmented legal framework (OECD, 2017q). Given the complexity of PPPs, the OECD guidelines highlight the importance of a robust governance structure where relevant agencies have a clear mandate and accountability (OECD, 2012b). In response to these concerns, Costa Rica is in the process of developing a new framework for public-private initiatives. In 2016, a public policy for PPPs was formulated and a decree was issued to regulate PPP projects. While positive, greater clarity is needed about how this new framework will be implemented within the current institutional and legal settings (OECD, 2017r). For example, the role of the new regulation in relation to the existing concessions legislation (Law 7762) which has been in place since 1998 should be clarified.

The OECD has also recommended that the National Concession Council (CNC) – which is responsible for promoting and managing concession projects – be moved from the Ministry of Public Works to the Ministry of Finance, which is better placed to account for the contingent liabilities arising from private-sector participation (OECD, 2016b). The current arrangement may also create a bias against private participation in infrastructure because the Ministry of Public Works also promotes publicly-funded infrastructure projects that can be in direct competition with privately funded ones (OECD, 2016b). This recommendation has not progressed, but a PPP unit has been created within the Ministry of Finance. Consistent with recommendations to align practices with the OECD *Principles for the Public Governance of Public-Private Partnerships,* the unit will manage the public financing issues relating to PPPs, including the associated contingent liabilities, and has also developed a number of guidelines and project assessment criteria and training on their use is underway (OECD, 2012; Pisu and Villalobos, 2016; OECD, 2017r). While it is positive that the PPP unit is implementing best-practice guidelines, the addition of another agency has the potential to further contribute to the institutional co-ordination issues. PPPs involve a host of issues such as selecting the most efficient bidder; designing contracts to effectively allocate risks, mitigating hold-ups and minimising costly renegotiations; the ongoing management and monitoring of PPP contracts; and accounting for the fiscal impact of PPPs through consideration and reporting of contingent liabilities (Araújo and Sutherland, 2010). In practice, it appears that the two entities are working together, with the PPP unit focussing on public financing issues and the CNC remaining responsible for the contract management and technical aspects. However, additional efforts are needed to clarify the roles of the two entities and establish mechanisms to align and coordinate their work (OECD, 2017r). More generally, these arrangements should continue to be monitored as they remain untested in practice as no PPP has taken place under the new regulatory and institutional arrangements.

Box 2.4. **Recommendations for structural policies to boost productivity and inclusion**

(Key recommendations included in the Executive summary are bolded.)

Making labour markets more inclusive

- **Continue moving to a smaller number of minimum wages.**
- **Implement a comprehensive plan to reduce informality, including greater enforcement of obligations to pay contributions.**
- **Increase the supply of publicly-funded childcare services. Classify all spending on early childhood education and care under the constitutionally-mandated spending on education.**
- Strengthen the enforcement of labour regulations by granting inspectors the right to impose sanctions directly and ensuring sanctions are large enough to act as a deterrent.

Enhancing the quality and efficiency of the education system

- **Establish better educational outcomes as the main policy target, instead of a focus on spending, and develop performance indicators.**
- **Rebalance education spending towards early childhood and secondary education. Strengthen targeted support for at-risk students, and teachers' training.**
- Establish and enforce a comprehensive set of minimum standards for all early childhood care centres.
- Strengthen the national assessment system to provide information at the system, school and student level.
- Monitor the results of the dual education pilot programme and consider options for developing vocational educational further, in close conjunction with employers.
- Reform the secondary school assessment system (*Bachillerato*) to better recognise partial achievement and increase flexibility.
- Increase the share of competitive funding for public universities, based on performance measures such as the labour-market relevance of qualifications and research outcomes.

Strengthening competition

- **Adopt and implement the bill reinforcing the powers, independence and funding of the competition commission.**
- **Continue implementation of the action plan to increase consistency with the OECD Guidelines on Corporate Governance of State-Owned Enterprises.**
- **Continue with the planned 25 sector studies evaluating the exemption from competition and eliminate unjustified exemptions.**
- **Open entry to FinTech start-ups, with appropriate regulation.**
- **Establish a one-stop-shop for business registration and licensing. Introduce performance targets. Continue to improve the insolvency regime and trade facilitation.**
- Approve and implement the proposal to institutionalise the Presidential Council on competitiveness, Innovation and Human Talent, unify its three sub-councils and strengthen its technical secretariat.
- Create a one-stop shop for government business assistance services.

Addressing transport infrastructure gaps

- **Improve co-ordination among the different public-works bodies by clarifying mandates and granting overall control to a single lead agency. Prioritise projects based on cost-benefit anlaysis.**
- Clarify the mandates of the National Concessions Council (CNC) and the PPP unit and introduce mechanisms to align and coordinate the work of the two entities.

Note

1. In this commission, according to Law 9220, Ministers or Viceministers from the Ministry of Education, Ministry of Health and Ministry of Labour and Social Security participate. Also, hierarchs from institutions such as: PANI, INAMU, CCSS and the Technical Secretariat of REDCUDI participate.

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(10 2018 10 1 P) ISBN 978-92-64-08522-0 – 2018

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Volume 2018/10
April 2018

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ISSN 0376-6438
2018 SUBSCRIPTION
(18 ISSUES)

ISBN 978-92-64-08522-0
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