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Basic statistics of Costa Rica, 2018

(Numbers in parentheses refer to the OECD average)[1]

LAND, PEOPLE AND ELECTORAL CYCLE					
Population (million)	5.0		Population density per km²	97.9	(37.8)
Under 15 (%)	21.3	(17.8)	Life expectancy at birth (years, 2017)	79.9	(80.1)
Over 65 (%)	9.5	(17.1)	Men (2017)	77.4	(77.5)
International migrant stock (% of population)	8.8	(12.6)	Women (2017)	82.6	(82.9)
Latest 5-year average growth (%)	1.1	(0.6)	Latest general election	February-2018	
ECONOMY					
Gross domestic product (GDP)			Value added shares (%)		
In current prices (billion USD)	60.6		Agriculture, forestry and fishing	5.0	(2.4)
In current prices (billion CRC)	34 937.9		Industry including construction	21.1	(27.3)
Latest 5-year average real growth (%)	3.6	(2.3)	Services	74.0	(70.4)
Per capita (000 USD PPP)	17.8	(47.3)			
GENERAL GOVERNMENT					
Per cent of GDP					
Expenditure	29.0	(40.3)	Gross financial debt (OECD: 2017)	53.5	(109.4)
Revenue	24.7	(37.4)	Net financial debt (2019, OECD: 2017)		(69.2)
EXTERNAL ACCOUNTS					
Exchange rate (CRC per USD)	576.9		Main exports (% of total merchandise exports)		
PPP exchange rate (USA = 1)	393.3		Food and live animals	39.3	
In per cent of GDP			Miscellaneous manufactured articles	30.6	
Exports of goods and services	33.5	(55.5)	Manufactured goods	9.9	
Imports of goods and services	33.2	(51.3)	Main imports (% of total merchandise imports)		
Current account balance	-3.3	(0.3)	Machinery and transport equipment	26.6	
Net international investment position	-53.5		Chemicals and related products, n.e.s.	18.1	
			Manufactured goods	17.7	
LABOUR MARKET, SKILLS AND INNOVATION					
Employment rate (aged 15 and over, %)	54.4	(57.1)	Unemployment rate, Labour Force Survey (aged 15 and over, %, 2011, OECD: 2018)	10.1	(5.3)
Men	68.0	(65.3)	Youth (aged 15-24, %, 2011, OECD: 2018)	22.2	(11.1)
Women	40.7	(49.4)	Long-term unemployed (1 year and over, %)	1.3	(1.5)
Participation rate (aged 15 and over, %)	60.7	(60.5)	Tertiary educational attainment (aged 25-64, %)	22.6	(36.9)
Average hours worked per year)	2 121	(1734)	Gross domestic expenditure on R&D (% of GDP, 2016, OECD: 2017)	0.5	(2.6)
ENVIRONMENT					
Total primary energy supply per capita (toe, 2017, OECD: 2018)	1.0	(4.1)	CO2 emissions from fuel combustion per capita (tonnes, 2017, OECD: 2018)	1.5	(8.9)
Renewables (%, 2017, OECD: 2018)	48.0	(10.5)	Water abstractions per capita (1 000 m³, 2017)	0.6	
Exposure to air pollution (more than 10 µg/m³ of PM 2.5, % of population, 2017)	99.6	(58.7)	Municipal waste per capita (tonnes, 2017)	0.3	(0.5)
SOCIETY					
Income inequality (Gini coefficient, 2019, OECD: Latest available)	47.8	(33.1)	Education outcomes (PISA score, 2018)		
Relative poverty rate (%, 2019, OECD: 2016)	19.9	(11.6)	Reading	426	(489)
Median disposable household income (000 USD PPP, OECD: 2016)	9.6	(23.9)	Mathematics	402	(492)
Public and private spending (% of GDP)			Science	416	(491)
Health care (2016, OECD: 2018)	7.5	(8.8)	Share of women in parliament (%)	45.6	(29.7)
Pensions (2016, OECD: 2015)	5.8	(8.5)	Net official development assistance (% of GNI, OECD: 2017)		(0.4)
Education (% of GNI, 2017)	7.5	(4.5)			

1. The year is indicated in parenthesis if it deviates from the year in the main title of this table. 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 80% of member countries.

Source: Calculations based on data extracted from databases of the following organisations: OECD, IEA, ILO, IMF, World Bank

Executive summary

Reform momentum has increased

Addressing the coronavirus outbreak is the overarching priority in the short term. Timely confinement measures and well-targeted economic actions are helping to contain the pandemic and support those hardest hit. Looking forward, boosting testing and tracing capabilities and continuing to prepare for increases in healthcare demand are essential priorities.

Costa Rica's social and economic progress, centred on trade, well-being and a sustainable use of natural resources, has been remarkable. A strong commitment towards trade openness has been key to attract foreign direct investment and move up the value chain. Well-being indicators are comparable with OECD standards, and even higher in some dimensions. However, Costa Rica faces substantial challenges to retain achieved successes and to continue converging towards higher living standards. The fiscal situation remains a critical vulnerability. Large deficits threaten the sustainability of remarkable economic, social and environmental achievements. The gap with advanced economies remain large, due to weak productivity and inequality remains high. Reducing emissions by the transport sector is the main challenge to meet the target of being a decarbonised economy by 2050.

Full implementation of the recent reform effort to bring key policies closer to best standards is essential. Despite a complex political environment, there has been significant cross-party consensus on the reform agenda linked to the OECD accession process. Reform momentum in the last 18 months has been extraordinary, as a significant number of initiatives linked to OECD accession have been finalised. Timely implementation is critical to reinvigorate the recovery, boost inclusive growth and fiscal sustainability.

Growth prospects are severely impacted by the global coronavirus pandemic. As a small open economy, Costa Rica is highly exposed to the global economic recession. The main transmission channels are trade and tourism. Domestic demand has also weakened, as necessary containment measures implemented in Costa Rica impact consumption and investment. Mitigating and upside factors are the significant fall in oil prices and the diversification of the economy. The unemployment rate will increase significantly.

Table 1. The recovery will be very gradual

Double-hit scenario	2018	2019	2020	2021
Gross domestic product	**2.7**	**2.1**	**-4.9**	**1.5**
Unemployment rate	10.3	11.8	17.0	15.5
Fiscal balance[1]	-5.8	-7.0	-9.1	-7.7
Primary fiscal balance[1]	-2.3	-2.8	-4.0	-2.1
Gross public debt[1]	53.2	58.5	68.8	73.1
Single-hit scenario	**2018**	**2019**	**2020**	**2021**
Gross domestic product	**2.7**	**2.1**	**-4.1**	**2.7**
Unemployment rate	10.3	11.8	15.9	13.9
Fiscal balance[1]	-5.8	-7.0	-8.9	-7.1
Primary fiscal balance[1]	-2.3	-2.8	-3.9	-1.7
Gross public debt[1]	53.2	58.5	67.9	70.6

Note: GDP refers to annual percentage growth. Unemployment rate is per cent of labour force. Fiscal balances and debt are shown for central government.
1. Per cent of GDP.
Source: OECD Economic Outlook 107 database.

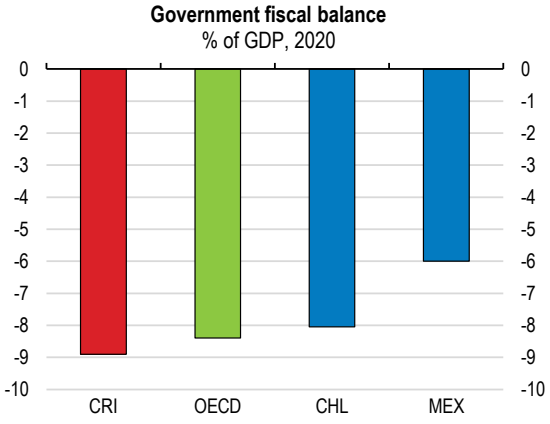
Policy efforts to strengthen public finances should continue

Costa Rica has recently taken significant steps to strengthen its macroeconomic framework. Monetary policy has been improved and key steps to improve the fiscal framework have also been taken. Complying with the commitments established and keeping sound macroeconomic policies over time is fundamental to boost trust.

Full and timely implementation of the fiscal reform approved in December 2018 is critical. The fiscal situation deteriorated significantly in the last decade, with the overall budget balance moving from a surplus in 2007 to a projected deficit of close to 9% of GDP in 2020 (Figure 1). Authorities have appropriately increased health and social protection spending to respond to the pandemic. Looking forward, once the economic recovery is underway, returning to a deficit-reduction path is vital. A critical element of the

reform is a fiscal rule that constrains gradually the growth of current spending. Debt simulations suggest that adhering continuously to the fiscal rule, as planned by authorities, would halt over time the increase in public debt. The trajectory is very sensitive to the implementation of the fiscal reform and slippages from the planned tightening would put the debt ratio on a rising trend.

Figure 1. The budget deficit is large



Note: Data for Costa Rica and Chile refer to central government. OECD is a simple average. Results for the single-hit scenario.
Source: OECD Economic Outlook 107 database.

StatLink https://doi.org/10.1787/888934148163

Creating additional fiscal space would help Costa Rica to respond to potential unexpected shocks. Adopting additional measures, such as those recently announced, would also create more room for capital spending and to respond to ageing. The political economy of increasing taxes once again is challenging, but Costa Rica has room to broaden tax bases without increasing rates. There is also room to improve the tax mix.

Improving public spending efficiency is a social challenge. Increases in public spending since 2008 have not been matched by an improvement in performance. A priority area for reform is public sector employment, as compensation of government employees accounts for half of total revenues. A reform of the public sector, to eliminate duplications and non-functional bodies, and of public procurement, to cover more purchases by government agencies outside central government, would help to boost efficiency.

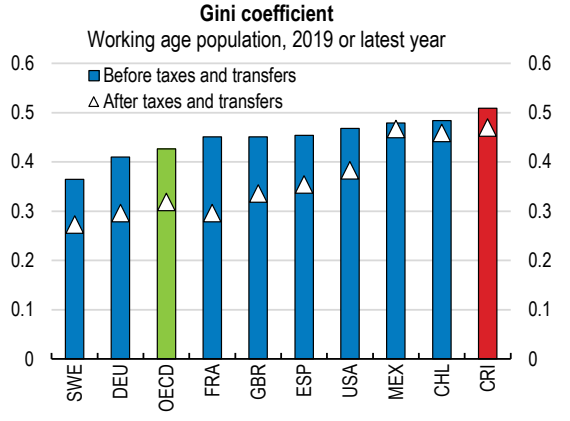
Improving debt management is key. As the interest rate bill is increasing, containing the cost of debt servicing and reducing risks become critical. Attracting international investors to local currency denominated debt can reduce both interest burden and currency risks.

Contingent liabilities are large. The explicit blanket public guarantee on deposits held by state-owned banks and other debts implies sizeable contingent liabilities and systemic risks of doom loops, as state-owned banks have large exposures to sovereign debt and state-owned enterprises. The pension system does not generate enough resources to be sustainable. A parametric reform, avoiding further increases in social security contribution rates, is needed. A more diversified investment strategy of pension assets, which are heavily concentrated in Costa Rica's sovereign debt, would reduce risks.

Boosting inclusiveness

Universal health care and pensions have led to remarkable social outcomes but inequality remains high (Figure 2). Social spending has increased, but this has not lowered inequality markedly. In light of the fiscal situation, policy efforts to ensure social spending leads to tangible improvements and solving existing inefficiencies are key to foster inclusive growth.

Figure 2. Inequality is high



Source: OECD Income Distribution Database.

StatLink https://doi.org/10.1787/888934148182

The commitment to education is strong, but outcomes remain weak. PISA results are low, despite high spending on education. Ensuring that all Costa Ricans have access to good and relevant education is critical to establish a more inclusive and productive economy. Teacher evaluations would help to tailor additional training opportunities. Updated curricula need to be implemented in classrooms and the university system needs to become more accountable, performance-based and responsive.

Early childhood education has been strengthened to boost female labour market participation. Women taking on family care responsibilities face difficulties to complete education or continue in the labour force after maternity. Access to early childhood education should be also expanded for children under the age of 4. Introducing paid and non-transferable paternity leave entitlements for fathers is also key.

Despite recent improvements, financial inclusion outcomes still display large regional disparities and gender gaps. Financial literacy is low. Complementing access to financial products with enrolment in financial education can help avoid excessive households indebtedness. A state-of-the-art electronic payments system provides Costa Rica with untapped potential to make FinTech a powerful catalyst for financial inclusion. Granting FinTech firms full access to the electronic payments system, while preserving security and consumer protection, would foster the development of this sector.

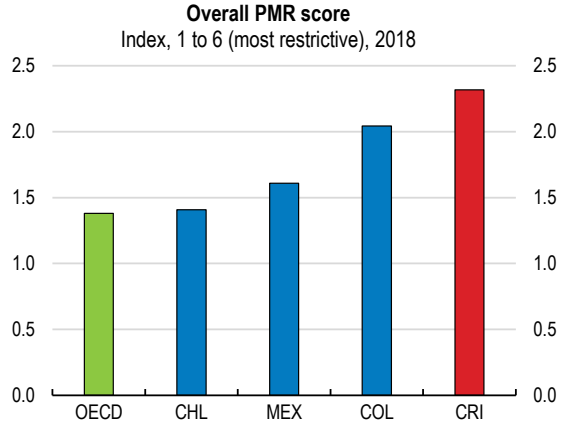
High informality contributes to inequality and hampers pension sustainability. There is no silver bullet to reduce informality. A comprehensive strategy, covering multiple policy areas, is required. This includes adapting regulations to facilitate compliance. The minimum wage system has been simplified, but there is still room to make the system even more job-friendly.

Boosting productivity

Growth potential has fallen due to weak productivity. Further advances on living standards will hinge on raising productivity by setting the right conditions for domestic companies to thrive and, at the same time, maintaining and reinforcing the commitment to foreign direct investment and trade, which has been key to increasingly diversify the export basket. Maintaining the commitment to preserving natural resources and biodiversity and pressing ahead with the decarbonisation plan will pay off also in terms of growth and jobs.

Improving regulations would boost productivity and job creation. Regulations in Costa Rica are among the most burdensome in advanced and emerging economies (Figure 3). Barriers to entry are particularly large. There is also room to further improve the performance of state-owned enterprises and upgrade the methodology to set up administered prices.

Figure 3. Regulations are burdensome



Source: OECD Product Market Regulation database.

StatLink https://doi.org/10.1787/888934148201

Strengthening competition would boost growth significantly. Many of the weaknesses in the competition framework, such as the lack of independence and resources of the competition authority, have been addressed in the new competition law. Complying strictly with the implementation road map is key. Existing exemptions to competition rules, such as those granted to rice, sugar, coffee, maritime transport and professional services, are regressive and inefficient and should be phased out.

MAIN FINDINGS	KEY RECOMMENDATIONS 2020 ECONOMIC SURVEY
Further improving macroeconomic policies	
The fiscal deficit remains large and continues to increase. Fiscal space remains limited, making Costa Rica vulnerable to shocks. If the fiscal reform is not fully implemented, public debt will grow without bounds. Addressing the coronavirus outbreak is the overarching priority in the short term.	Any support to firms and households during the coronavirus crisis should be temporary and targeted to the most affected sectors. Prepare for increases in healthcare demand, including by boosting testing capabilities. Ensure that the fiscal reform is fully implemented without exceptions. Establish clear guidelines for the implementation of the fiscal rule. Eliminate tax exemptions benefiting more affluent tax payers. Allow that all spending categories can be adjusted when public debt exceeds 50% of GDP.
Growth has decelerated, economic slack has widened and inflation is below 3%. As a response to the coronavirus outbreak, the central bank has cut interest rates by 150 bp, and deposit rates have fallen to a historically-low level. Prudential regulation has been adapted so that banks can re-profile loan repayment of borrowers facing difficulties.	Be ready to ease monetary policy further to support the economy during the coronavirus outbreak. Continue to provide liquidity to the banking system to preserve its integrity and support confidence and continue to adjust prudential regulation as required during the coronavirus outbreak.
For placing its public debt, Costa Rica relies heavily in local investors, thus putting upward pressure on interest rates. Instruments in foreign currency may provide some short-term savings but entail exchange rate risks.	Create a public debt management agency. Target attracting foreign investors to instruments issued in local currency.
Public employee remuneration is complex, contributes to income inequality and accounts for half of total revenues.	Adopt a single salary scale, streamline incentives schemes and make them performance-based.
Regulatory distortions fragment the banking market, hamper competition and efficiency and translate into high interest rate spreads.	Gradually reduce existing regulatory distortions affecting public and private banks, including, in due time, phasing out the public guarantee of state-owned bank liabilities.
Improving equality of opportunities	
Poverty remains high despite increasing social programmes.	Improve targeting and focus social spending programmes on low-income individuals.
Female labour participation is very low.	Continue to increase the supply of affordable childcare. Introduce a paid leave entitlement reserved to fathers.
At more than 45% of workers, informality is high. Social security contribution rates are high in international perspective.	Establish a comprehensive strategy to reduce informality, including shifting part of the tax burden from social security contributions to property taxes and strengthening enforcement mechanisms.
Skill mismatches are large. Recent increases in universities budget have been channelled mostly to increase salaries of administrative staff. PISA results are low and declining.	Link part of universities funding to responding to current and future labour market needs. Strengthen teacher recruitment, selection and training based on regular teachers evaluations.
The demographic bonus is ending and the pension system will run operational deficits in 10 years.	Devote all social security contribution charges to finance the social security system. Link the retirement age to increases in life expectancy.
High intermediation margins and fees in the banking sector create difficulties for both SMEs and households in access to finance.	Grant FinTech companies full and direct access to the national payments system while preserving regulatory compliance, security and consumer protection.
Boosting productivity	
Barriers to entry are large. Setting up a firm is costly and burdensome. Regulatory burden is high. Few procedures can be resolved online.	Introduce online one-stop mechanisms and ensure physical ones cover all licences and permits and are present in all major cities.
The competition framework suffers from a number of limitations, which are expected to be remedied through implementation of the recently approved competition reform law.	Ensure a full and timely implementation of the competition reform road map.
Remaining exemptions to competition law are regressive and inefficient.	Gradually phase out remaining exemptions to competition law in rice, sugar, coffee, maritime services and professional services.
Corruption perceptions have recently increased.	Enact a law or legal provision related specifically to protect reporting or prevent retaliation against whistle-blowers in the public sector.
Strengthening green growth	
The transport sector is the major source of emissions. The planned full electrification of public transport requires substantial investment.	Issue green bonds.
As zero-emission vehicles become more frequent, Costa Rica will eventually need to substitute transport fuel tax revenues.	Modulate vehicle taxes according to pollution or emission performance. Introduce road use charges.
Waste is a significant source of emissions. Costa Rica has slightly improved wastewater treatment but only 14% of wastewater is treated, while the world average is 60%.	Require separate waste collection by municipalities and improve wastewater treatment.

1 Key policy insights

Costa Rica's social and economic progress has been remarkable. A strong commitment towards trade openness has been key to attract foreign direct investment and move up in the global value chain. The effort to provide virtually universal health and pensions has translated into well-being indicators comparable with OECD standards in several dimensions. Costa Rica has also shown a strong commitment to preserving natural resources. Challenges to retain achieved successes and to continue converging towards higher living standards are substantial. The fiscal situation remains a critical vulnerability. Reform momentum has been extraordinary, as a significant number of legal initiatives linked to OECD accession have been finalised. This includes the fiscal reform approved in December 2018, a historic step to restore fiscal sustainability. These reforms would also facilitate the recovery from the COVID-19 shock. In the short term, addressing the coronavirus outbreak is the overarching priority. Once the recovery is established, full implementation of the fiscal reform is critical to restore medium-term fiscal sustainability, ensure macroeconomic stability and set the basis for higher incomes and wider spread improvements in living standards. Putting Costa Rica on a path to stronger growth requires boosting productivity by adopting structural reforms to streamline regulations and maintaining the commitments to trade, foreign direct investment and natural resources preservation. Extending the benefits of growth to all Costa Ricans will require improving public spending efficiency, reducing informality and increasing female labour market participation.

Costa Rica's social and economic progress (centred on trade openness, well-being and a sustainable use of natural resources) has been remarkable. Over the last 30 years, growth has been steady and GDP per capita has tripled. A strong commitment towards trade openness has been key to attract foreign direct investment and move Costa Rica up in the global value chain and upgrade its exports.

The effort to provide virtually universal health and pensions has translated into well-being indicators comparable with OECD standards in several dimensions (Figure 1.1). Costa Rica has the highest life expectancy at birth in Latin America and self-reported well-being is above the OECD average. In other dimensions, such as quality of education or female labour market participation, gaps persist (Table 1.1).

Costa Rica has also shown a strong commitment to preserving natural resources. It is one of the few countries succeeding into reversing deforestation (Figure 1.2). The area covered by forests increased from 26% in the early 1980s to more than 55% today. Costa Rica also stands out internationally as it was one of the first countries to establish the ambitious target of achieving zero net emissions of CO2 by 2050.

Costa Rica faces substantial challenges to retain achieved successes and to continue converging towards higher living standards, including responding to the coronavirus crisis. The fiscal situation remains a critical vulnerability. Large deficits and rapidly rising public debt threaten Costa Rica's remarkable achievements. The fiscal reform approved in December 2018 was a historic step to restore fiscal sustainability. Boosting growth is also a key priority, as the gap in GDP per capita with advanced economies remains large (Figure 1.3). Unemployment, informality and inequality remain high (Figure 1.4). The COVID-19 pandemic has significantly impacted Costa Rica, with the global economic slowdown and the necessary containment measures hampering growth prospects and fiscal accounts.

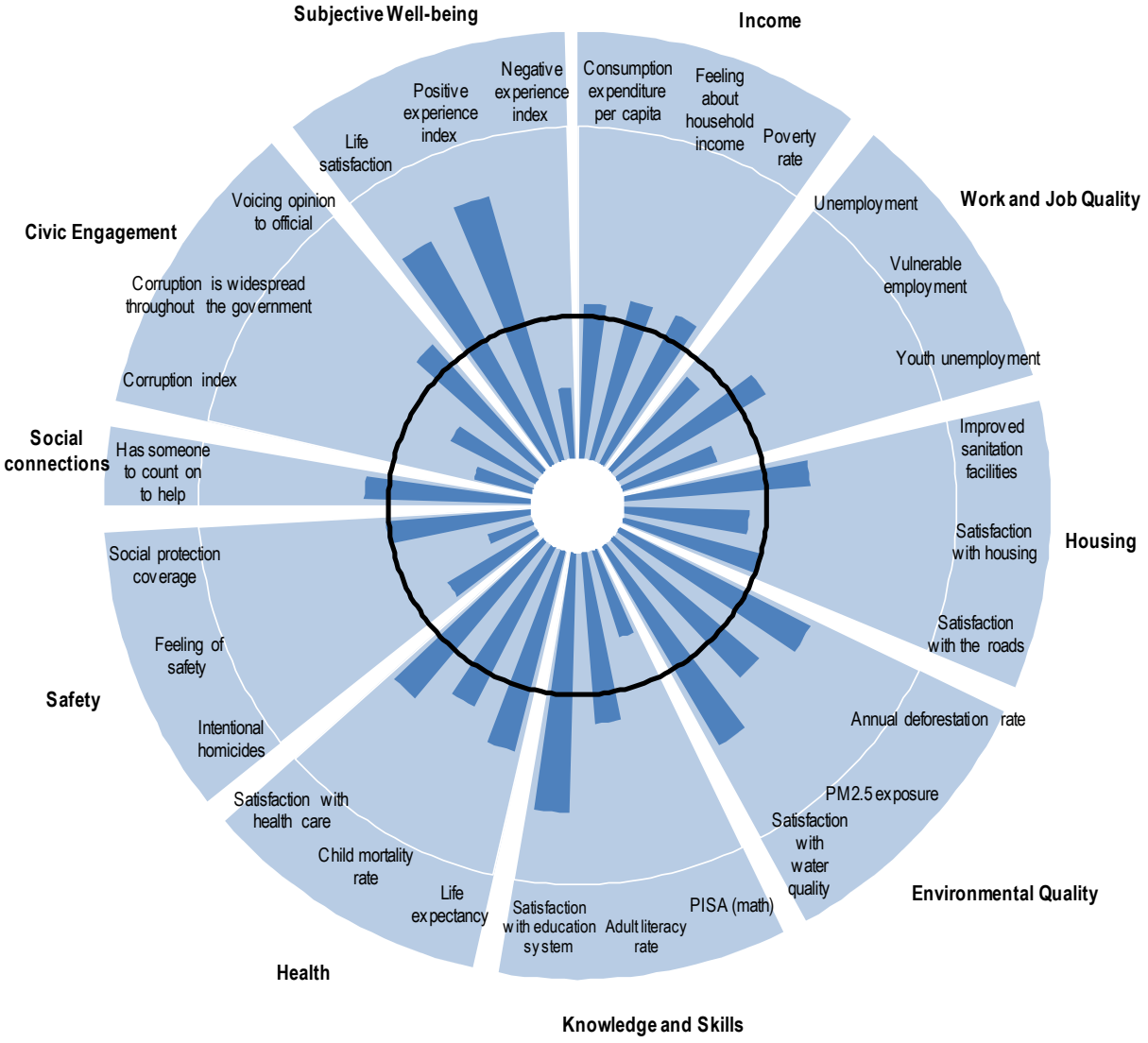
Responding successfully to these substantial challenges will hinge on buttressing the fiscal framework and implementing reforms to foster inclusive growth. Despite a complex political environment, there has been a significant cross-party consensus in Congress on the reform agenda linked to the OECD accession process. Reform momentum in the last 18 months has been extraordinary, as a significant number of legal initiatives linked to OECD accession have been finalised (Box 1.1). Full implementation of this wide-ranging effort to improve legal frameworks and bring them closer to best standards will be key to boost growth and well-being. OECD estimates suggest that GDP per capita could rise by 15% in 10 years (Table 1.2). The largest benefits stem from improving the competition framework. Maintaining the reform momentum and undertaking additional key reforms, as identified in this Economic Survey, could increase GDP per capita by an additional 13 percentage points (Table 1.3). Reforms would also contribute to reduce income inequality significantly (Table 1.4). These reforms would also facilitate the recovery from the COVID-19 shock and improve resilience to possible future shocks. Communicating clearly that the reforms would help to share the benefits of growth more widely among Costa Ricans would help to overcome political economy barriers to their implementation. The special OECD committee in the Legislative Assembly, key to facilitate recent reforms, can play a fundamental role to maintain the reform momentum.

Against this background, the main messages of the Survey are:

- In the short term, addressing the coronavirus outbreak is the overarching priority. Additional health spending and providing temporary cash and liquidity support to households and firms help to mitigate the economic and social impact of the pandemic and long-term damages.
- Full and timely implementation of the fiscal reform is critical to restore medium-term fiscal sustainability, ensure macroeconomic stability and set the basis for higher incomes and wider spread improvements in living standards.
- Extending the benefits of growth to all Costa Ricans will require improving public spending efficiency to maximise the impact of key policies such as education, reducing informality and increasing female labour market participation.

- Putting Costa Rica on a path to stronger growth requires boosting productivity by adopting structural reforms to streamline regulations and maintaining the commitments to trade, foreign direct investment and natural resources preservation.

Figure 1.1. Prior to the pandemic, Costa Rica ranked highly in many dimensions of well-being



Note: Data for all indicators are from 2018 or latest year available. The bars represent the observed well-being values for Costa Rica and the black circle shows the expected values based on Costa Rica's level of GDP per capita. The observed values falling inside the black circle indicate areas where Costa Rica performs poorly in terms of what might be expected from a country with a similar level of GDP per capita.
Source: OECD.

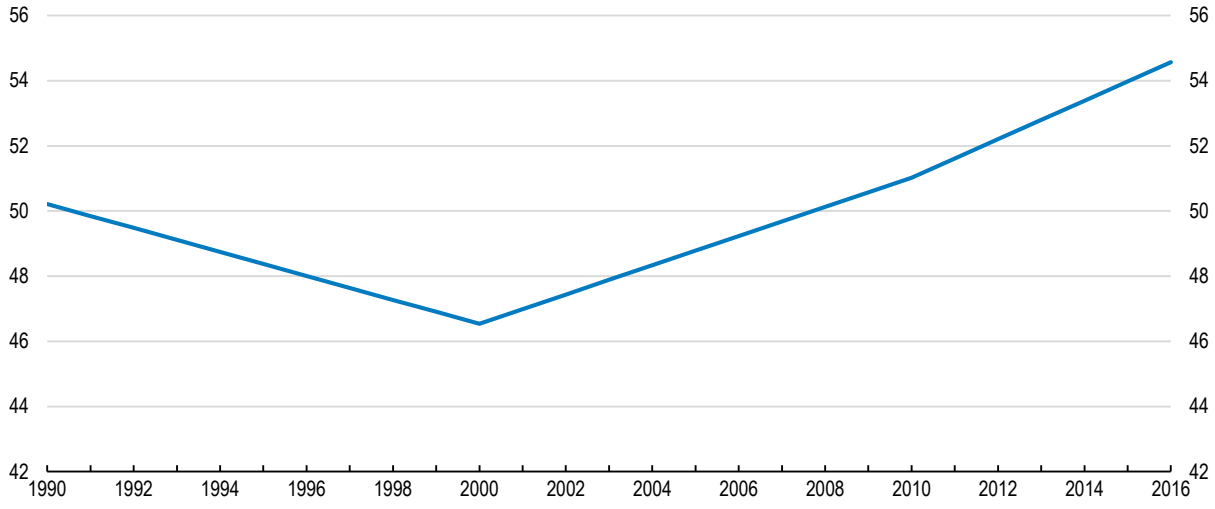
Table 1.1. Costa Rica: Selected indicators in comparison with the OECD

Indicator	Rank	Measure	Costa Rica	LAC OECD average	OECD average
Life Satisfaction	13	Self-reported satisfaction	7.1	6.3	6.7
Life expectancy	26	Life expectancy at birth, total population	80.4	76.6	80.7
Basic sanitation services	27	People using at least basic sanitation services, %	98.4	93.6	98.3
Infant mortality	35	Total, Deaths/1 000 live births	7.9	12.0	3.8
Female labour force participation rate	36	Female labour force participation rate, % of aged 15-64	53.9	56.0	64.6
Pisa score	37	Unweighted average of mean score in reading, mathematics and science	414.8	419.8	490.6

Note: Data for all indicators are from 2018 or latest year available.
1. Ranked out of 38 countries: 36 OECD countries, Colombia and Costa Rica.
2. LAC refers to the unweighted average of Chile, Colombia and Mexico. 3. The OECD average refers to an unweighted average.
Source: OECD.

Figure 1.2. Forest cover has rebounded since 2000

Land covered by forest, % of total land area

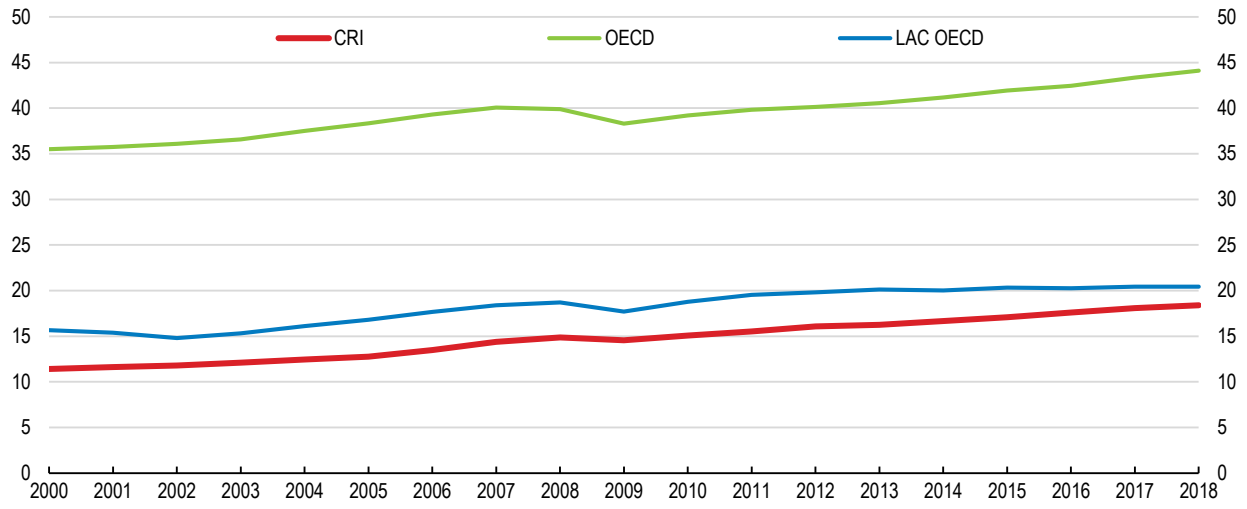


Source: OECD Environment database.

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Figure 1.3. The gap with advanced economies remains large

Thousands of PPP-adjusted 2015 USD per capita

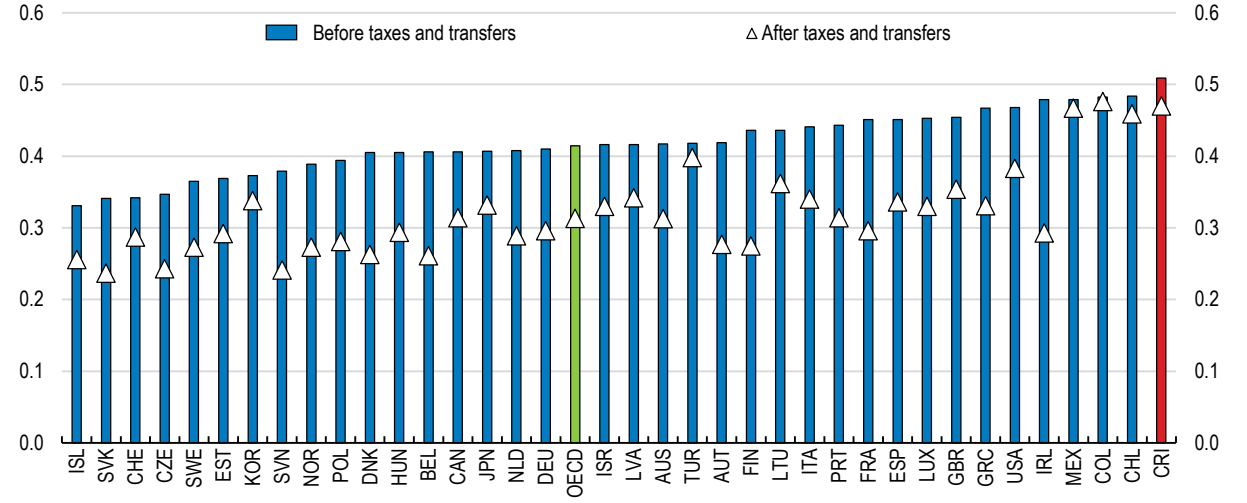


Note: LAC OECD refers to the simple average of Chile, Colombia and Mexico.
Source: OECD Analytical database; and World Bank World Development Indicators.

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Figure 1.4. Inequality remains high

Gini coefficient, working-age population, 2019 or latest year



Source: OECD Income Distribution database.

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Box 1.1. Recent economic reforms

Fiscal reform law: Introduces a fiscal rule, creates a VAT and two new income brackets in the personal income tax scheme and reduces earmarking (Box 1.4).

Central Bank Organic Law: Strengthens the independence of the Central Bank (Table 1.8).

Amendment to Free Trade Zone Regime Law: Eliminates restriction of local sales in services, to adhere with OECD's Action Plan to Prevent Base Erosion and Profit Shifting.

National Statistics System Law: The regulatory framework was updated to achieve best international practices in the production of statistics.

Liability of legal persons for committing domestic and foreign bribery: The law establishes the criminal liability of legal persons on domestic and transnational briberies, and other crimes related to corruption.

Law to remove Minister of Environment from the Board of the Costa Rican Petroleum Refinery: Strengthen the corporate governance of the state-owned enterprise.

Branching of Foreign Banks: This law proposes to allow foreign banks to choose how to establish in Costa Rica (either through a subsidiary or a branch) with equal rights and obligations.

Strengthening of the Competition Authorities: Strengthens the country's competition framework, grants more independence and resources to one of the competition authorities (COPROCOM) and reduces the scope of exemptions from competition law (chapter 2).

Amendment to the Securities Market Regulatory Law: The law enables the exchange of information between the financial authorities and with supervisory bodies of other countries, the access of the General Superintendence of Securities (SUGEVAL) to the information on beneficial ownership, strengthens accounting regulations and creates a legal protection regime for the officials that execute the supervision work.

Consolidated supervision: This law aims to strengthen the legal capacities of the supervisor by allowing the issuance of prudential regulation and enabling monitoring risk exposures of the entities and companies that together create a Costa Rican financial group, regardless of the territory of activity.

Deposit insurance and resolution regime: Establishes a deposit insurance scheme covering all banks, and sets out a comprehensive resolution regime.

Table 1.2. Ongoing structural reforms will boost growth

Potential impact of structural reforms on GDP per capita at different horizons

Structural policy	Policy change		Effects on the level of per capita income [%]		
	Latest data	After reform	2-years	5-years	10-years
Improve the competition framework	2.5	2.1	2.5	5.9	7.5
Improve governance of SOEs	2.5	2.3	1.4	3.4	4.3
Reduce time of insolvency procedures	3.0	2.4	0.2	0.7	1.1
Increase active labour market spending (per unemployed, % GDP/capita)	4.5	11.2	1.0	1.3	1.9
All of the above			*5.1*	*11.3*	*14.8*

Note: These estimates were obtained based on numerical indicators of Costa Rica's policy stance in each policy area. The scenarios about competition and SOEs governance are based on the Product Market Regulator (PMR) indicator and reflect possible changes in the indicator following the ongoing reforms. Other scenarios assume that the gap with the OECD average is halved. The quantifications are illustrative, as they are subject to uncertainty about both their magnitude and the time horizon of their materialisation.
Source: OECD calculations based on Égert and Gal (2016[1]) and Égert (2017[2]).

Table 1.3. Additional reform efforts would pay off

Potential impact of structural reforms on GDP per capita at different horizons

Structural policy	Policy change		Effects on the level of per capita income [%]		
	Latest data	After reform	2-years	5-years	10-years
Reduce barriers to entry (PMR)	2.1	1.3	2.6	6.1	7.5
Improve public transportation (PMR)	2.1	1.8	1.1	2.6	3.2
Increase effective retirement age	61.0	62.7	0.4	1.3	2.1
All of the above			*4.1*	*10*	*12.8*

Note: These estimates were obtained based on numerical indicators of Costa Rica's policy stance in each policy area. The scenarios about barriers to entry, public procurement and public transportation are based on the Product Market Regulator (PMR) indicator and reflect possible changes in the indicator if recommendations are implemented. Reform related with increasing effective retirement age implies halving the gap to the OECD average. The quantifications are illustrative, as they are subject to uncertainty about both their magnitude and the time horizon of their materialisation.
Source: OECD calculations based on Égert and Gal (2016[1]) and Égert (2017[2]).

Table 1.4. Reforms would also help to reduce inequality

Potential impact of selected reforms on the GINI coefficient

	Impact on GINI
Reforming public sector remuneration	-0.019
Reducing informality	-0.067
Improving targeting of social policies	-0.003
Improving education outcomes	-0.009
Overall reduction in GINI (units)	*-0.1*
Overall reduction in GINI (percentage)	*20.0*

Note: The scenario of improving targeting of social policies assumes that the share of social transfers received by those households in third to fifth quintiles are reallocated to households in first and second quintiles. The informality scenario assumes that the income of non-qualified workers increases by 20% when they become formal. The education scenario assumes that, because of better education outcomes, the skill premium falls by 20%. The public sector remuneration scenario assumes that, as consequence of a rationalisation in wages and incentives, the remuneration of qualified workers is reduced by 20%. The quantifications are illustrative.
Source: OECD calculations based on González Pandiella and Gabriel (2017[3]).

The economy is contracting due to the coronavirus outbreak

The COVID-19 is having a significant impact on Costa Rica, although the hit is less severe than in other countries in the region. The authorities have taken timely and well-targeted measures. Prompt containment measures helped to flatten the infection curve, while well-targeted economic measures are helping to mitigate the economic and social impact of the crisis (Box 1.2). The propagation of the virus started in early March and accelerated in April. Following a slowdown in early May, the number of cases have sharply increased since late May. The authorities announced in mid-May an exit strategy that aims to gradually phase out confinement measures, depending on the evolution of the pandemic. Looking forward, boosting testing and tracing capabilities and preparing the health system for increases in healthcare demand are important priorities.

Prior to the pandemic, macroeconomic conditions were stable and the economy was expected to grow slightly above 2% in 2020. The global economic downturn triggered by the pandemic, coupled with the necessary containment measures, are taking a significant toll on the economy (Figure 1.5).The estimated initial output loss from the confinement measures in the first half of the year could reach 22%. Tourism exports have collapsed, following border closures and travel restrictions in source countries. Conversely, services in the information and telecommunications sector remain relatively dynamic. The unemployment rate is increasing, eroding consumer confidence. Around 7 100 companies, employing more than 8% of all workers, have applied to the temporary work scheme introduced by the government, which allows distressed firms to proportionally reduce working hours and salaries. Prior to the COVID-19 shock, business confidence, hampered by uncertainty surrounding the fiscal situation, and credit growth were subdued. Investment has further weakened, hit by disruptions in global value chains.

Box 1.2. Summary of measures to respond to the Coronavirus crisis

Containment measures

- A state of national emergency was declared on Monday 16th March.
- Recreational areas, schools and universities have been closed (conditional cash transfers are maintained).
- As of 18 March only Costa Ricans and residents in Costa Rica can enter the country but will be placed in quarantine for two weeks. Restrictions on foreign residents are imposed when leaving the country.
- Teleworking has been strongly encouraged and private vehicle traffic restricted.
- Individuals at risk are asked to implement social distance measures.
- Restaurants, bars and cinemas should operate at 50% of capacity.
- Easter week activities have been cancelled.
- A four-stage exit strategy was announced in mid-May to gradually phase out confinement measures until August, assuming that the pandemic will subside by then.

Economic measures

The following measures have been implemented:

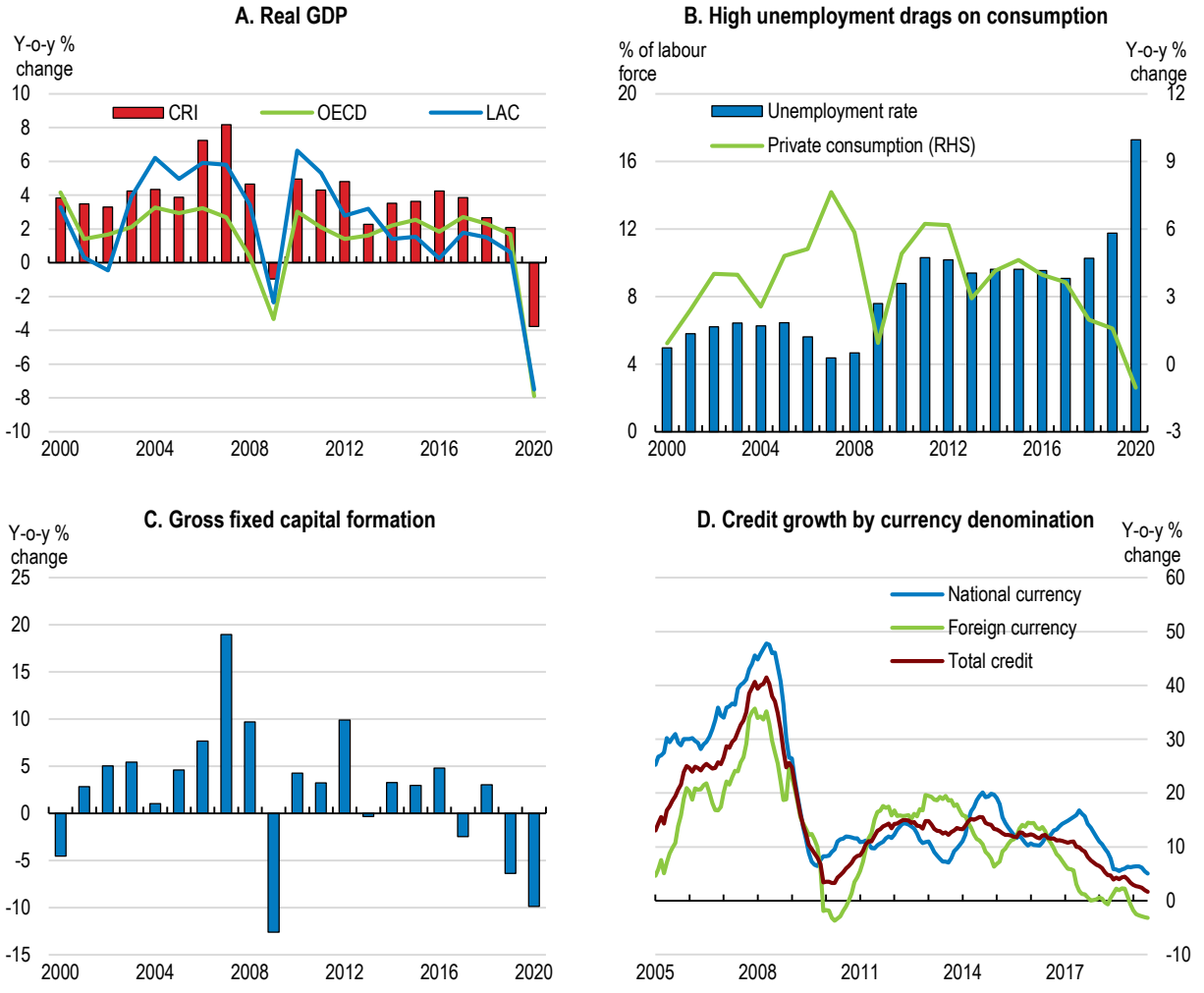
- The Central Bank reduced the monetary policy rate by 150 basis points to 0.75%.
- Temporary adjustments to prudential regulations to create space for the reprofiling of credit repayments. In particular, it becomes possible to renegotiate twice in a 24-month period the

agreed conditions of loans, without these being considered a special operation and having negative effects on the risk rating of debtors.

- Temporary reduction of countercyclical provisions by banks.
- Change in minimum reserve requirement regulations to provide greater flexibility to financial intermediaries to manage their liquidity.
- Three-month moratorium on the payment of Value Added Tax, Income Tax and customs duties, all for formally constituted companies.
- Collection of social security contributions for the time actually worked, in addition to deferring the payment of social security contributions.
- Public banks will be asked to reschedule loan repayments, including a possible moratorium on the payment of principal and / or interest for three extendable months, particularly for the most affected sectors.
- A preferential rate for occupational risk insurance for companies with less than 30 workers.
- Authorizing a new insurance product for tourists coming to Costa Rica.
- Four month moratorium by the Costa Rican Tourism institution to companies owing taxes to the institution.
- Direct cash transfer programme (*Bono Proteger*), targeted at those who lost their job or faced reduced working hours, including those in the informal sector.
- Short-term jobs retention scheme, allowing to reduce worker hours (by up to 50%) for companies that report annualised income losses between 60% and 75%. The scheme was applied during the second quarter of 2020 and can be extended for three more months.
- Provision of delivery of food and home care for 15 thousand senior citizens.

Costa Rica's current account deficit has remained comfortably financed by foreign direct investment (Figure 1.6). Total external debt has increased (Figure 1.7), reaching 49% of GDP and is expected to continue rising over the medium term owing to planned external public debt issuances. This suggests that Costa Rica's exposure to global financial conditions, capital flow reversals and exchange risks is increasing. International reserves, on the other hand, had increased to 14% of GDP, covering 8 months of imports prior to the COVID-19 shock. The fall in tourism receipts and other exports triggered by the shock, together with an expected deceleration of direct investment inflows, will imply a significant balance of payments financing gap, which is estimated to reach 2.5% of GDP (IMF, 2020[4]). The authorities have promptly reacted and secured financial assistance from the IMF and other multilateral organisations to fill this gap, which allows also to keep reserves at adequate levels.

Figure 1.5. The economy is in recession

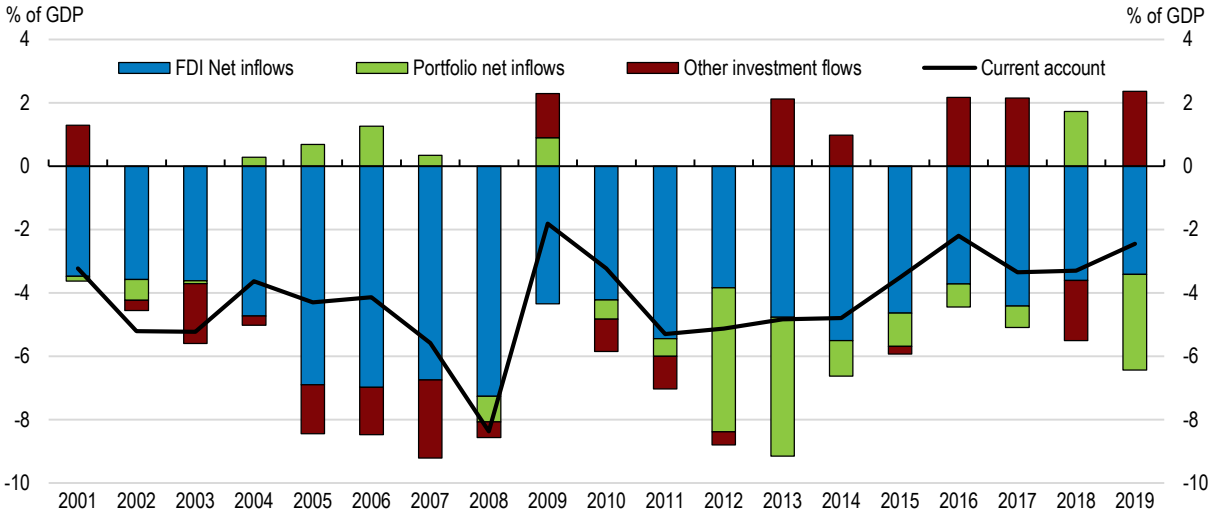


Note: LAC is simple average of Argentina, Brazil, Chile, Colombia and Mexico. Data for 2020 refer to the average over 2020Q1 and 2020Q2, which are forecasts. In Panel D, foreign currency refers to USD.
Source: OECD Economic Outlook database; and Banco Central de Costa Rica.

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As a small open economy, Costa Rica is highly exposed to the global economic effects of the coronavirus. The main transmission channels are trade and tourism. The Costa Rican economy is hampered by logistics delays in obtaining supplies, less foreign demand for goods and services and a drop in tourism. The fall in tourism will particularly impact Costa Rica, as the direct contribution of tourism to GDP amounts to 6%. Domestic demand will also weaken, as containment measures implemented in Costa Rica impact consumption and investment. Mitigating and upside factors are the significant fall in oil prices and the diversification of the economy. The impact on the growth outlook will depend on the degree of the spread of the virus in Costa Rica and the severity of the global economy recession.

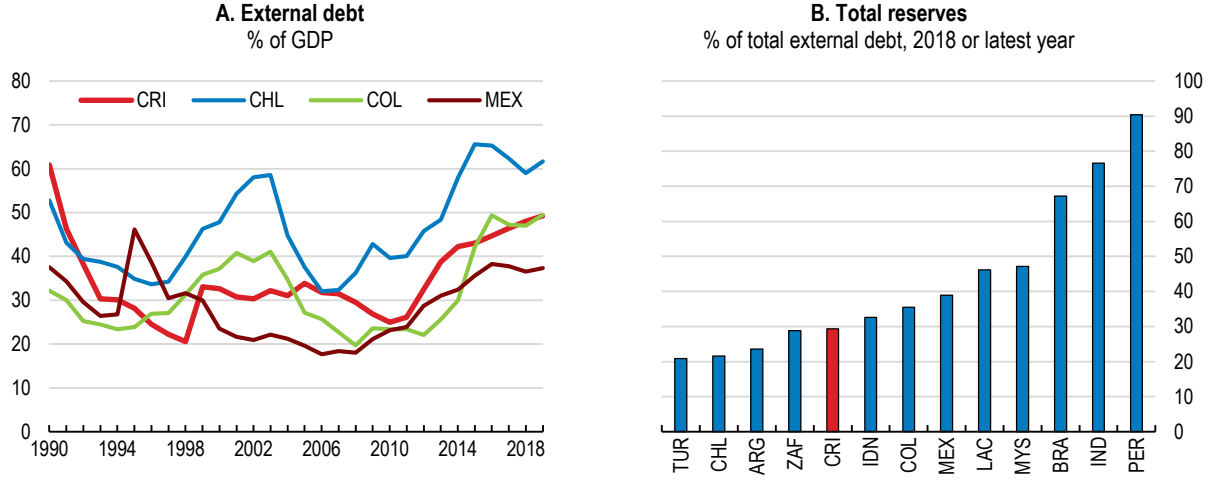
Figure 1.6. The current account deficit is financed by large direct investment flows



Source: IMF Balance of Payments database; IMF World Economic Outlook October 2019.

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Figure 1.7. External debt has increased



Note: Panel B: LAC refers to the World Bank Latin America and Caribbean (excluding high income) grouping of 25 countries. Data for Costa Rica are for 2019.
Source: IMF World Economic Outlook, Oct. 2019; World Bank World Development Indicators; Central Bank of Chile; and Banco Central de Costa Rica.

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In a scenario of the pandemic subsiding after the first outbreak, Costa Rica would experience a recession in 2020 (Table 1.5), as would the global economy. A gradual resumption of tourism and other exports would support a gradual recovery in 2021, although they would remain below pre-pandemic levels for some time.

Table 1.5. Macroeconomic and financial projections

A. Single-hit scenario						
	2016	2017	2018	2019	2020	2021
	Current prices CRC trillion	Percentage changes, volume (2012 prices)				
GDP at market prices	31.1	3.9	2.7	2.1	-4.1	2.7
Private consumption	20.0	3.6	2.0	1.6	-1.3	2.6
Government consumption	5.4	3.1	0.5	4.9	1.0	0.4
Gross fixed capital formation	5.7	-2.5	3.0	-6.4	-9.2	4.8
Final domestic demand	31.0	2.4	1.9	0.7	-2.2	2.5
Stockbuilding[1]	0.0	1.5	-0.7	0.6	-0.4	0.0
Total domestic demand	31.1	3.8	1.1	1.2	-2.7	2.4
Exports of goods and services	10.0	4.0	4.7	2.7	-10.4	1.6
Imports of goods and services	9.9	3.7	0.1	0.2	-6.3	0.9
Net exports[1]	0.1	0.0	1.6	0.9	-1.3	0.2
Memorandum items	_					
GDP deflator	_	2.6	2.5	1.7	1.4	1.9
Consumer price index	_	1.6	2.2	2.1	1.3	2.0
Core inflation index[2]	_	1.2	2.1	2.4	1.4	1.9
Government financial balance (% of GDP)	_	-6.1	-5.8	-7.0	-8.9	-7.1
Government primary financial balance (% of GDP)	_	-3.0	-2.3	-2.8	-3.9	-1.7
Government gross debt (% of GDP)	_	48.6	53.2	58.5	67.9	70.6
Unemployment rate (% of labour force)	_	9.1	10.3	11.8	15.9	13.9
Current account balance (% of GDP)	_	-3.3	-3.3	-2.5	-4.4	-3.8

B. Double-hit scenario						
	2016	2017	2018	2019	2020	2021
	Current prices CRC trillion	Percentage changes, volume (2012 prices)				
GDP at market prices	31.1	3.9	2.7	2.1	-4.9	1.5
Private consumption	20.0	3.6	2.0	1.6	-2.0	1.3
Government consumption	5.4	3.1	0.5	4.9	1.4	0.3
Gross fixed capital formation	5.7	-2.5	3.0	-6.4	-11.2	3.0
Final domestic demand	31.0	2.4	1.9	0.7	-2.9	1.4
Stockbuilding[1]	0.0	1.5	-0.7	0.6	-0.4	0.0
Total domestic demand	31.1	3.8	1.1	1.2	-3.4	1.4
Exports of goods and services	10.0	4.0	4.7	2.7	-12.2	0.8
Imports of goods and services	9.9	3.7	0.1	0.2	-7.6	0.6
Net exports[1]	0.1	0.0	1.6	0.9	-1.5	0.0
Memorandum items	_					
GDP deflator	_	2.6	2.5	1.7	1.2	1.6
Consumer price index	_	1.6	2.2	2.1	1.0	1.7
Core inflation index[2]	_	1.2	2.1	2.4	1.2	1.5
Government financial balance (% of GDP)	_	-6.1	-5.8	-7.0	-9.1	-7.7
Government primary financial balance (% of GDP)	_	-3.0	-2.3	-2.8	-4.0	-2.1
Government gross debt (% of GDP)	_	48.6	53.2	58.5	68.8	73.1
Unemployment rate (% of labour force)	_	9.1	10.3	11.8	17.0	15.5
Current account balance (% of GDP)	_	-3.3	-3.3	-2.5	-4.8	-4.1

1. Contributions to changes in real GDP.
2. Consumer price index excluding food and energy.
Note: The table shows financial balances and debt for central government.
Source: OECD Economic Outlook 107 database.

In a scenario of a second outbreak of the virus in the last part of the year, containment measures would need to be reintroduced and the impact on domestic demand would be more protracted. Tourism firms would continue to operate below capacity and the rebound in 2021 would be softer. Additional spending needs, such as in health, may arise. Accessing financial support by international financial organisations could help to provide needed support to those more affected and facilitate an orderly recovery.

The main downside risk to these projections is a failure or delay in implementing the fiscal reform and lowering the headline budget deficit once the economy recovers, which would curb investor confidence and put pressure on fiscal and financial stability. A weaker-than-expected global recovery is also a downside risk to the exports outlook. Spillovers from financial volatility in emerging economies also present risks. On the upside, the positive effects of the already implemented structural reforms on investment and growth might turn out larger than anticipated. The economy may also face additional unpredictable shocks, whose effects are difficult to factor into the projections (Table 1.6).

Table 1.6. Possible shocks to the Costa Rican economy

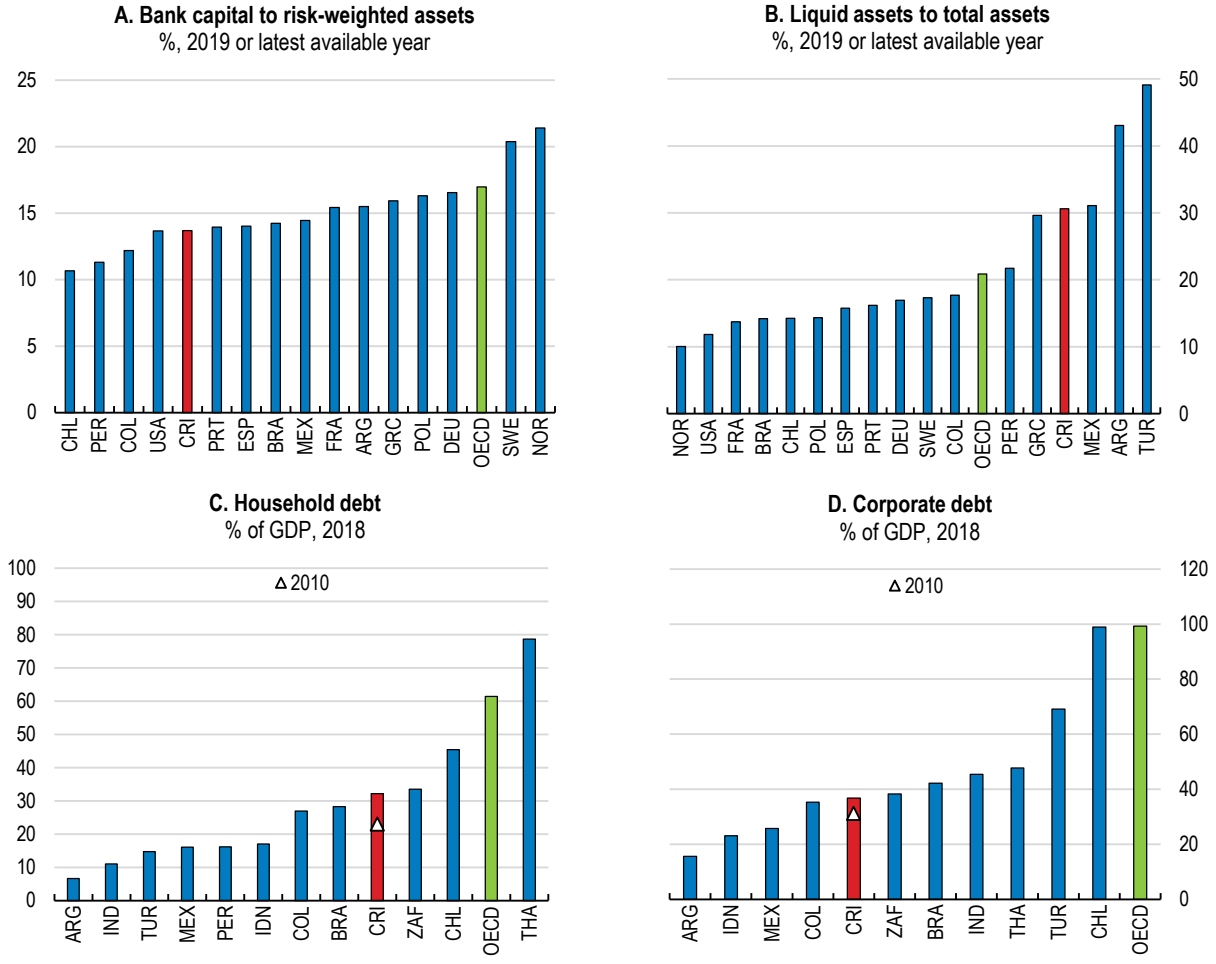
Vulnerability	Possible outcome	Possible policy action
Contagion from emerging markets financial volatility	Large exchange rate depreciation and higher costs of financing the fiscal deficit and servicing debt.	Tighten monetary policy and take additional fiscal measures to reduce the fiscal deficit.
Deepening crisis in Nicaragua	Large inflows of migrants with high humanitarian assistance needs.	Provide border assistance to immigrants and flexible residence permits.
Increase in social unrest	Political disruption that could hamper implementation of ongoing reforms.	Communicate that reforms will help to share the benefits of growth more widely. Pursue efforts to reduce inequalities.
Environmental risks	Seasonal and unpredictable extreme weather events, such as El Niño or La Niña, hampering the agriculture sector. Earthquakes or volcanic eruptions damaging the infrastructure.	Strengthen disaster risk management and foster climate change adaptation strategies.
Global pandemic continues in 2021	A protracted global recession.	Seek relief from multilateral institutions.

Enhancing financial resilience

The authorities have appropriately put in place an array of regulatory actions (Box 1.2) with the aim of easing credit and liquidity conditions for households and firms and avoiding that the economic disruptions associated with the pandemic hamper financial stability. The authorities consider banks to be liquid and well capitalised according to standard metrics (Figure 1.8). Asset quality has been resilient through 2019 (Fitch, 2019[5]). Weaker economic activity has translated into increasing non-performing loans, reaching 3% at end-2018, a low rate in international perspective. The ongoing recession will likely trigger additional increases in non-performing loans, in particular in the most affected sectors. Latest stress tests, run by the IMF prior to the pandemic outbreak, suggest that banks would remain well capitalised even under the adverse scenario of a combined shock consisting of a large increase in non-performing loans, an increase in interest rates and a significant foreign exchange depreciation. Household and corporate indebtedness levels have increased but remain comparable to other countries in the region. The increase in household borrowing has been particularly sharp in the last decade, with borrowing in local currency growing by 8% of GDP and borrowing in dollars by 3% (IMF, 2019[6]). Actual indebtedness is likely to be larger, as loans by non-supervised creditors are not included in official statistics. To reduce excessive household leverage, the government launched in October 2019 a debt exchange programme (*Crédito de Salvamento*) for highly indebted workers, which requires state-owned banks to extend loan maturities and to lower interest rates (chapter 3). This initiative is likely to hamper state-owned banks' performance and already low profitability and should be carefully monitored and evaluated, as it can trigger additional contingent liabilities. Introducing a personal bankruptcy scheme, as done by many OECD countries, would be a better solution

to provide relief and fresh start opportunities. Strengthening the credit registry office and financial education can help to contain excessive borrowing in the first place.

Figure 1.8. The authorities consider banks to be well capitalised



Note: Panel A refers to regulatory tier 1 capital to risk-weighted assets. Panel B refers to liquid assets as a percentage of total assets.
Source: IMF Financial Soundness Indicators; and IMF Global Debt database.

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The Costa Rican banking sector remains highly concentrated (OECD, 2018[7]). Three public banks control around 60% of assets, while the rest is controlled by nine foreign private banks and two domestic private banks. Credit cooperatives account for around 10% of the assets of the financial sector. Bank profitability remains low (OECD, 2018[7]); (IMF, 2019[6]). A number of distortions and regulatory asymmetries hamper both public and private banks, as described in previous OECD Economic Surveys (OECD, 2018[7]).

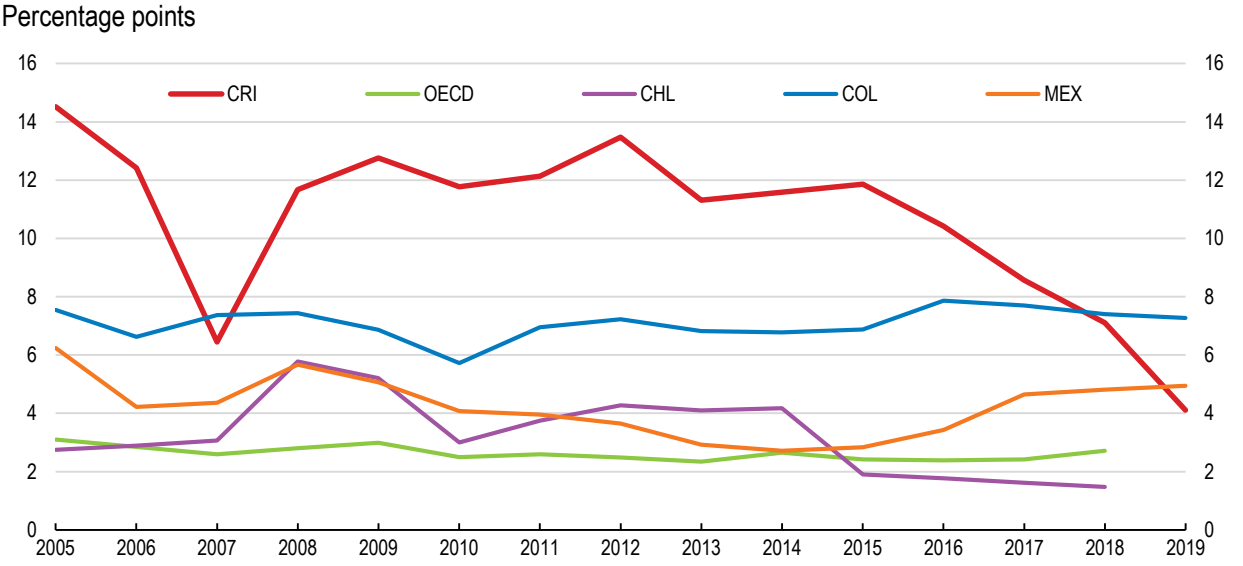
A key distortion concerns deposit insurance. So far, only deposits in state-owned banks enjoy a guarantee. In line with previous recommendations (Table 1.7), and also in line with practice in almost all OECD countries, a bill introducing a deposit insurance scheme, covering both state-owned and private banks, was approved by the Legislative Assembly on February 2020. The scheme would guarantee deposits up to USD 10 000 (covering 96% of deposits, according to Central Bank estimates) and would streamline bank resolution processes. According to the bill, both state-owned and private banks will contribute to the insurance fund. Contributions by public and private banks would go initially to different compartments, but the bill allows eventual changes in its design without the need of additional legislative change. This is

important as pooling eventually the compartments would boost risk-sharing and financial stability (Schoenmaker, 2018[8]).

Even with the deposit insurance covering public banks, Costa Rica continues to be subject to large and systemic risks of "doom loop", as state-owned banks have large asset exposures to the sovereign debt market and to state-owned enterprises and the existing state bank blanket guarantee covers not only deposits but all financial instruments, with the exception of subordinated debt. Internationally, blanket guarantees to the banking system tend to be triggered at times of systemic financial crisis but are not in place permanently, as they entail sizeable contingent liabilities, diminish the monitoring incentives for investors and encourage increased risk-taking by banks (so-called moral hazard). Once the deposit insurance scheme is in place, Costa Rica should also plan to phase out the existing blanket guarantee.

Beyond the deposit insurance, other key distortions are the obligation for private banks to lend 17% of their deposits to a development credit fund managed by state banks and mandatory contributions imposed on state-owned enterprises, which amount to 63% of state-owned earnings. Conversely, public banks benefit from the obligation for public institutions to deposit their local currency funds in state-owned banks. All these asymmetrical regulations fragment the Costa Rican banking market, hamper public and private banks' efficiency, limit competition and translate into interest rate spreads higher than in OECD countries (Figure 1.9). Gradually phasing out these asymmetries would ultimately help Costa Rican firms and households to access more credit and at better terms.

Figure 1.9. Interest rate spreads are relatively high

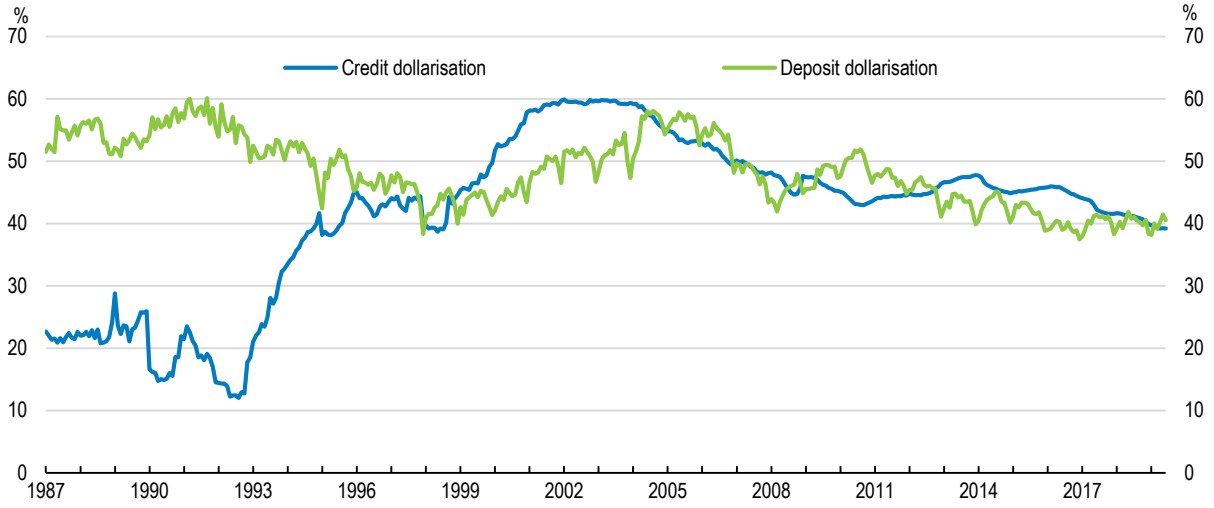


Note: Interest rate spread is the lending rate less the deposit rate in national currencies. OECD refers to an unweighted average.
Source: World Bank World Development Indicators.

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Financial dollarisation has fallen but remains high (Figure 1.10). Both credit and deposits dollarisation are around 40%. According to authorities' estimates, two-thirds of the dollarised debt in Costa Rica is unhedged. In June 2018, provisions for granting foreign exchange loans to non-dollar earners were reduced (IMF, 2019[6]). This measure should be undone to avoid building up even higher vulnerabilities in the form of unhedged foreign exchange lending positions. The Central Bank recently introduced a lower reserve requirement for liabilities in local currency, which has the potential to reduce dollarisation over time.

Figure 1.10. Financial dollarisation remains large



Source: Banco Central de Costa Rica.

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Past bank failures, including in two state-owned banks, argue for close supervision. In line with OECD recommendations, supervision has been recently strengthened. The supervisor, SUGEF, got stronger sanctioning powers and its supervisory perimeter was extended. According to the Central Bank and the financial supervisor, stress tests indicate that the banking system is sufficiently well capitalised to absorb sizable shocks. Individual stress tests are not published, contrary to practices in most OECD countries (Box 1.3) and recommendations in the 2016 and 2018 OECD economic Surveys (Table 1.7). This limits the effectiveness and usefulness of the exercise, especially when individual banks have private knowledge of their capital adequacy (Goldstein and Leitner, 2018[9]). A quicker implementation of the roadmap to move to Basel III, as recommended in previous Economic Surveys and, in line with other countries in the region, would buttress financial stability further.

Table 1.7. Past OECD recommendations on financial stability

Past recommendations	Actions taken since the 2018 survey
Create a bank resolution mechanism and a deposit guarantee scheme for all banks.	A bill to create a scheme covering private and public banks was approved in February 2020.
Accelerate the adoption of Basel III principles	Draft regulation to adopt Basel III definitions of capital, leverage ratio and loss absorbency of domestic and systemically important banks is ready. Regulatory capital and leverage ratio definitions are planned to be aligned with Basel III by the second half of 2021. Draft regulation to adopt Basel III definitions of minimum capital requirements for credit, operational and market risk is also ready. Minimum capital requirements for credit and operational risk are planned to be compliant with Basel III in January 2022; and for market risk in January 2023. Risk management and supervision practices are planned to be compliant with Basel III by the second half of 2021. A draft regulation on the net stable funding ratio will be developed starting from the second half of 2021. No plan to revise the liquidity coverage ratio.
Consider releasing publicly the results of banks' stress tests.	The publication of aggregate stress tests results is planned in 2020 in the Financial Stability Report. The authorities are assessing the legal feasibility of the disclosure of stress test results on individual financial entities.

Box 1.3. OECD practices on the disclosure of individual stress tests

Disclosing stress test results is optimal from a welfare point of view when there is bank opaqueness (Goldstein and Leitner, 2018[10]). Recent experience shows that markets have been unable to anticipate stress tests results due to the existence of private knowledge by banks (Petrella and Resti, 2013[11]). Taking that into account, 24 OECD member countries disclose individual bank stress test results. In Europe, stress tests are assessed and disclosed simultaneously by the European Central Bank and the European Banking Association. Supervisory authorities or central banks in 8 other member countries, such as Chile and Mexico, report detailed stress test results at the aggregate level. In some country cases, some disaggregation is introduced, dividing the system into clusters of different regions or bank sizes (e.g. Japan). Two countries (Switzerland and Turkey) only summarise aggregate results and two do not disclose.

Sources: European Central Bank, European Banking Authority and country sources including financial supervisory institutions and central banks.

Macroeconomic policies have improved but the fiscal framework should be reinforced

Both prompt monetary and fiscal measures have been put in place, aiming at supporting credit, liquidity, providing needed resources in the health system and supporting those hit by the pandemic (Box 1.2). Prior the COVID-19 outbreak, Costa Rica had taken significant steps to improve its macroeconomic framework by strengthening the independence of the Central Bank and improving its fiscal framework (Table 1.8). Looking ahead, Costa Rica would benefit from fully complying with the fiscal commitments established, and from taking additional measures to buttress the fiscal framework. Experiences in other countries in the region, as Mexico (OECD, 2019[12]), Chile (OECD, 2018[13]) or Colombia (OECD, 2019[14]), attest that keeping sound macroeconomic policies over time is fundamental to build up reputation and boost trust, protecting the country in case of financial turbulences and, ultimately, translating into better financing conditions in global markets.

Monetary policy has improved

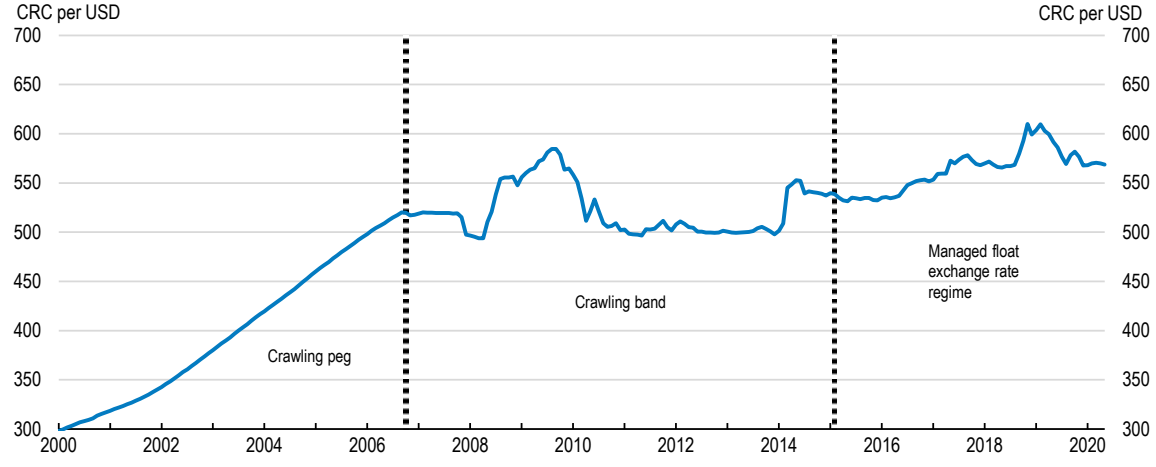
Costa Rica has improved its inflation targeting framework, in line with previous Economic Surveys recommendations (Table 1.8); OECD, (2018[7]). The Central Bank has also shown a stronger commitment towards exchange rate flexibility (IMF, 2019[6]); (Figure 1.11). Exchange rate interventions have become more limited and aimed at addressing episodes of large exchange rate volatility. The Central Bank has recently started to announce the yearly calendar of monetary policy meetings in advance, in line with practices in most OECD countries. The Central Bank has joined the Central Banks and Supervisors Network for Greening the Financial System, aiming at enhancing environment and climate risk management in the financial sector and mobilising finance to support the transition toward a sustainable economy.

Table 1.8. Past OECD recommendations on macroeconomic policies

Past recommendations	Actions taken since the 2018 survey
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.	The designation of the President of the central bank has been delinked from the political cycle and the dismissal rules have been clarified. The vote of the Minister of Finance in monetary policy decisions has been removed.
Gradually reduce interventions in the foreign exchange market.	Exchange rate interventions are limited to address episodes of large exchange rate volatility.
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.	The fiscal reform approved in December 2018 includes measures to increase revenues, introduces a fiscal rule, aiming at containing nominal current spending growth, reduces earmarking and rationalizes some remuneration incentives (Box 1.4). On 10th February 2020, the authorities announced a complementary fiscal package to further consolidate the fiscal position, including actions in four areas: i) fighting evasion and reducing tax expenditures; ii) reorganisation of public sector institutions and enactment of a public employment law, iii) improving debt management, and iv) selling of state-owned assets.
Assess contingent liabilities.	Some contingent liabilities have been assessed (debt, municipalities, pension system, PPPs or lawsuits against the state) while others (public enterprises, natural disasters, financial risks) are in process.
Create a fiscal council and introduce a multi-year expenditure framework.	The three board members of the fiscal council have been appointed. They will be working part-time and supported by the Finance Ministry.
Modernise debt management by reducing the number of benchmark securities and improving communication with the markets.	The number of benchmark securities has been reduced to 8. Since January 2019, the calendar of quarterly auctions is published. Debt management plans are now presented to markets twice per year.

Headline inflation remained within the official target range of 2-4% during 2018 (Figure 1.12), and started to decelerate in 2019, falling below the 2% target floor, as the economy weakened. In response, the Central Bank gradually, and appropriately, reduced the policy interest rate during 2019. The new value-added tax, introduced in July 2019, induced a pick-up in inflation, which is expected to be transitory. The central bank has cut interest rates by 150 basis points as response to the coronavirus outbreak. Going forward, monetary policy should be ready to ease further to support the economy during the coronavirus outbreak and support liquidity conditions as required.

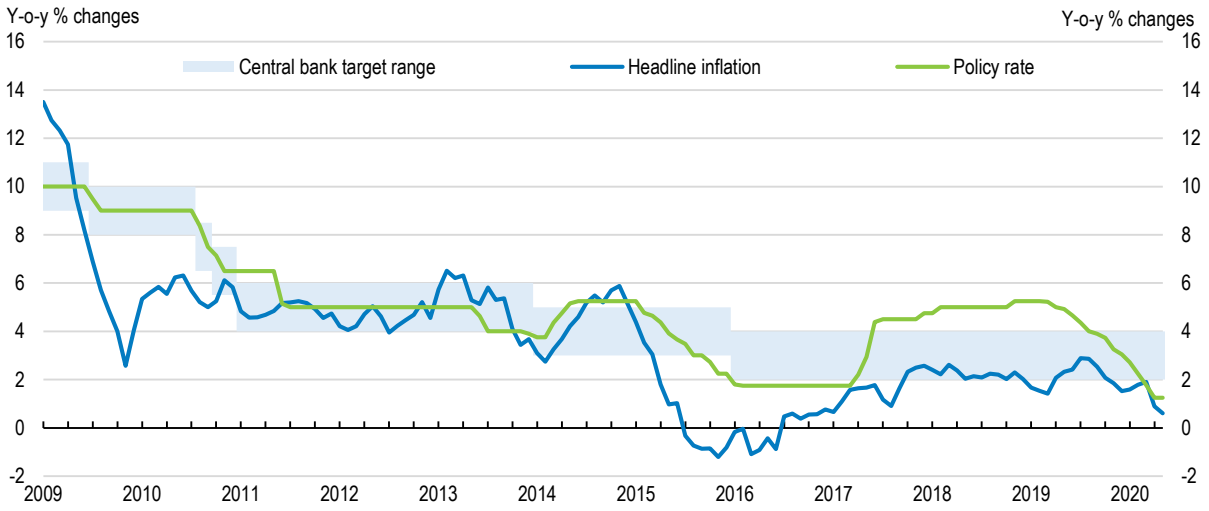
Figure 1.11. The exchange rate has become more flexible over time



Source: OECD Economic Outlook 107 database.

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Figure 1.12. Monetary policy is appropriately accommodative



Note: Shaded area represents the central bank target. Data are based on monthly averages. Latest value refers to May 2020.
Source: Banco Central de Costa Rica.

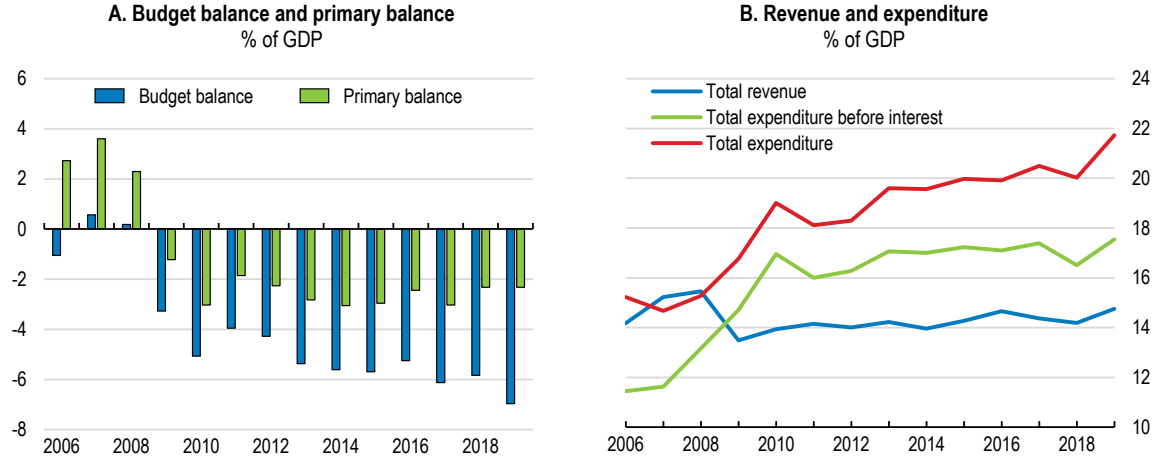
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Recent improvements in the inflation targeting framework are hampered by a weak transmission of changes in policy rates to real economy financing conditions. The authorities estimate that the pass-through from policy interest rate to market rates is of around 70%. The transmission of monetary policy is hampered by the lack of competition in the banking sector and by the high financial dollarisation. International experience shows that large currency mismatches can cause monetary policy to be more attentive to exchange rate fluctuations and hinder countercyclical monetary policy (Mimir and Sunel, 2019[15]). In this sense, policy efforts to de-dollarise the financial system, for example by tightening prudential regulation for unhedged borrowers, would allow for a more floating exchange rate without building up unhedged currency risks. In turn, increasing exchange rate flexibility would favour that economic agents internalise exchange rate fluctuations, helping to curb dollarisation.

The fiscal deficit and the public debt were high and increasing even before the COVID-19 shock

Costa Rica's fiscal situation deteriorated significantly in the last decade, with the overall balance moving from a 0.6% surplus in 2007 to a 7% deficit in 2019 (Figure 1.13). In tandem, public debt has more than doubled, jumping from 28% in GDP in 2008 to almost 60% of GDP in 2019. The Costa Rican government has taken fundamental steps to address the growing fiscal imbalances. A historic fiscal reform law (Box 1.4) was approved in December 2018, after two decades in the works, and under a complex social situation, including a three-month public sector strike. A critical element in the reform is the introduction of a fiscal rule that ties down gradually the growth of current spending.

Figure 1.13. Fiscal deficits remain large



Note: Data refer to central government only. Total revenues do not include social security contributions.
Source: Ministerio de Hacienda.

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Box 1.4. The fiscal reform

The main elements on the revenue side are:

- The sales tax is transformed into a value-added tax, covering previously untaxed services. The standard rate is 13%. There are three reduced rates:
  - 4% on airfares and private healthcare services (if paid by credit or debit card, healthcare is exempted).
  - 2% on private education, medicines and insurance premiums.
  - 1% on basic domestic essentials.
- Two new personal income tax brackets for top earners, at 20% and 25%.
- Capital gains starts to be taxed at 15%.
- A tax amnesty, finished three months after the approval of the law.

On the spending side, the fiscal reform focuses on public employment in central government and decentralised institutions:

- Establish limits for public wages.
- Establish that some incentives will be defined in fixed nominal terms rather than as proportion of the salary.
- Strengthen the eligibility criteria for some incentives for public workers.
- The Planning Ministry becomes the steering body for public employment issues.

The law also reduced the scope of mandated spending. When central government debt exceeds 50% of GDP, the Ministry of Finance is entitled to reallocate spending from specific legal destinations, taking into account revenues and the level of budgetary execution and the fiscal balance of beneficiary entities.

The reform also introduced a fiscal rule limiting the growth of nominal spending depending on the level of public debt, as follows:

- 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 law establishes that the spending of all non-financial entities of the public sector are subject to the rule. This includes the central government, all deconcentrated bodies, the legislature, the judiciary, local governments or non-financial public companies. Exceptions are the Costa Rican Social Security Fund (CCSS), concerning the resources of the contributory pension regime (IVM regime) and the non-contributory regime, the Costa Rican Refinery of Oil (Recope), concerning the oil bill and state-owned enterprises, concerning the part of their activities subject to competition.

The Finance Ministry is in charge of ensuring that the formulation of the budget for central government and deconcentrated bodies is compliant with the fiscal rule. For the central government, the General Comptroller will verify during the budget approval phase that the budget is in line with the law. Once the fiscal year is over, the General Comptroller will also verify if the fiscal rule has been met. The independent fiscal council will also make an assessment on this. A final report on compliance will be delivered to the General Comptroller Office in April of the following year and published on the website of the Ministry of Finance. The General Comptroller Office will verify that the budget of state-owned enterprises is in accordance with the law.

The government estimates that the total fiscal impact of the fiscal reform is 4% of GDP (Table 1.9). Measures on the spending side account for around 65% of the fiscal adjustment. This would limit reform's impact on growth, as spending adjustments tend to have a lower impact on growth, particularly in Costa Rica (World Bank, 2019[16]). A significant part of the adjustment implies reducing public workers salary bonuses, which will reduce income inequality, as these workers are in the highest percentiles of the income distribution in Costa Rica. By reducing the need of domestic savings to finance the public deficit, the reform will also have a positive effect on private investment, as it will reduce crowding-out effects.

Table 1.9. Fiscal impact of the fiscal reform

% of GDP

	2019	2020	2021	2022	2023
Revenue (increase)	1.0	0.7	1.3	1.4	1.4
VAT	0.3	0.3	0.7	0.7	0.7
Income (personal and corporate)	0.3	0.4	0.7	0.7	0.7
Amnesty	0.4				
Spending (decline)	0	0.9	1.3	1.8	2.5
Wage bill	0.1	0.4	0.6	0.8	1
Current transfers	-0.1	0.5	0.7	1	1.5
Cumulated impact	1.0	1.6	2.6	3.2	3.9
Yearly fiscal impact	*1*	*0.6*	*1.0*	*0.5*	*0.7*

Note: Current transfers include transfers to the institutionally-decentralised sector.
Source: Marco Fiscal Presupuestario de Mediano Plazo. 2019-2023.

The main elements of the reform have already entered into effect. As of July 2019, the existing sales tax has been transformed into a value-added tax and Budget 2020 is the first budget subject to the fiscal rule. Preliminary data for 2019 show that revenues increased by 0.6 percentage points in 2019, thanks to the new VAT and one-offs, such as the tax amnesty (Table 1.10). However, these exceptional revenues were not sufficient to offset increases in the interest bill, capital spending and transfers. The latter were expected to remain constant, according to Budget 2020, but finally increased by 0.3 percentage points. Hence, the headline deficit widened to 7% of GDP in 2019, from 5.8% in 2018. This is the highest deficit in the last 30 years, and 0.6 percentage points higher than anticipated by the government when Budget 2020 was published. The primary deficit also increased, contrary to expectations in Budget 2020, due to higher than foreseen capital spending. The authorities announced on 10 February a complementary fiscal package. The package included a set of measures to reduce public debt, such as the sale of two state-owned enterprises, one of them being the overseas subsidiary of a public bank, and financial surpluses of decentralized public entities. This is expected to reduce public debt by 2% of GDP. It also includes additional measures to boost revenues and reduce spending, such as modernising tax collection, removing tax exemptions and merging public agencies.

Table 1.10. Main revenue and expenditure categories

% of GDP

	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
Total revenues	**14.6**	**14.4**	**14.2**	**14.8**	**14.6**	**16.5**	**16.9**	**17.3**	**17.6**	**17.7**
Tax revenues	13.4	13.3	13.1	13.5	13.9	15.1	15.5	15.9	16.2	16.3
Personal taxes	1.3	1.4	1.4	1.5						
Corporate taxes	2.4	2.6	2.6	2.9						
Value added taxes	4.5	4.4	4.3	4.5						
Other	5.1	5.0	4.8	4.6						
Other revenues	1.3	1.1	1.1	1.3	0.7	1.4	1.4	1.4	1.4	1.4
Total expenditures	**19.9**	**20.5**	**20.0**	**21.7**	**23.3**	**23.2**	**22.1**	**21.2**	**20.4**	**19.7**
Current expenditure	18.0	18.5	18.7	19.7	21.4	21.3	20.1	19.2	18.4	17.7
Wages	7.0	6.9	6.9	6.8	7.0	7.3	6.8	6.4	6.2	6.0
Goods and services	0.6	0.7	0.6	0.6	1.2	0.9	0.7	0.7	0.7	0.7
Interest	2.8	3.1	3.5	4.2	5.0	5.4	5.2	5.1	5.0	4.2
Transfers	7.6	7.8	7.7	8.0	8.3	7.8	7.4	7.0	6.5	6.8
Capital expenditure	1.8	2.0	1.4	2.0	1.9	1.9	2.0	2.0	2.0	2.0
Central government primary balance	**-2.4**	**-3.0**	**-2.3**	**-2.8**	**-3.7**	**-1.4**	**0.0**	**1.2**	**2.2**	**2.2**
Central government overall balance	**-5.2**	**-6.1**	**-5.8**	**-7.0**	**-8.7**	**-6.7**	**-5.2**	**-4.0**	**-2.8**	**-2.0**
Consolidated public sector overall balance	**-3.8**	**-4.3**	**-3.9**							
Government financing needs	10.4	10.4	12.2	12.1	12.5	14.9	12.4	10.7		
Non-budgetary debt reducing flows					1.2	1.3	0.6	-0.2	-0.2	-0.2
Central government debt	45.0	48.6	53.2	58.5	67.2	69.1	69.9	70.0	68.9	67.0

Note: Data for 2020-2025 are projections. Other revenues include social security contributions; non-tax revenues; and transfers. Total revenues in 2019 include several one-offs, such as the tax amnesty, which increased revenue by 0.4% of GDP, or the recovery by the Finance Ministry of the resources for the absorption of a failed public bank (Banco Crédito Agrícola de Cartago) by another public bank (Banco de Costa Rica). Non-budgetary debt-reducing flows reflect the net impact of asset sales and other one-off measures that reduce the stock of central government debt.
Source: Finance Ministry.

The deficit will continue to increase in 2020, pushed by fiscal measures taken to mitigate the impact of the pandemic and lower revenues due to the recession. Looking forward, the government expects the headline deficit will decline gradually as of 2021, as the gradual adjustment in primary current spending implied by the fiscal rule more than offsets increases in interest and capital spending, and revenues increase

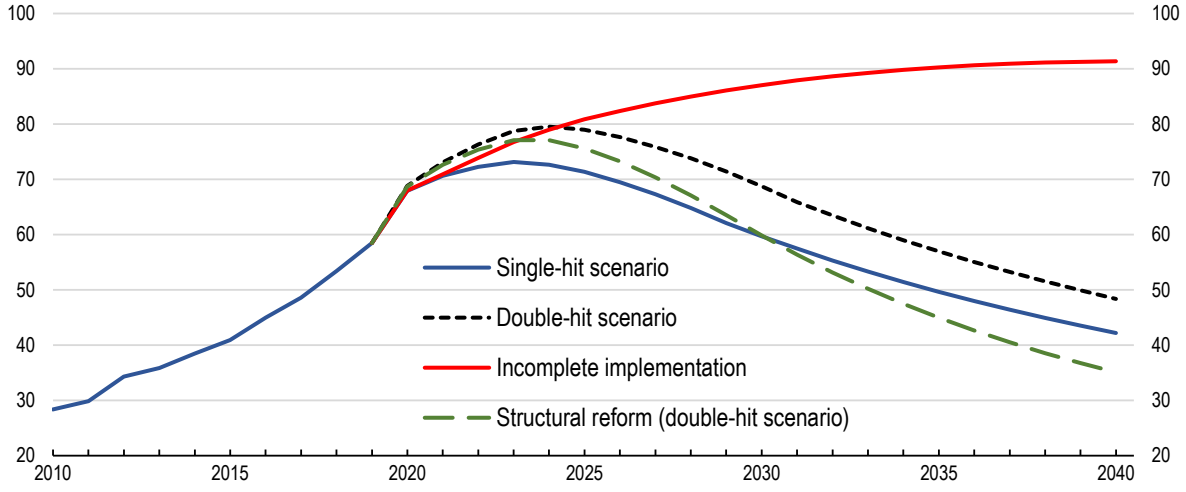
significantly as of 2021. The authorities expect that the primary deficit will get to zero in 2022. Assets sales would also contribute significantly to reduce the stock of debt up to 2023. Measures underlying the increase in revenues, the containment in spending and the reduction of public debt are subject to uncertainty about its size, composition and time horizon, as most of these measures require approval by the Legislative Assembly.

The government's fiscal plans seek to strike a delicate balance between the critical need to improve debt sustainability in an environment of weak economic growth and the need to preserve spending in key social areas. Debt simulations suggest that current government plans would halt the increase in public debt, which would peak at around 73% of GDP in 2023 if the pandemic remains under control after the first outbreak (Figure 1.4). If there is a second wave, debt would peak at around 80% of GDP in 2024. These simulations assume that the Finance Ministry's fiscal plan up to 2025 is met and that there is full compliance with the fiscal rule thereafter. However, the trajectory is very sensitive to the implementation of the fiscal reform. In a scenario with spending growing above the limits established by the fiscal rule, the debt ratio will continue to rise without bounds. An ambitious reform scenario, boosting potential output as described in Table 1.2 and Table 1.3, would put debt below 50% earlier, even in the double-hit scenario.

These debt simulations suggest that Costa Rica's fiscal situation remains challenging, making Costa Rica vulnerable to possible shocks, such as a further tightening of global financial conditions or additional volatility in emerging markets. Costa Rica's room to increase capital spending remains also constrained. The implementation of the other planned revenue and expenditure measures, along with the asset sales, would be fundamental to put the debt on a declining path. Continuing with the ongoing reform agenda is also critical to improve the fiscal situation in the uncertain and complex current environment.

Figure 1.14. Current fiscal policies would halt the increase in public debt in the medium term

Central government public debt, % of GDP



Note: "Single-hit" and "Double-hit" scenarios assume that real GDP growth, inflation and GDP deflator will be as in Panels A and B of Table 1.5 up to 2021 and gradual convergence towards potential growth and 3% inflation. During 2020-2025, revenue and expenditures are assumed to evolve as foreseen by Ministerio de Hacienda. All scenarios except for "Incomplete implementation" assume full compliance with fiscal rule after 2021. "Incomplete implementation" assumes a 1% higher average total spending growth relative to the "Single-hit scenario". "Structural reform" assumes real GDP potential growth will strengthen gradually as depicted in Table 1.2 and Table 1.3 relative to the "Double-hit scenario". This debt sustainability analysis focuses on assessing public debt dynamics in the short and medium term and takes into account the impact of recent non-budgetary revenue and spending measures as well as additional borrowing from multilaterals. Ageing-related spending pressures are not included. A dedicated debt sustainability analysis, presented in Figure 1.32, assesses the impact of ageing on long-term debt dynamics, including a longer time horizon.

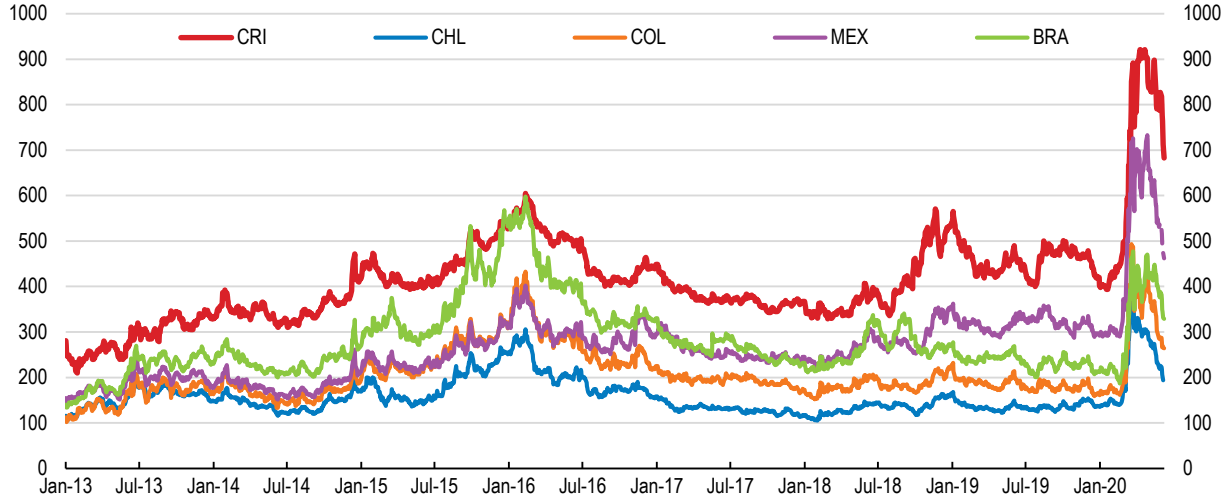
Source: OECD calculations based on data from Ministerio de Hacienda.

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Debt simulations also highlight that full compliance with the fiscal rule, is critical. The authorities have appropriately and temporarily activated the emergency escape clause in the fiscal rule for health-related institutions. Maintaining income support payments as long as confinement measures weigh on jobs and household earnings would help to mitigate the social impact of the pandemic. However, it is vital to ensure that the fiscal responses to the COVID-19 shock are temporary and well targeted. Once the recovery is underway, it will remain particularly critical that the growth of nominal spending is put on a steady declining path, as advocated by the fiscal rule. Implementation of the fiscal rule has met significant opposition and legal challenges from different segments of the public sector, such as municipalities, the judiciary and the university sector. There have also been different understandings on whether fiscal rule calculations should be based on budgeted spending or on executed spending (CGR, 2019[17]). It is fundamental that all existing uncertainties concerning how to apply the rule and its scope are resolved univocally as soon as possible, and without creating exceptions, which would undermine the fiscal rule's credibility and feeling of ownership among public sector institutions and citizens. Costa Rica could also consider enshrining the fiscal rule in the Constitution, as done by several OECD countries, as this can foster compliance and provide a useful counterweight to other items which appear in the Constitution and have fiscal implications, such as mandated spending in some areas. Sovereign risk premia in Costa Rica continue to be higher than in other Latin American countries (Figure 1.15). International experience shows that it is only through continuous and unequivocal compliance with the rule that trust in public finances increases, boosting confidence and ultimately reducing sovereign risk premia and financing costs. As in other Latin American countries, risk premia increased by around 500 basis points last March. If they remain at the current level, meeting sizeable financing needs in 2021, which will reach 15% of GDP, would be challenging. Costa Rica has initiated talks with multilateral financing institutions to access their lending facilities, which would supplement the multilateral financing already secured for 2020.

Figure 1.15. Sovereign risk premia remain high

Sovereign risk bond spreads, basis points



Source: Refinitiv.

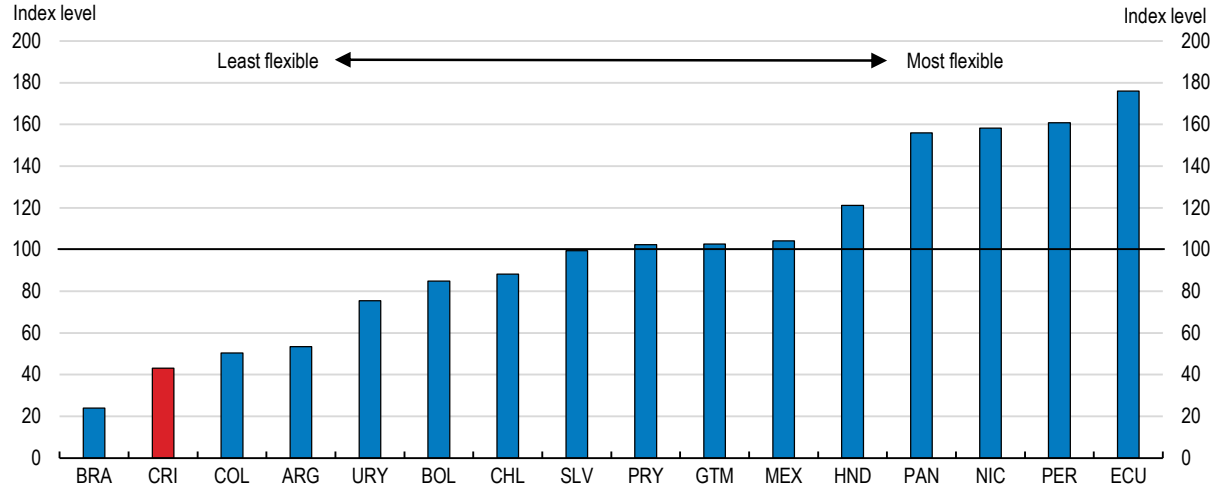
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The fiscal reform has removed significant revenue-earmarking provisions introduced over the years. The Finance Ministry can now reallocate spending away from legally mandated destinations when public debt exceeds 50% of GDP, with the exception of areas mandated by the Constitution, such as public education and the judiciary. Following recommendations in previous Economic Surveys, the fiscal reform expanded the definition of the public education sector by including early education centres and vocational education,

which should mitigate their effect in the budget. In 2020, total spending in education, including teachers pensions, will amount to 9% (MFPMP, 2019[18]), already above the 8% mandated by the constitution. Overall, the government's ability to allocate budget spending to changing needs remains limited (Figure 1.16). In addition to remaining earmarking, current transfers that are not earmarked cannot be reduced below the nominal level of the previous fiscal year, and the growing interest rate bill also increasingly restrains the government's ability to manage spending. Further efforts to increase spending flexibility are warranted. Allowing that all spending categories can be adjusted when the public debt exceeds 50% of GDP, would help the authorities to respond more swiftly to current and future fiscal challenges.

Figure 1.16. Public spending remains inflexible

Expenditure flexibility index, 100 = LatAm average



Note: The expenditure flexibility index tracks central government spending from 2010 to 2016 and classifies outlays as operating expenses (wage and other), transfers, investment or interest payments. Transfers include pensions and payments to subnational governments. For the index, spending on interest, wages and transfers are considered to be mandatory and the share of mandatory outlays to total spending is calculated for each country. The index is scaled using the regional average for mandatory spending as a share of total spending, creating a relative ranking.
Source: Moody's Investors Service.

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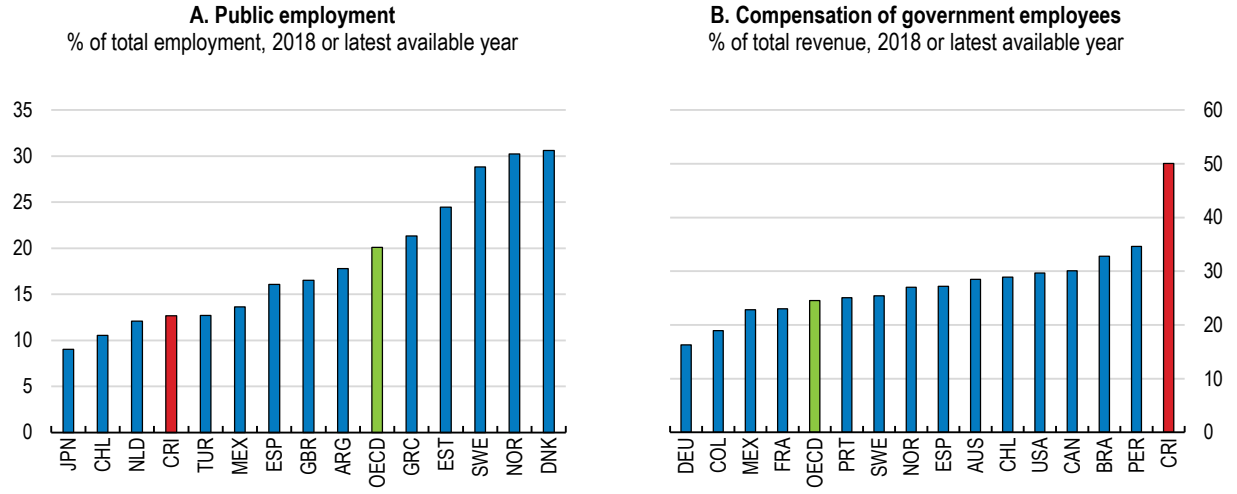
The need to meet the fiscal rule, together with the need to reduce inequality and boost growth, makes improving the efficiency of public spending a fundamental and social challenge. Public spending is on an increasing trend since 2008, but these increases have not been matched by an improvement in performance or outcomes.

A first priority area for reform is public sector employment, as compensation of government employees accounts for more than half of total revenues (Figure 1.17), the largest share in OECD countries and more than double the OECD average. Public salaries are also almost 50% higher than in the private sector, after controlling for employees' characteristics (World Bank, 2019[16]).

High public sector remuneration comes from a highly fragmented compensation scheme. This is the result of a combination of numerous allowances and incentives, which vary from one employee to the next, and a multiplicity of interrelated collective agreements and legislations, which tie increases in the salary of one group to another (OECD, 2015[19]). For instance, the base salary of employees on the Civil Service regime can be complemented by more than 20 different incentives, including seniority pay and bonuses (OECD, 2017[20]).

Deconcentrated entities, such as the Costa Rican Department of Social Security, enjoy a high degree of autonomy over their pay policy and have the largest share of additional pay benefits in compensation, amounting to 46%. There are also large differences in additional pay components within the same institutional category. In total there are up to 260 additional pay benefits across all institutions, according to General Comptroller's inventory. This results in large differences within the same job category, which can reach more than 600% in some cases (OECD, 2017[20]).

Figure 1.17. Public employment accounts for a large share of public revenues



Source: ILOSTAT; OECD Analytical database; and IMF Global Finance Statistics.

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This makes public employee remuneration overly complex, opaque, and extremely difficult to control. It has also made the largest contribution to income inequality (González Pandiella and Gabriel, 2017[3]) and hampers staff morale and public sector performance. Measures included in the fiscal reform are a first step to rationalise the remuneration of public employment. The government has expressed strong commitment to a more comprehensive public sector reform and a reform bill is under the discussion in the legislative assembly. Introducing a single salary scheme, with equal pay scales for the same functions across the public sector, would improve transparency. Streamlining incentives and bonuses and making them performance-based would provide a more equitable remuneration scheme. It would also facilitate management and control over the wage bill, while maintaining competitive remuneration schemes, as exemplified by the Central Bank and the General Comptroller, who implemented a single salary scheme in 1998 and 2007 respectively. Full implementation of the recently approved decree on general performance, which establishes clearer guidelines for performance evaluation, would set the basis for a fairer and more efficient remuneration scheme.

A second priority area to improve efficiency constitutes public sector reform. Costa Rica's public administration is highly fragmented into a large number of decentralised bodies and public corporations, with more than 100 new public sector institutions created since the 1990s (OECD, 2017[20]). This high fragmentation is combined with limited coordination, steering and accountability, resulting in duplications, unclear assignment of responsibilities and lack of leadership in some policy areas (OECD, 2018[7]).

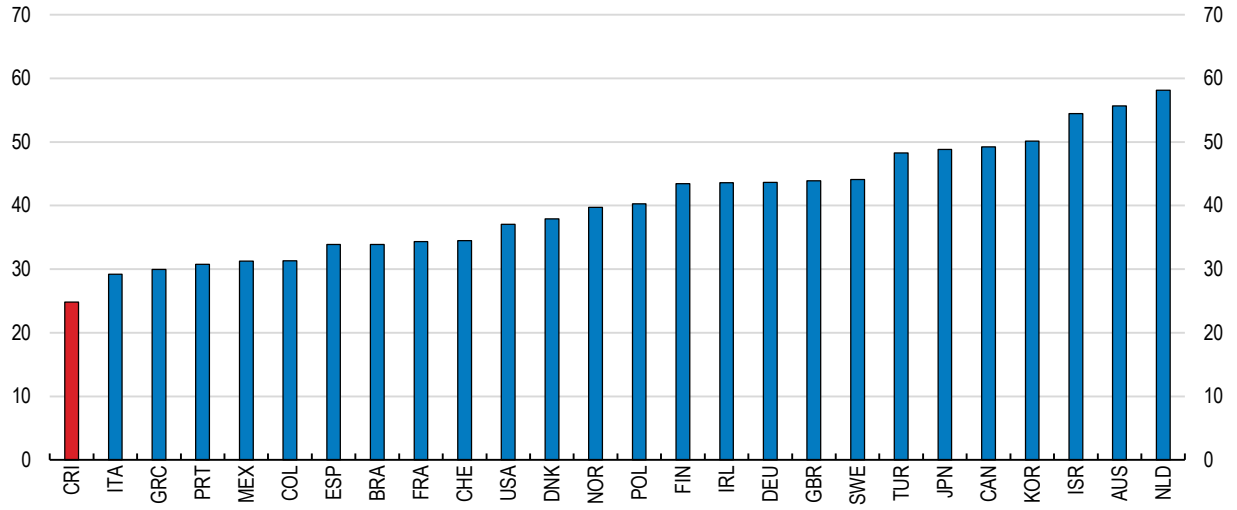
A thorough review of the public sector is needed to boost public sector efficiency and central government's ability to reallocate funds to priority areas. Previous studies already identified that a large number of public institutions are non-functional (OECD, 2018[7]). The authorities are in the process of delineating a strategy to reduce duplications and boost public sector efficiency, which will result in a law to be submitted to the

Legislative Assembly. Efforts to identify responsibilities of each government body and to eliminate duplications and non-functional bodies would set the basis for a more efficient public sector. First steps in this direction have been taken, including the decision to close one agency and restructure another one. Developing clearer steering and control mechanisms is also needed to increase accountability towards central government and citizens.

A third priority to improve spending efficiency is public procurement. The share of public spending subject to public procurement in Costa Rica is low (Figure 1.18). Boosting public procurement can generate significant fiscal savings (World Bank, 2019[16]); (OECD, 2020[21]). E-procurement and centralised purchasing are valuable tools to boost public spending efficiency. E-procurement decreases the administrative burden for both contracting the authorities and tenderers and improves access by firms to procurement opportunities. Costa Rica implemented the electronic public procurement system (SICOP) and its use became mandatory in 2016. However, SICOP's uptake is still relatively limited, as about 20% of public entities are not yet using it as of May 2019 (Radiográfica Costarricense, 2019[22]), suggesting that there is room to boost public sector efficiency by continuing the uptake of e-procurement.

Figure 1.18. The share of government spending subject to public procurement is low

% of general government expenditure less salaries and interest payments, 2018 or latest available year



Note: Data for Costa Rica refer to 2017.
Source: Calculations based on the OECD Government at a Glance database.

StatLink https://doi.org/10.1787/888934148543

Centralised purchasing has been a major driver of the performance of public procurement systems in many OECD countries, such as Finland (OECD, 2019[23]) or Korea (OECD, 2016[24]). Indeed, the benefits of centralised purchasing activities – such as better prices through economies of scale, lower transition costs and improved capacity and expertise are widely acknowledged. In Costa Rica, the Ministry of Finance is responsible for centralising public procurement, but only for the central administration, which represents less than 10% of the total procurement volume of the country. Indeed, the public sector demand for specific goods, works, and services is dispersed across a large number of government agencies. This results in a myriad of bidding processes to purchase similar items. A more strategic approach to procurement, bringing purchases by government agencies into the centralised public procurement procedures, could unlock significant savings. It is particularly important to bring procurement by autonomous institutions, such as

the Costa Rican Department of Social Security (*Caja Costarricense de Seguro Social*, CCSS) and the largest university (*Universidad Nacional*) (CGR, 2019[25]) into the centralised system.

There is room to make additional savings by increasing competition for government contracts. Open and competitive procedures have ceased to be the rule and direct contracting is the most frequently used procedure (World Bank, 2019[16]). This is due to provisions in the regulatory framework on exemptions (bodies that are out of the scope of the public procurement regulatory framework), exceptions to competitive tendering, and the threshold system in place (OECD, 2019[26]). In Costa Rica public entities excessively resort to exemptions granted in law to allow public entities greater flexibility to contract with other public entities without a public bidding process. Furthermore, they also use various exceptions to ordinary procedures. In 2017, the use of exceptions to ordinary procedures accounted for nearly 50% of the total procurement volume and 80% of the total number of procedures. The most used exception to open and competitive tendering was the one related to "procurement volume below threshold". In Costa Rica, thresholds depend on: i) the procurement category; ii) the budget allocated to each entity (ten different categories); and iii) the scope of the law. Therefore, the higher is the budget received by an entity, the higher is the threshold for open tender (OECD, 2019[26]). Some SOEs have their own specific exemptions, making for an uneven treatment not just between the private and public sectors but also between SOEs (OECD, 2020[21]). This is all preventing the private sector from competing on a fair footing for public procurement, implying also excessive costs to the state and poor service delivery. The authorities are currently undertaking a full reform of the procurement law, streamlining the threshold system and reducing scope for exceptions. This holds the promise of a medium-term solution but, in the short term, the exemptions granted to public entities should also be phased out.

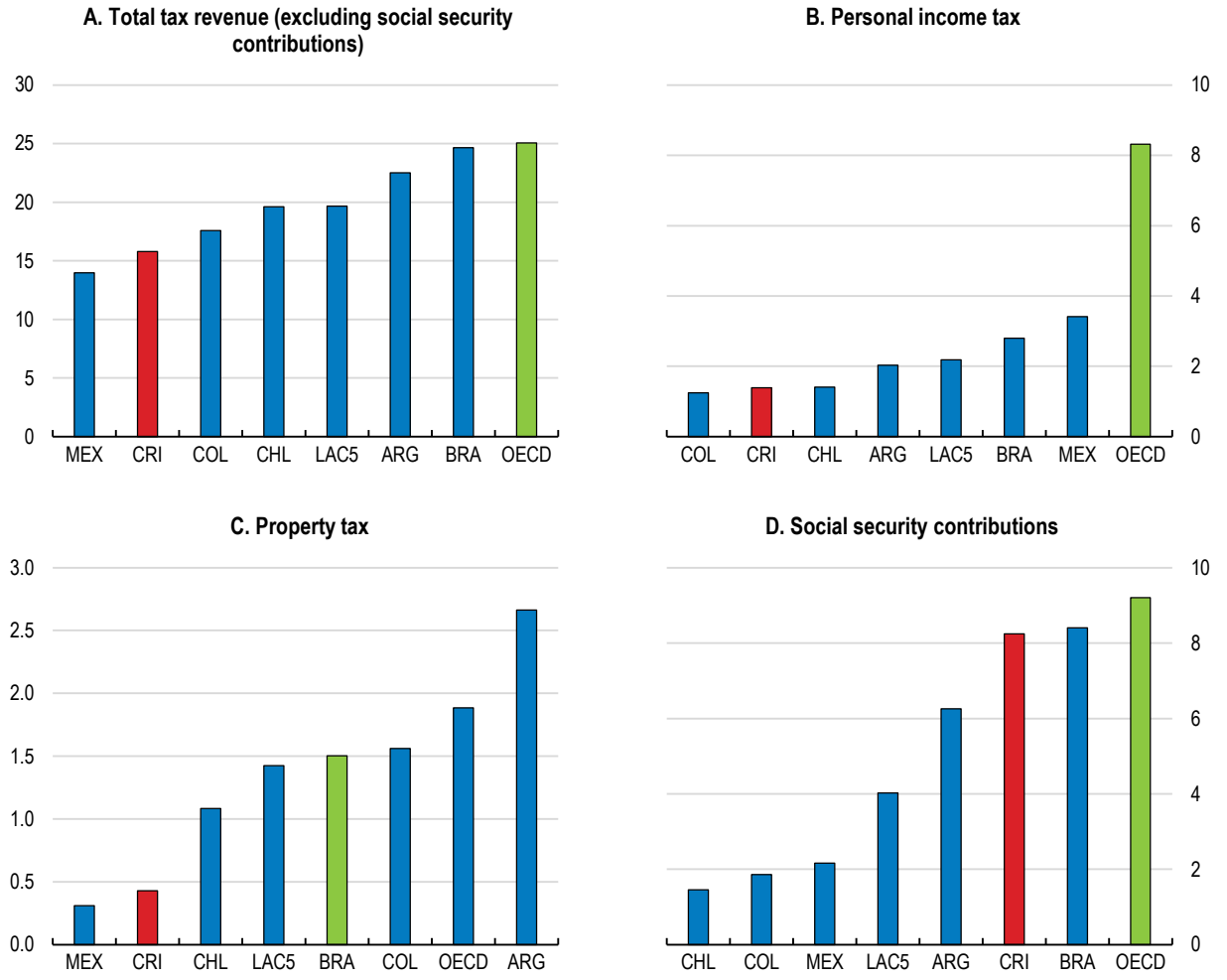
Broadening tax bases and improving the tax mix

The fiscal reform was a step forward for increasing tax revenues as well as improving efficiency and equity. The political economy of increasing taxes again is challenging, but Costa Rica has ample room to broaden tax bases without increasing rates. This room should be used in case the fiscal reform fails to deliver the planned increase in revenues, which is key to close fiscal unbalances. Tax changes increasing revenue and reducing income inequality should be prioritised. This includes starting to tax the income of cooperatives, which remain exempt despite some of them enjoying monopolistic conditions in key markets and benefiting from trade protection. Eliminating tax exemptions that benefit high-income households should also be prioritised. This includes taxing the additional salary paid at the end of the year (the so-called 13th salary), currently exempted from the personal income tax despite benefiting particularly affluent taxpayers. There is also room to optimise reduced VAT rates, in particular concerning their impact on equity. Taxing the spending on private education and health at reduced VAT rates is particularly regressive, as it benefits disproportionately high-income households.

Moreover, there is room to improve the tax mix, as the current tax structure relies excessively on social security contributions (Figure 1.19). These account for one third of total revenues. Employer's social security contributions are relatively high (Figure 1.20); (OECD, 2017[27]), which discourages formality. Conversely, Costa Rica raises relatively little revenue from property taxes. Gradually shifting taxation away from social security contributions to property tax would help to reduce informality and inequality. Colombia's recent efforts to improve and update the cadastre, which are expected to yield 0.3% of GDP of additional revenue, exemplifies that this can be an important source of additional revenue in Latin American countries. Establishing different property tax rates can be useful to ensure progressivity, as exemplified by several OECD countries such as Ireland. These tax changes would help to raise additional revenue (Table 1.11) in an efficient and progressive manner, which could help to close the fiscal unbalance. Costa Rica is also strengthening the fight against tax evasion. Electronic invoicing became mandatory in 2019, which can help to increase revenues, as exemplified by experience in neighbouring countries such as Chile.

Figure 1.19. There is room to improve the tax mix

% of GDP, 2018 or latest available year

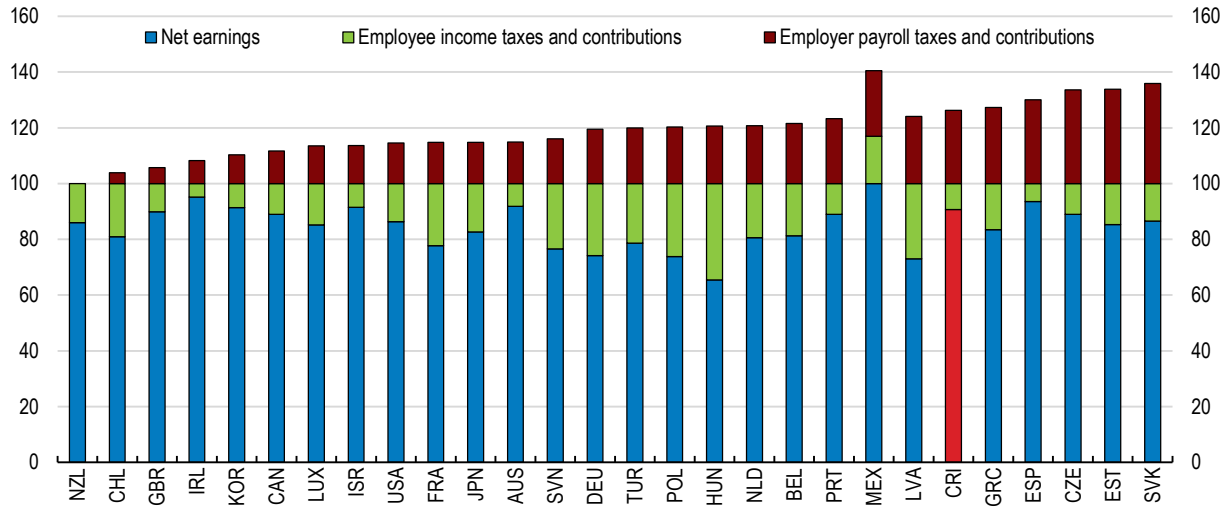


Note: LAC5 refers to the simple average of Argentina, Brazil, Chile, Colombia and Mexico.
Source: OECD Global Revenue Statistics database.

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Figure 1.20. Employer social charges are among the highest in the OECD

% of gross earnings, 2013



Note: 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.
Source: OECD Reviews of Labour Market and Social Policies: Costa Rica.

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Table 1.11. Fiscal quantification of some recommendations

% of GDP

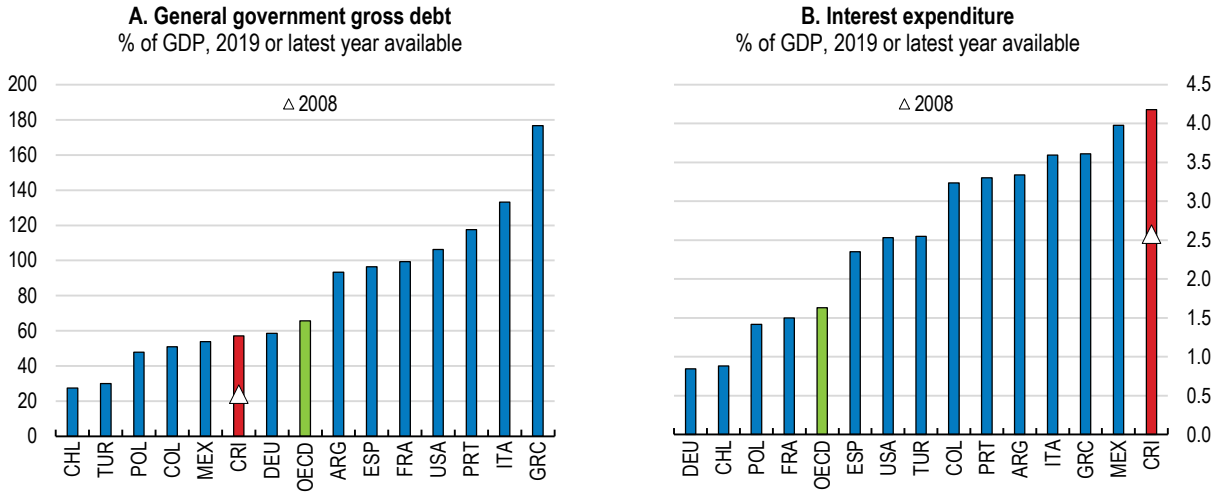
Measure	Change in fiscal balance
Removing some tax exemptions in personal tax (13th salary and school expenses)	0.35
Removing some tax exemptions in corporate tax (cooperatives)	0.15
Strengthening property tax	0.6
Increasing e-procurement and centralised purchasing	1.55

Note: Estimates are accounting effects of measures on fiscal balance.
Source: OECD calculations based on World Bank (2019[16]) and CGR (2019[25]).

Improving debt management

The interest rate bill is increasing fast (Figure 1.21), reaching more than 4% of GDP at the end of 2019. This makes improving debt management, a long-standing OECD recommendation, a fundamental priority to reduce risks and contain the cost of debt servicing. Debt management has suffered from institutional fragmentation, as different departments are in charge of local and external debt, which creates overlaps and inefficiencies (OECD, 2018[7]). The government relies heavily on local investors, making Costa Rica one of the emerging economies with the lowest share of foreign investors. Expanding the foreign investor base would help decrease funding costs. Reducing the reliance on the small local capital market would also reduce existing upwards pressure on interest rates. The authorities are issuing Eurobonds, which may ease financing pressures in the short term and provide some savings, relative to placing the debt in local markets to local investors. However, they also bring foreign currency risks, and the savings are likely to be limited. During last November's issuance, Costa Rica paid a higher interest than in its previous placement in 2012 (Figure 1.22), despite the environment of ample liquidity and global search for yield existing at that time.

Figure 1.21. Interest expenditure is high

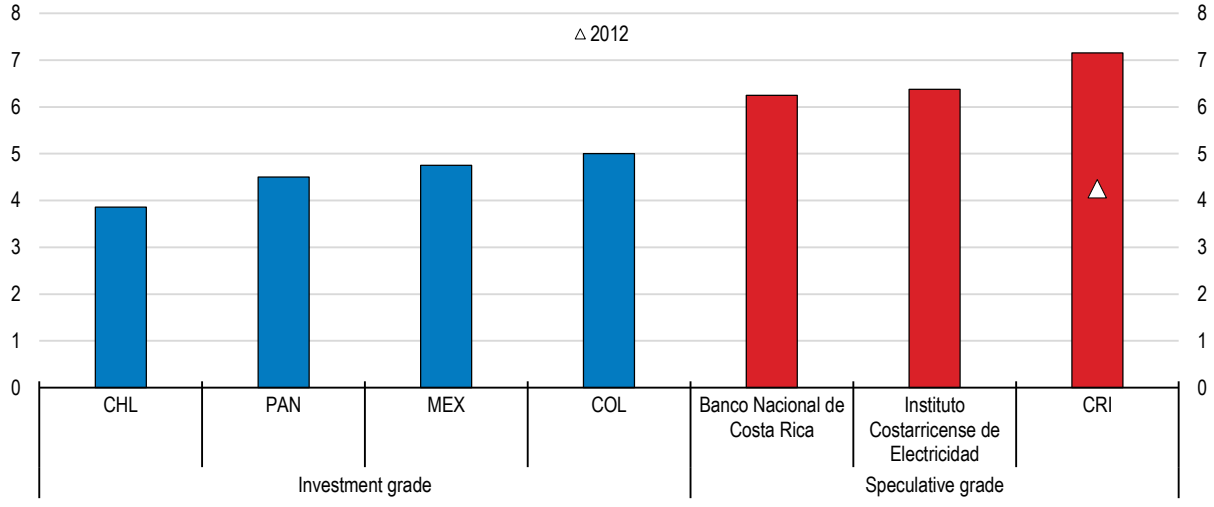


Note: IMF definition of general government debt refers to all liabilities requiring payment of interest.
Source: IMF World Economic Outlook, Oct. 2019. Data on interest expenditure for Costa Rica are from Ministerio de Hacienda.

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Figure 1.22. The cost of external financing is high in comparison with other countries

Coupon rates (%) of Eurobond issuances in 2019



Note: Annualised coupon rates denominated in USD. All bond issuances were listed in the Luxembourg Stock Exchange with comparable maturities except for the one by Banco Nacional de Costa Rica. The triangle denotes the coupon rate of Eurobond issuance by Costa Rica in 2012. Investment and speculative grade groupings reflect the rating definitions of the Fitch Ratings Inc. for each rated bond issuance.
Source: Fitch Ratings Inc.

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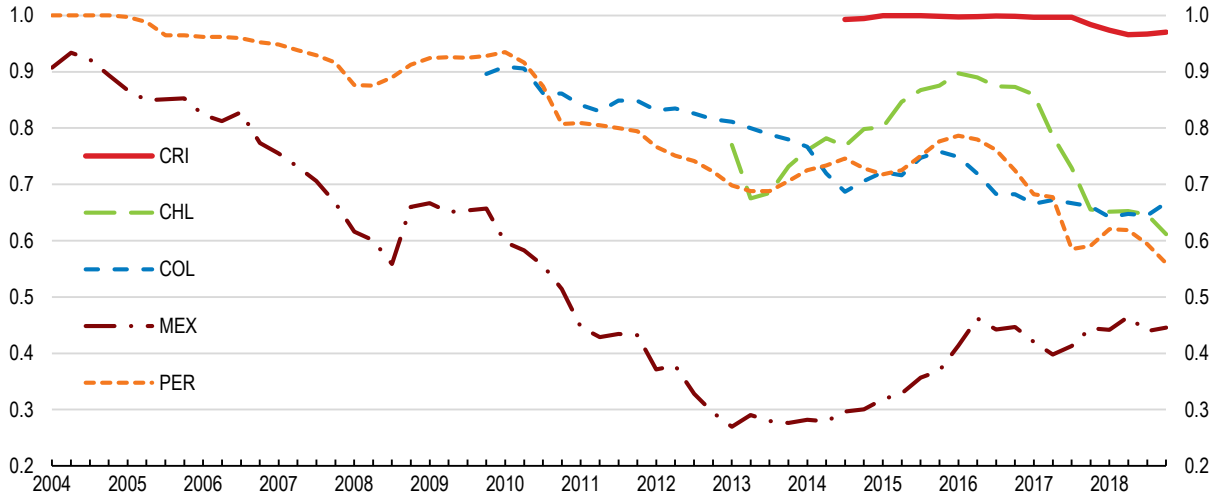
Issuing debt in foreign currency may help to reduce interest costs in the short term, but it also increases currency risks, as exemplified by Argentina. Almost all Costa Rican external government debt is already denominated in foreign currency. Other countries in Latin America have been increasingly able to attract international investors to local currency-denominated debt (Figure 1.23); (Ottonello and Perez, 2019[28]), reducing both the interest burden and currency risks. The global search for yield and improved

commitments to price stability in emerging market economies can explain the appetite for domestic currency public debt in the last decade (Engel and Park, 2019[29]). Costa Rica, given ongoing improvements in its monetary and fiscal frameworks, has the potential to follow suit and start attracting foreign investors to debt denominated in *colones*. To that end, communication with markets should be improved. Experiences in other countries show that having all debt functions in a single unit or agency, the so-called debt management office, improves communication with investors, credit rating agencies, lenders, international financial institutions, and market regulators, which also require transparency through sound and timely reporting. By reducing information asymmetries, debt management offices can increase demand, reduce issuance costs, and promote sounder bases for credit ratings.

Debt servicing costs would also decrease by accessing financing by multilateral financial institutions, which tends to be accompanied with technical assistance. Costa Rica is expecting to access significant multilateral funding in 2020, with four credit lines amounting to more than 2% of GDP helping to cover a significant part of financing needs at below-market interest rates.

Figure 1.23. Costa Rica is not able to borrow internationally in domestic currency

Original Sin Index (0-1)



Note: The Original Sin Index shows to what extent countries are able to place public debt to foreign investors in their domestic currency. It is defined as one minus the local currency share of foreign-held general government debt. A value close to 1 indicates that the country is unable to place public debt to foreign investors in domestic currency.
Source: Superintendencia General de Entidades Financieras; National Book-Entry System (SAC); Bloomberg; IMF Sovereign Debt Investor Base for Emerging Markets dataset.

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Looking forward, Costa Rica has unrealised potential to tap new areas of finance, such as green bonds. Green bonds imply a commitment to exclusively use the funds raised to finance or re-finance green projects, assets or business activities and are increasingly used by both advanced and emerging economies (Box 1.5). Long-standing commitments with natural resources preservation, ecotourism and clean energies place Costa Rica in an advantageous situation to access international green finance opportunities. Costa Rica's ambitious decarbonisation targets also require deep economic transformation, entailing large-scale investment. Green bonds, whose spreads tend to be low relative to conventional bonds (Daubanes, Rochet and Steffen, 2019[30]), would help Costa Rica to meet these targets and, at the same time, access international finance at more convenient terms. A successful issuance of green bonds by a Costa Rican state-owned bank in 2016 illustrates that this is a viable source of financing for the sovereign.

Box 1.5. Sovereign green bonds: experience in advanced and emerging economies

Sovereign green bond instruments started being launched four years ago and are increasingly used by several advanced and emerging economies, as they enable a direct mobilisation of capital investment towards green and sustainable activities. Poland, France, Belgium, Lithuania, Ireland, Netherlands and South Korea have successfully raised international capital to finance green investment at relatively low rates. Sovereign green bonds represent also an interesting opportunity for emerging economies. Chile was the pioneer among Latin American countries and issued its first sovereign green bond in 2019, with the aim of financing infrastructure for electrified public transport (trains and buses), solar projects, renewable energy or water management. Chile attracted an interest rate of 3.53%, the lowest interest that Chile has ever paid for an instrument of similar term, and a spread of 95 basis points over the US Treasury rate. Investor demand was high; 13 times the offer. Mexico has also announced its intention to place its first green bond during 2020. Germany, Spain and Peru are also seeking to raise green financing throughout 2020.

Continuing to buttress the fiscal framework

To reinforce its commitment towards fiscal prudence and macroeconomic stability, Costa Rica is setting up an independent fiscal council and planning to introduce a full-fledged medium-term expenditure framework. The planned fiscal council will be composed of three council members, will have no staff and relies on the Ministry of Finance's staff for technical analysis. The three board members were appointed on 17th March. The council held its first session at the beginning of April and will convene every four months. Creating the council is a valuable first step to improve fiscal surveillance and getting closer to OECD standards (Box 1.6). However, the current configuration of the council limits its effective independence and its potential benefits. To strengthen the independence of the council, Costa Rica could consider setting up the council under the auspices of the Central Bank, who would provide the required technical analysis, instead of the Ministry of Finance. This has proved an effective arrangement to provide stronger independence to the council in some OECD countries such as Estonia.

Multi-year expenditure frameworks have proven to be an effective tool to control public expenditure and ensure support to government strategic priorities, as illustrated by experiences in OECD countries, such as the Netherlands or Sweden in the 1990s. Today, almost all OECD Members have established a multi-year framework (OECD, 2018[7]). Costa Rica, building on its recently improved medium-term framework, should also proceed with plans to establish a fully-fledged multi-year expenditure framework.

Additional efforts to continue recording and reporting contingent liabilities are also warranted. Progress has been achieved in reporting explicit contingent liabilities, such as related to loans taken by public sector agencies with a state guarantee. Improving the recording of implicit contingent liabilities is the next priority. This includes contingent liabilities derived from pension schemes, natural disasters and those related to Public-Private Partnerships, state-owned enterprises, the financial sector and municipalities (CGR, 2019[31]).

Box 1.6. Boosting the independence of Fiscal Councils: the Chilean case

Chile has been gradually strengthening its fiscal framework over the last decades. This has contributed to sustain economic growth and keep public debt relatively low. A fiscal rule helped to shield public spending from the copper boom, generating savings crucial when the country faced negative shocks, such as the global financial crisis. A key additional step forward to boost the fiscal framework was the creation of an autonomous fiscal council in 2019. The council is composed of five members nominated by the President and approved by the Senate. The new council has own resources and the mandate of the members do not coincide with the government term to foster independence. It is tasked, among other things, with conducting analyses, evaluating the calculation of the structural revenues, monitoring the compliance with the structural balance targets, proposing mitigating measures, and evaluating and proposing changes to the fiscal rule. The institutional framework of the council is in line with OECD good practices for effective independent fiscal institutions design and operation.

Social indicators have improved but Costa Rica remains a very unequal country

Virtually universal health care, pensions and primary education have led to remarkable social outcomes, such as relatively long life expectancy (above 80 years) and low infant mortality. However, inequality remains very high and poverty has remained largely unchanged at around 20% (according to the national definition) over the last 25 years (Figure 1.24). The poor and vulnerable will be particularly impacted by the pandemic. The authorities have reacted promptly to mitigate the impact, putting in place new social programmes, such as *Bono Proteger* (Box 1.7).

Box 1.7. Bono Proteger: Complementing jobs retention schemes with income transfers

In April 2020, the government announced the *Bono Proteger* programme, which entails direct cash transfers for three months to individuals who lost their job or faced reduced working hours due to the pandemic. For workers who lost their jobs, the disbursement is CRC 125 000 (USD 217). For employees whose working hours were reduced by 50% as per the new retention scheme defined by Law No. 9832, the payment is also reduced by half. The total budget of the programme is CRC 296 billion (around 0.8% of 2020 GDP). Three-fourths of this budget has already been approved by the legislature.

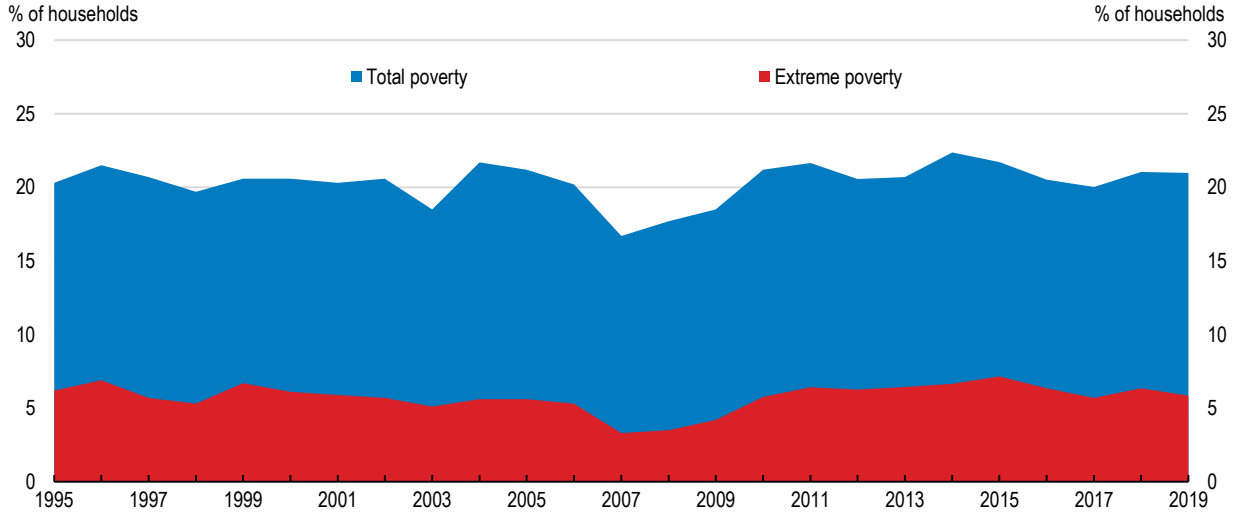
The programme is well targeted, as being economically affected by the COVID-19 is a requirement, and inclusive, as informal sector workers also can receive the transfer. Public sector workers, pensioners of any regime, citizens under 15 years old, persons deprived of liberty and families that currently receive other cash transfers from the State are excluded from the programme. Applicants should fill out an on-line form, sign an affidavit as a statement of good faith and provide a valid domestic or foreign document of identity and an IBAN attached to a *colones* denominated bank account in the domestic financial system. Those who do not have a bank account can request one using the same application form. As of early June, 533 000 applicants have received the transfer.

Source: Ministry of Labour and Social Security.

Spending on social policies has increased over the years, but the higher expenditure has not translated into better public services. On the contrary, the quality of some public services has deteriorated over the last decade. For example, poor access to primary care has led to congestion in hospital emergency rooms; the coverage of social assistance is still relatively low (Estado de la Nación, 2019[32]); (World Bank, 2019[16])

and students' performance in international evaluations, like PISA, has deteriorated since 2009. In light of the fiscal situation, to make growth more inclusive, it is critical that social spending leads to tangible improvements and solving existing inefficiencies. Making growth more inclusive will rely on improving opportunities for all Costa Ricans in education and work, improving their chances to find sustainable income generation opportunities. There is also a need to safeguard the sustainability of the pension and health systems. Closing existing gaps in financial inclusion would also help to make growth more inclusive (chapter 3).

Figure 1.24. Poverty rates have not fallen consistently over the last 25 years



Source: INEC Encuesta Nacional de Hogares (ENAHO) and Encuesta de Hogares de Propósitos Múltiples (EHPM).

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Improving the targeting of social policies

The government has made important efforts to improve the delivery of social policies. *Puente al Desarrollo*, a strategy to fight extreme poverty, was launched in 2015, helping to stop the increasing trend in extreme poverty observed since 2007. A key remaining challenge is to reduce fragmentation, improve coordination and targeting. Costa Rica has made progress in improving coordination in some key areas, such as early childhood education and care (Table 1.12), but there is ample room to reduce fragmentation in several other areas.

With poverty largely unchanged over the last 25 years, despite increasing social programmes, improving the targeting of social programmes is a priority. 24 per cent of beneficiaries of social programmes aiming at reducing poverty are high and middle-income households (OECD, 2016[33]). The institute for social assistance, *IMAS*, has made remarkable progress in integrating all registries from social programmes into a common database, SINIRUBE. This database holds the promise of maximising the impact of social policies in Costa Rica. It enables better targeting, thorough evaluation of social programmes and eliminating overlaps. It can also help to increase the coverage, as it enables to identify potential eligible beneficiaries not yet covered by the programmes. The tool has started to be used to improve the targeting of some social programmes, such as scholarships or non-contributory pensions. The government has recently disbursed additional cash transfers to about 24 000 families that are registered within SINIRUBE to mitigate the impact of COVID-19 on poverty. Using it also to improve the delivery of the largest social programmes, such as *Avancemos*, the conditional cash transfer scheme, or a housing subsidy, would be

a key step forward. The latter, offers the largest potential for savings that could be reallocated to other social programmes, as almost half of recipients of the housing subsidy are high and middle-income households (OECD, 2016[33]). The recently launched *Bono Proteger* is an excellent example of a well-targeted programme, as it is focused on providing direct support to those experiencing income losses during the pandemic.

Table 1.12. Past OECD recommendations on making growth more inclusive

Past OECD recommendations	Actions taken since the 2018 survey
Continue moving to a smaller number of minimum wages.	Number of minimum wages has been reduced from 26 to 16, with a medium-term objective to reduce it further to 11.
Implement a comprehensive plan to reduce informality.	Some actions have been implemented recently, such as lower employer and employee's social security contribution for informal companies that become formal (temporary and only for small firms). Sectoral pilot programmes to reduce informality for domestic workers and some agro activities (coffee) have been deployed and there are plans for fishing sector, street vendors and part-time workers.
Increase the supply of publicly-funded childcare services. Classify all spending on early-childhood education and care under the constitutionally-mandated spending on education.	Enrolment rates for children of age 5 have increased. Spending related to early education has been classified as part of total mandated spending on education in Budget 2020.
Establish better educational outcomes as the main policy target, instead of a focus on spending and develop performance indicators.	There are plans to move to a performance-based system, including students' performance tests and teachers' evaluations.
Rebalance education spending towards early childhood and secondary education. Strengthen targeted support for at-risk students, and teachers' training.	No action taken with regards to rebalancing the spending. New training programmes for teachers have been introduced. A special unit to provide support to drop-outs have been created.
Develop an apprenticeship system that closely involves employers.	The dual vocational training bill was approved.

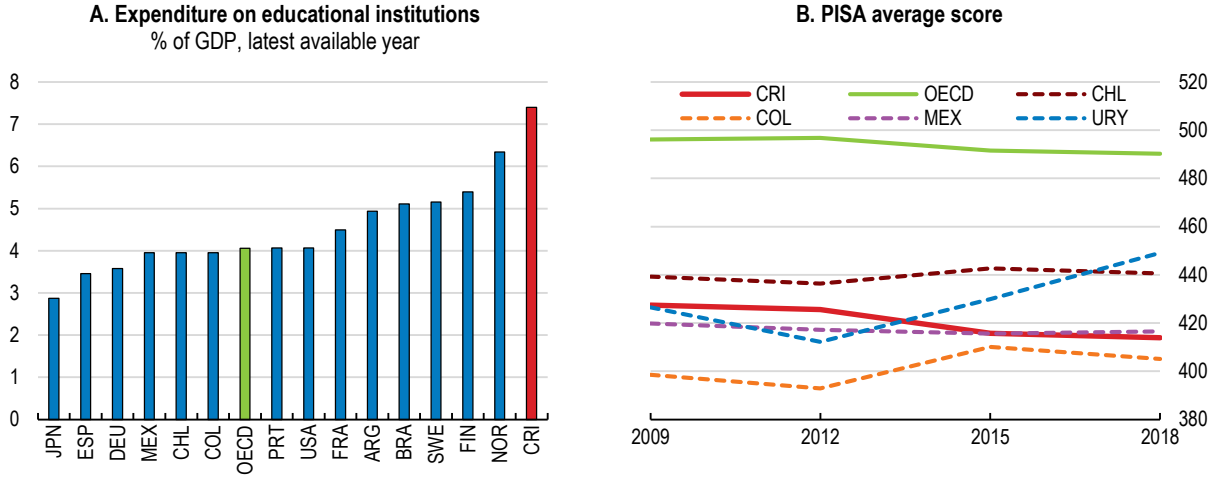
Making education policies more conducive to growth and equity

Education outcomes in Costa Rica remain low, despite spending more than in OECD countries (Figure 1.25). Costa Rica has achieved almost full enrolment in primary education but lags behind in key education outcomes. Half of Costa Rica's population aged 25-34 has completed upper secondary education, far from the OECD average (85%) and other Latin American countries, such as Chile (85%), Colombia (70%), Argentina (72%) or Brazil (66%). According to PISA 2019 tests, students in Costa Rica perform 76 points lower than OECD students, equivalent to two years of schooling. Firms also face increasing difficulties in hiring workers with the appropriate skills. Ensuring that all Costa Ricans have access to high quality education and training and that the education system delivers the skills the labour market needs, is critical to establish a more inclusive and productive economy.

Education policies are becoming more targeted, with a special unit providing additional support to disadvantaged schools and students (UPRE). The Education Ministry, in collaboration with the Finance Ministry, is also preparing the move to a performance-based planning system. There has been also progress in increasing enrolment in early childhood education and care, although increasing quality is a pending challenge, as there is a significant delay in implementing standards designed by the Education Ministry (Estado de la Educación, 2019[34]). Increasing standards is fundamental, as starting strong in education is key to decrease inequalities. Retaining students in secondary education remain also a pending key challenge, as nearly one third of 15 year olds have dropped out of school. Evaluations of *Avancemos,* a conditional cash transfer programme, suggest it has helped to retain students. The special unit aimed at providing support to disadvantaged students also helped to increase retention rates in disadvantaged prioritised schools. Given the still high drop-out rate, further policy efforts are warranted, including widening the scope of the unit. Measures to encourage more capable teachers to work in the

schools with highest needs have proved useful to curb drop-out rates in several OECD countries, such as Finland.

Figure 1.25. Spending on education is high and PISA results are declining



Note: Data for Costa Rica is based on 2020's budget of Education Ministry and the Vocal Education Agency (INA). Including teachers pensions, spending in Costa Rica reaches 9% of GDP. Data for all other countries are for 2017.
Source: OECD estimate; OECD Education at a Glance database; and OECD PISA database.

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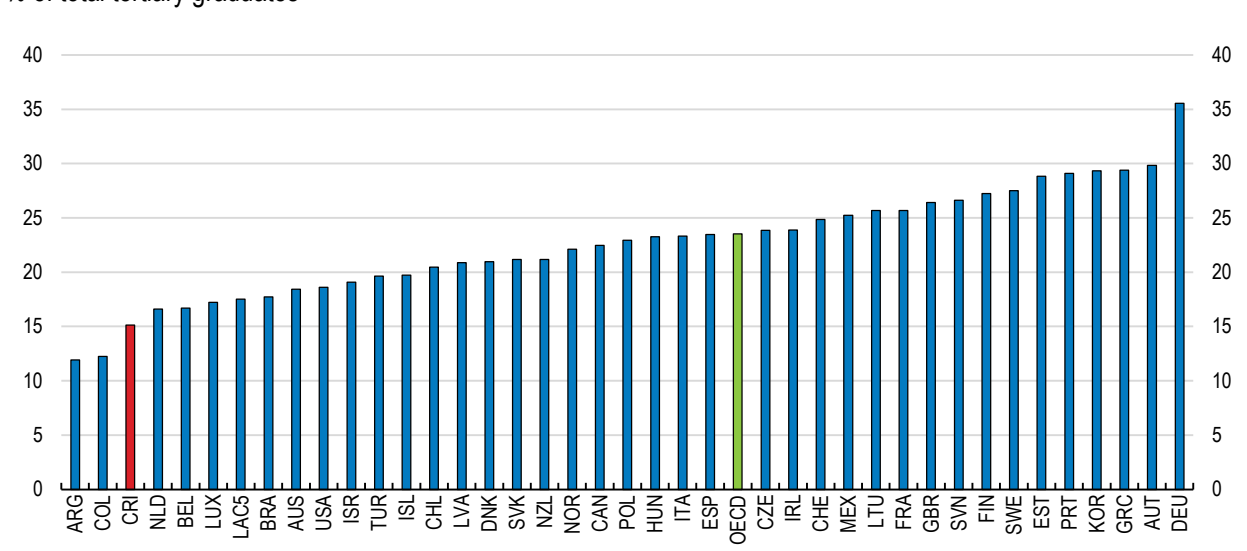
Digitalisation, globalisation, demographic shifts and other changes in work organisation are constantly reshaping skills needs. Despite the significant educational efforts made by Costa Rica and the relatively high level of unemployment, employers face difficulties in filling vacancies (Manpower, 2019[35]), particularly in technical and scientific fields (Monge-Gonzalez et al., 2015[36]). The mismatch between the demand and supply for skills is translating into people acquiring obsolete skills and persistent skill shortages and mismatches. This is costly for individuals, firms and the society in terms of lower employability, wages, productivity and accordingly, growth. The authorities are planning to run regular students' performance tests, which should help detect learning gaps early on. It would be particularly important that gaps in digital skills are also assessed and addressed. The authorities have also recently approved a dual vocational training law. Dual schemes have proved valuable to reduce skill mismatches in several OECD countries, such as Germany, Austria or Switzerland.

Updating curricula regularly is therefore fundamental. The Ministry of Education has made good progress in adapting and improving curricula in primary and secondary education, but there are significant delays in implementing the new curricula in classrooms (Estado de la Educación, 2019[34]). Experience in some OECD countries, such as Norway or the Netherlands, suggests that developing guidance materials can help teachers to bring the new curricula to the classrooms. Continuing to provide teachers with additional training would also help. The planned new teachers evaluations is key, as they help to detect in which areas training and teacher's professional development should be prioritised.

A particular concern is the excessive inertia in Costa Rican universities, which remain heavily biased towards social science and humanities, producing few science, technology, engineering and mathematics (STEM) graduates (Figure 1.26). Only 15% of graduates follow STEM, the same share as in 2005 (Estado de la Educación, 2019[34]). Reducing skill mismatches requires both supply and demand side actions. On the supply side, there is a need to improve the governance of the universities to make them more accountable, performance-based and responsive to Costa Rica's skills needs. This requires a change in the funding model, as the existing one creates incentives to increase places in fields that are less expensive

to deliver, such as the humanities and social sciences, to the detriment of those that are more costly to provide such as engineering, which requires investment in expensive equipment. Recent increases in the university budgets have been mostly channelled to increasing the salaries and number of the administrative staff, which is large in relation to the number of academic staff (Delgado Benavides, 2018[37]). Introducing better incentives into the universities' funding formula, by linking funding to responding to labour market needs, would help to ensure a better alignment of curricula with skills demand, as illustrated by Ireland, who introduced this type of scheme in 2018. Students should also be informed early on in their educational life, about employment options, wages and labour market prospects by degree and university.

Figure 1.26. STEM graduates as a share of total tertiary graduates



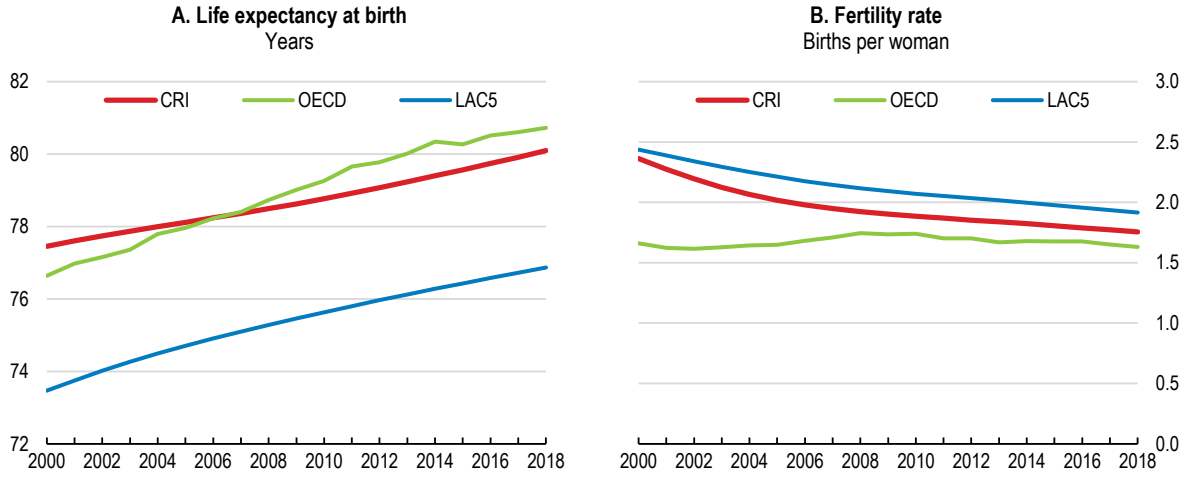
Note: STEM includes all graduates (short-cycle tertiary, bachelor's, master's, and doctoral degrees) with a degree in natural sciences, mathematics and statistics; information and communication technologies; and engineering, manufacturing and construction. LAC5 refers to the simple average of Argentina, Brazil, Chile, Colombia and Mexico.
Source: OECD Education at a Glance database.

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The demographic bonus is ending

Costa Rica has been so far reaping the benefits of a significant demographic dividend but trends are shifting. Improvements in health and economic development have led to a steep increase in life expectancy and a decline in fertility rates (Figure 1.27). The share of the population over age 65 will triple over the next 50 years, from 10% in 2020 to 30% in 2070, according to United Nations projections. Consequently, the demographic bonus will end soon (Figure 1.28). This demographic trend can have a significant impact on economic growth and fiscal sustainability, by putting additional pressure on public pension and health care systems. Promoting women's labour force participation, fostering formalisation and gradually reforming the pension and healthcare systems can help to moderate the impact of ageing on economic growth and fiscal sustainability, while preserving equitable access to health services and adequate pension benefits.

Figure 1.27. Life expectancy is higher and the fertility rate lower

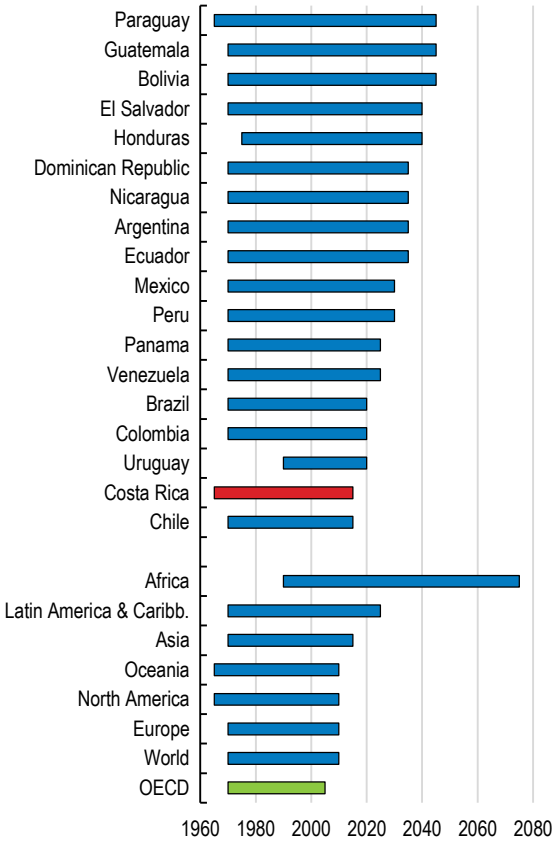


Note: OECD refers to the unweighted average of its member countries. LAC refers to the unweighted average of Argentina, Brazil, Colombia, Costa Rica and Mexico.
Source: World Bank World Development Indicators.

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Figure 1.28. The demographic dividend is ending

Duration of demographic dividend, total dependency ratio



Note: Dependency ratio = (population <15 and >65) / (population >15 and <65).
Source: United Nations Population Division.

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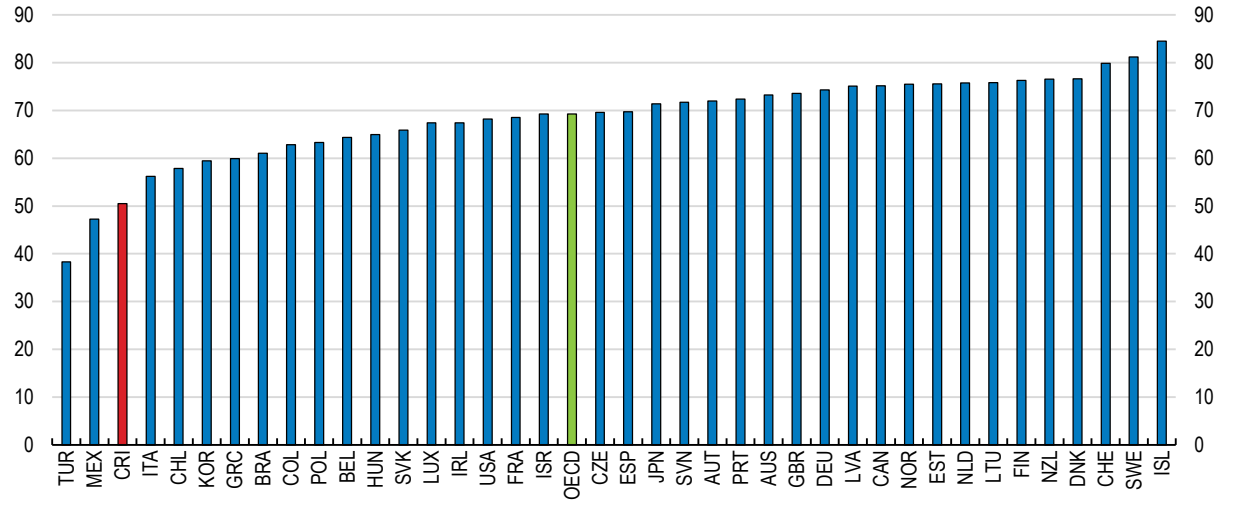
Boosting female labour market participation

Female labour force participation continues to lag the OECD average and other Latin American countries (Figure 1.29). Women taking on family care responsibilities face difficulties to complete education or continue to be in the labour force. Around half of all working-age women in inactivity report family caring responsibilities as the main cause for not looking for or taking up a job. Migrant women particularly struggle to get a foothold in the formal labour market, and tend to be trapped in informal jobs. The low female labour market participation, together with the higher informality rate, hampers women's access to pension entitlements. More than a third of inactive elderly women do not receive a pension of their own – more than twice as many as inactive elderly men (OECD, 2017[27]).

Recent progress in extending the coverage of early childhood education and care for 5 year old children and the introduction of flexible working arrangements help but further policy action is needed. Access to early childhood education should also be expanded for children under the age of 4. Promoting more flexible working time arrangements and introducing paid paternity leave entitlements for fathers would also help. OECD countries have on average 8 weeks of paid leave reserved for fathers. There is no leave entitlement for fathers in Costa Rica, except for public sector workers, who are entitled to one week of leave. Introducing a paid leave entitlement reserved to fathers, as done in most OECD countries would help to reduce hiring discrimination against women in the workplace and change gender perceptions and attitudes towards family care.

Figure 1.29. Female labour market participation is low

Female labour force participation rate (% of female population aged 15-65), 2018



Source: OECD Labour Force Statistics. Data for Costa Rica are from INEC and refer to 2019.

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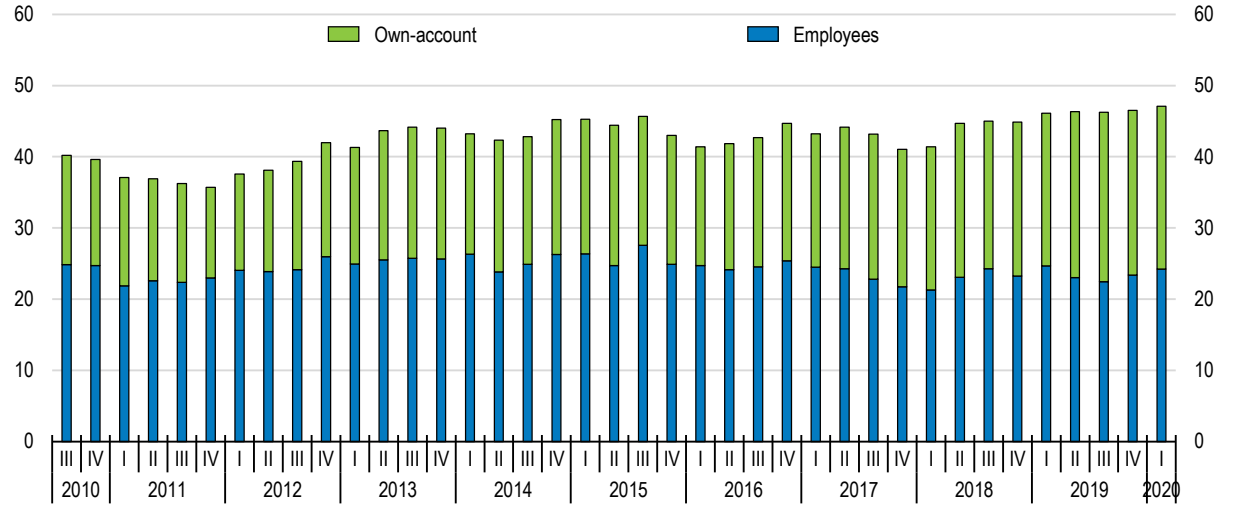
Reducing informality

At more than 45% of workers (Figure 1.30), informality is high and is likely to increase further after the COVID-19 shock. It particularly affects women and low-skilled workers. Migrants, people with disabilities and indigenous populations face also particular difficulties to access the formal labour market (OECD, 2017[27]). Informal workers will be particularly impacted by the pandemic. The authorities' response, including them as beneficiaries of the new cash transfer mechanism, will help to mitigate the impact and

is a valuable first step to help these workers transition towards government support programmes which could help them access formal employment. There is no silver bullet to reduce informality. A comprehensive strategy is required, as recommended in previous OECD Economic Surveys (OECD, 2016[33]); (OECD, 2018[7]). Such a strategy should cover multiple policy areas, including labour and business regulations, taxes or skills. The authorities set up a number of roundtables to hold discussions with all relevant stakeholders about how to boost formalisation.

Figure 1.30. Informality is high

% of total employed population



Note: Informality is defined as the percentage of workers in employment 1) not contributing to the social security system, 2) unpaid workers or 3) self-employed workers and employers who have companies that are not registered in the National Property Registry and do not keep a formal accounting.
Source: Instituto Nacional de Estadística y Censos: Encuesta Contigua de Empleo.

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On the tax side, the authorities are stepping up efforts to reduce informality and have recently introduced lower employer and employee's social security contributions for informal companies that become formal. The reduced contribution rates are temporary (4 years) and targeted at small firms (1 to 5 workers) in order to contain tax revenue losses. Experience in other Latin America countries, notably Colombia (OECD, 2019[14]), shows that reducing social security contributions can help to lower informality. The authorities have also launched an ambitious initiative to overhaul the employment services agency, moving to a single-window scheme and introducing profiling mechanisms. This is a welcome initiative, as employment services have so far remained under-developed and fragmented (OECD, 2017[27]). These new procedures, once fully implemented, would help to connect people to jobs and could have a material impact to curb informality, as they will help workers get the support and skills needed to access formal jobs.

Adapting regulations to facilitate compliance is another way to encourage job formalisation. Following previous OECD recommendations, the number of minimum wages has been reduced from 26 to 16, through social dialogue with employers and trade unions, with additional plans to reduce this number to 11. This is still a high number, suggesting that there is further room to make the minimum-wage system more job-friendly. There is also room to reduce regulatory barriers for the formalisation of firms (chapter 2), notably by reducing the cost and administrative burden to register firms.

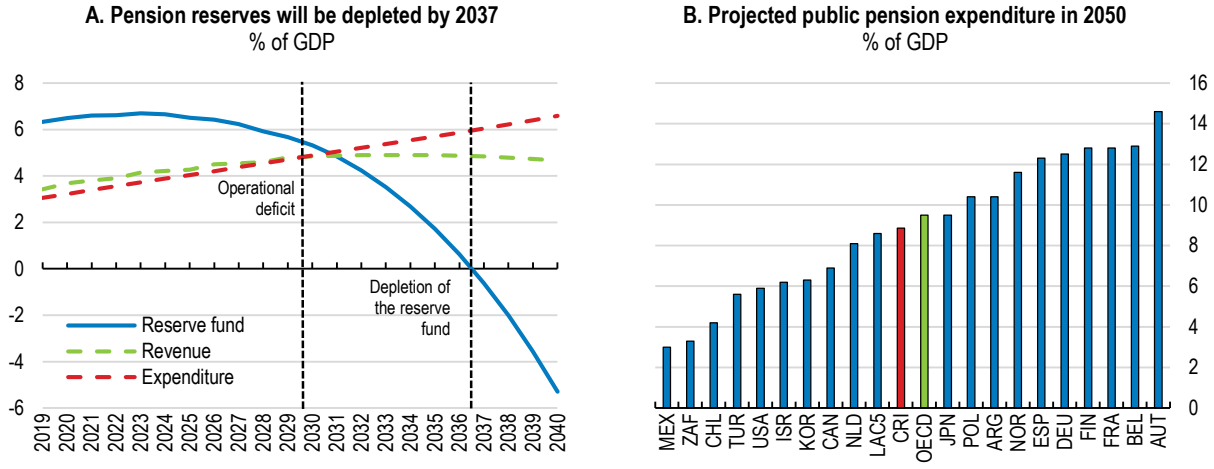
Improving the sustainability of the pension system

Population ageing will imply significant pressures for the pension and health care systems, whose financing is heavily dependent on employment-linked contributions and is also hampered by increasing labour market informality. Recent efforts to improve efficiency in the health system are paying off and waiting times for surgical operations and the number of pending cases have declined. Policy efforts are also needed to improve the sustainability of the pension system.

The pension system in Costa Rica stands out in the region for its high coverage, making the pension system a key pillar for inclusiveness. The Costa Rican pension system comprises four pillars: 1) a contributory defined benefit scheme; 2) a non-contributory regime paying a minimum pension (below the poverty line), which is financed from the government budget; 3) a compulsory contributory defined-contribution scheme; and 4) a voluntary defined contribution scheme. In addition, there are special regimes for some public employees, such as those in the judiciary.

The contributory system does not generate enough resources to be sustainable in the medium term. Given the current demographic trends, a recent actuarial study shows that the system will run operational deficits in about 10 years and the reserves will be depleted in 15 to 20 years (Carranza and Jiménez, 2019[38]). Public expenditures on pensions are projected to reach 9% of GDP by 2050, placing Costa Rica close to the OECD average (Figure 1.31). The gap between pension expenditures and revenues will have to be financed by the reserve fund as of 2030 and, once the reserve fund is depleted in 2037, by the central government budget.

Figure 1.31. The pension system does not generate enough resources



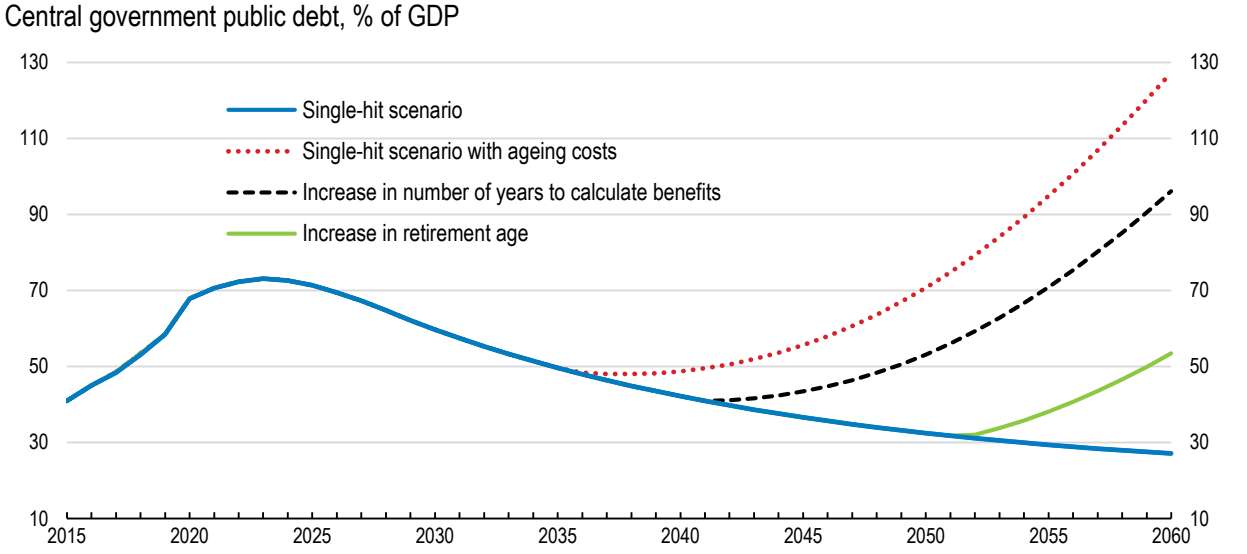
Note: Panel A reflects Caja Costarricense de Seguro Social's pension income, expenditure and reserve fund evolution scenario based on the actuarial study conducted by Carranza and Jiménez (2019[38]). This scenario assumes that pension contributions increase by two percentage points by 2029, an annual inflation rate of 4%, a target contributory coverage rate of 70% as of 2050 and average annual real rates of wage growth and return on pension fund investment of 1.8% and 3%, respectively. The GDP ratios are obtained using the long-term nominal GDP growth assumptions in the baseline scenario of the debt sustainability analysis in this Survey. The data point for CRI in Panel B reflects 2050 projection of Caja Costarricense de Seguro Social. Projections for the other countries are taken from OECD's Pensions at a Glance database.
Source: Carranza and Jiménez (2019[38]); Caja Costarricense de Seguro Social; OECD Pensions at a Glance database; and OECD calculations.

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Recent actions by the authorities include parametric changes in the judiciary segment of the pension scheme. However, the pension-to-wage ratio is around 85% in Costa Rica, considerably larger than the OECD average of 59% (OECD, 2017[27]). Furthermore, although the statutory retirement age is 65, women can opt for early retirement at the age 60 and men at the age 62, with full pension if a minimum number of contributory years is achieved.

To ensure medium- and long-term sustainability, there is a need to make further parametric changes. Raising contributions should be avoided, as employer's social security contributions are already the highest among the OECD countries (OECD, 2017[27]). Further increases are likely to trigger higher informality. Instead, all social security charges, a share of which are currently used to finance anti-poverty programmes or a public bank, should be used to finance the pension and health systems, using the general budget to finance other programmes. Using the average lifetime wage to calculate pension benefits, instead of the last twenty years of wages, would strengthen the link between contributions and pensions and improve the sustainability of the system. Decoupling the calculation of pension benefits bases from the minimum wage would avoid sharp rises in pension costs, as illustrated by Brazil. Linking the statutory retirement age to increases in life expectancy or reducing the possibilities of opting for early retirement would also help to maintain contributor-to-beneficiary ratios that are consistent with pension sustainability. Debt sustainability analysis showing the impact of different reforms suggests that, even with significant pension reforms, ageing will add to public debt in the long term (Figure 1.32). This can be regarded as lower bound estimates, as ageing will also entail additional health care and long term care costs.

Figure 1.32. Financing pension deficits can hamper public debt dynamics



Note: "Single-hit scenario" refers to the scenario presented in Figure 1.14. In "Single-hit scenario with ageing costs", the income of the pension system starts falling short of its expenditures in 2030 and the pension fund will be depleted by 2037 as depicted in Figure 1.31. Once the pension fund is depleted, the gap between pension expenditures and revenues is assumed to be financed by the central government budget. "Increase in number of years to calculate benefits" assumes that reference pension salaries are calculated by using the highest 300 monthly wages rather than the last 240 monthly wages. "Increase in retirement age" assumes that the effective retirement age is increased to 65.
Source: Carranza and Jiménez (2019[38]); OECD calculations.

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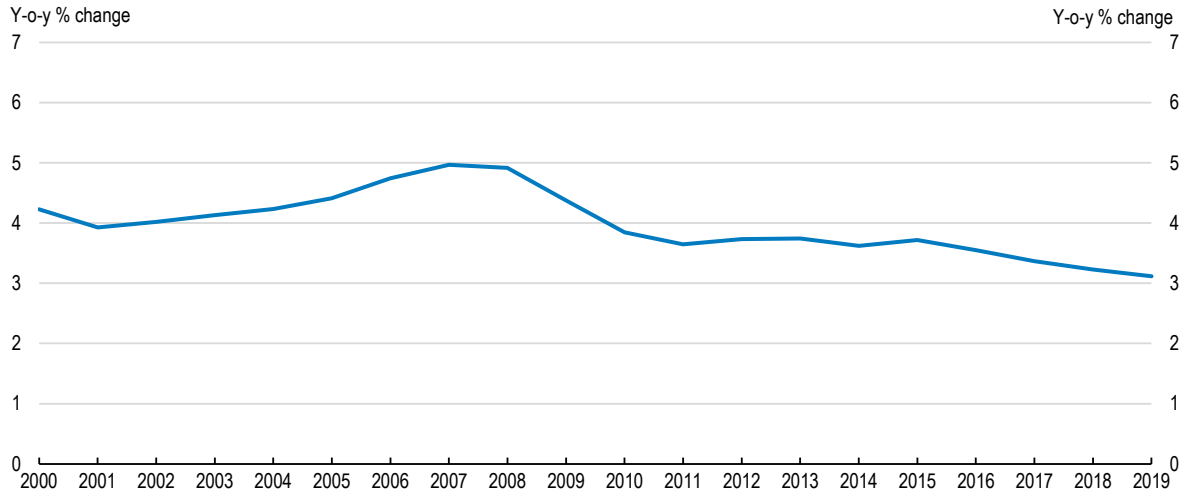
Costa Rica's pension system has a highly concentrated asset portfolio, as 95% of the contributory defined benefit pillar assets are invested in general government debt, and 87% on central government debt (SUPEN, 2019). The third pillar has a more diversified portfolio, yet general government debt represents 74% of its assets. Therefore, a downgrade in the credit classification of Costa Rica would have a severe impact on the system's sustainability. As the government itself guarantees CCSS, adverse feedback loop risks are significant. A more diversified financing strategy, decreasing investment in government securities is key to reduce risks.

Broadening growth sources and boosting productivity

Medium-term growth prospects have weakened

Over the last decade, the growth potential of the economy, which measures how fast GDP can grow sustainably, has declined substantially from around 5% in 2009 to now less than 3% (Figure 1.33), as productivity is weak. Consistently, the income gap with OECD countries remains large, due to comparatively weak productivity (Figure 1.33 and Figure 1.34). Further convergence towards higher living standards will therefore hinge on boosting productivity growth.

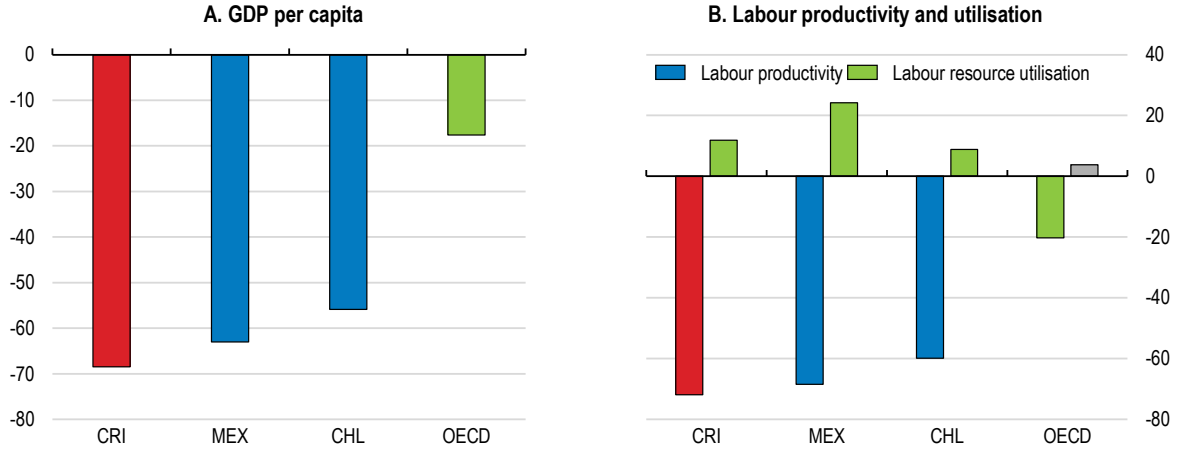
Figure 1.33. The economy's growth potential has declined



Source: OECD Economic Outlook database.

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Figure 1.34. Income gaps with the OECD are large due to low productivity

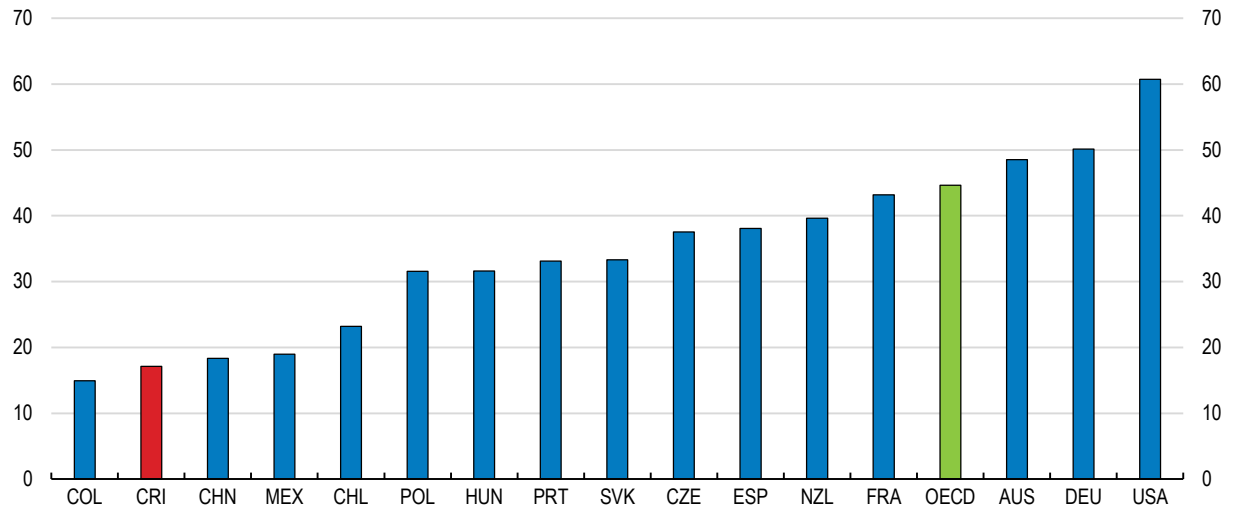


Note: Compared to the weighted average using population weights of the 18 OECD countries with highest GDP per capita in 2018 based on 2018 purchasing power parities (PPPs). The sum of the percentage difference in labour resource utilisation and labour productivity do not add up exactly to the GDP per capita difference since the decomposition is multiplicative.
Source: OECD National Accounts database; OECD Productivity database; and OECD Economic Outlook database.

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Figure 1.35. Labour productivity is relatively low

1000s of PPP-adjusted USD per capita, 2018 or latest available year



Note: OECD average calculated as the simple average across OECD countries with available data.
Source: OECD Productivity database.

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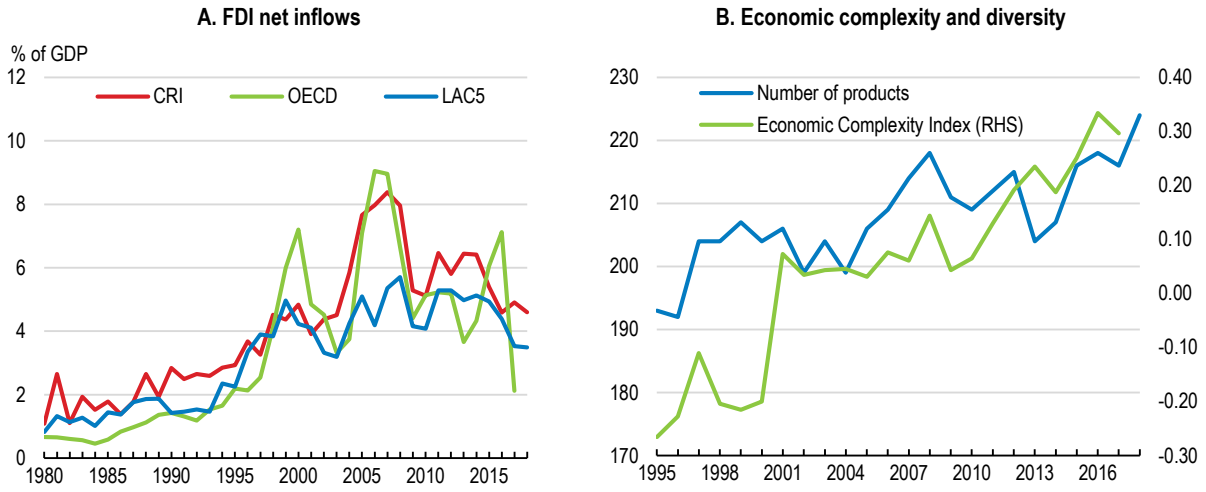
Boosting productivity of local firms

Costa Rica remains a dual economy, combining an innovative and dynamic export sector with another sector mainly composed of local SMEs which are unable to benefit from the opportunities provided by integration into the global economy. Boosting productivity will require setting the right conditions for domestic companies to thrive and at the same time, maintaining and reinforcing a long-standing commitment to trade and foreign direct investment.

Costa Rica's strategy to open up has been successful to attract significant flows of foreign direct investment, which have shifted from low value-added sectors, such as agro-industry, to medium and high value ones, such as advanced manufacturing, medical devices and IT services. This has translated into an increasingly diversified and sophisticated exports basket (Figure 1.36 and Figure 1.37, which will help during the recovery. Further policy efforts to promote diversification are underway, with a particular focus on the agriculture sector and rural areas (Descubre, 2019[39]).

Free trade zones play a central role in this successful diversification strategy and there is multiple evidence for positive spillovers between foreign-owned firms and domestic firms (OECD, 2018[7]); (Alfaro-Urena et al., 2019[40]); (Sandoval et al., 2018[41]). Boosting the productivity and competitiveness of local firms to help them reach their full potential would strengthen the potential for even stronger spillovers. Improving the regulatory framework is particularly important. Costa Rica has made significant progress into strengthening its competition framework and improving the governance of state-owned enterprises, but there is further room to improve regulations (chapter 2). There is also room to boost the competitiveness of Costa Rican firms by improving the innovation performance and closing infrastructure gaps.

Figure 1.36. FDI has increased and the export basket has become increasingly diversified

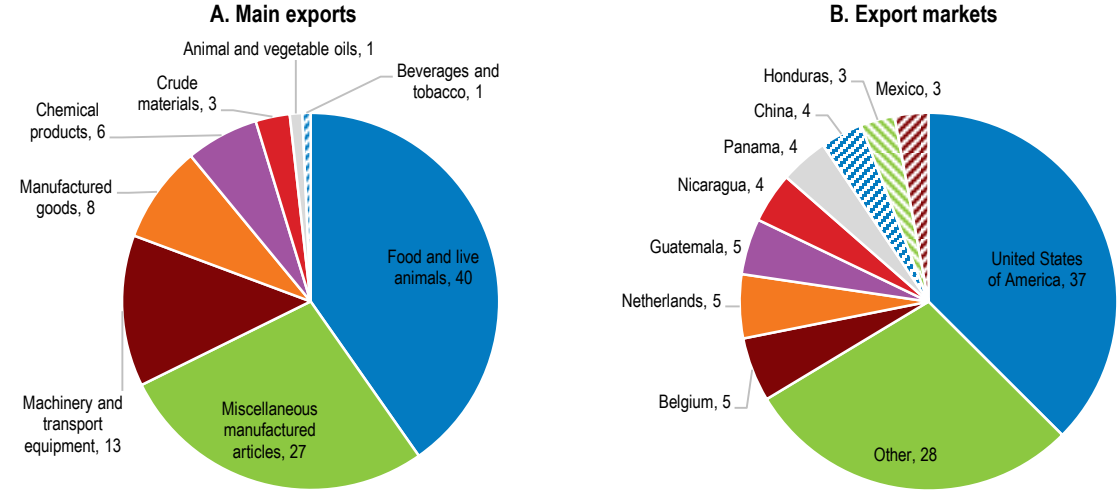


Source: World Bank World Development Indicators; UNCTAD; and the Harvard University Center for International Development Atlas of Economic Complexity.

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Figure 1.37. The United States is the main export market

Total goods, % of total, 2018



Source: UNCTAD.

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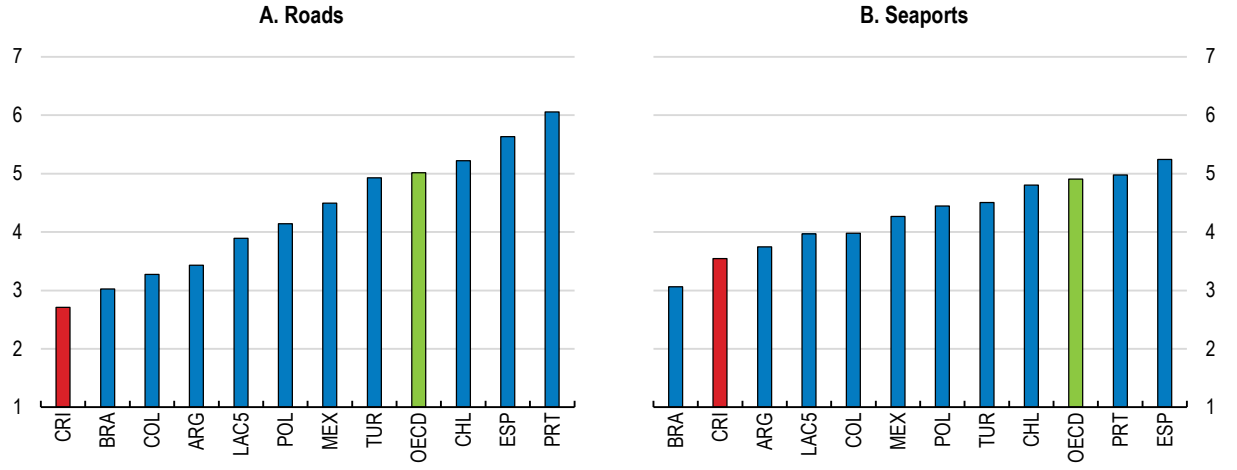
Boosting the innovation performance of SMEs would be key to closing their productivity gaps. Across OECD countries, universities play a key role to enhance SME innovation activities, as it is through close collaboration between universities and firms that the latter, especially small ones, can access advanced knowledge capital, laboratories and skills. In Costa Rica, interactions between public universities and the business sector are weak (OECD, 2016[33]). To trigger stronger interactions, Costa Rica could consider

changing the way public research is funded. Currently, most of the funding is allocated directly to universities, and contrary to most OECD countries, competitive funding based on performance criteria remains limited (OECD, 2017[42]). In addition, also contrary to OECD practices, there are no centralised and independent external evaluation mechanisms. Moving to performance-based and competitive funding and establishing the connection with the business sector as one of the eligibility criterion will increase incentives for universities to raise the quality and relevance of their research and innovation.

Infrastructure bottlenecks are large (Figure 1.38), particularly in road transportation. This not only hinders productivity but also has a detrimental impact on the environment and regional development. The road network is extensive but the quality is poor, suffering from years of underspending due to weak governance, planning and execution (Pisu and Villalobos, 2016[43]). Previous OECD Economic Surveys (OECD, 2016[33]); (OECD, 2018[7]) recommended institutional reforms to favour sounder planning and clearer accountability (Table 1.13), but the complex institutional setting continues to hamper infrastructure development. Standards for using cost-benefit analysis have been defined, but in practice, there has been little progress in having the public-works agencies using them. To achieve progress, a lead agency could get the responsibility to run the cost-benefit analysis for all projects. Given the fiscal situation, there is a growing recognition that private participation in infrastructure projects is needed. A public-private partnership (PPP) unit was created in the Ministry of Finance, and two PPP contracts have taken place since its creation. Experience in OECD countries provide valuable guidance on how to design PPP contracts (Box 1.8).

Figure 1.38. Costa Rica's infrastructure lags behind

Index 1 to 7 (best), 2018



Note: LAC5 refers to the simple average of Argentina, Brazil, Chile, Colombia and Mexico.
Source: World Economic Forum Global Competitiveness Indicators.

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Table 1.13. Past OECD recommendations on boosting productivity

Past recommendations	Actions taken since the 2018 survey
Adopt and implement the bill reinforcing the powers, independence and funding of the competition commission.	A bill has been approved, providing the competition authority with more independence, higher budget and the ability to focus more on investigating anti-competitive conduct (chapter 2).
Continue implementation of the action plan to increase consistency with the OECD Guidelines on Corporate Governance of State-Owned Enterprises.	Ministers and high-level government officials have been removed from boards. Selection of board members have been strengthened. The advisory unit has elaborated an ownership policy (chapter 2).
Continue with the planned 25 sector studies evaluating the exemption from competition and eliminate unjustified exemptions.	The new competition reform act has reduced exemptions to some acts in 5 sectors. The competition authority will run studies evaluating these exemptions (chapter 2).
Open entry to FinTech start-ups, with appropriate regulation.	6 FinTech firms out of 65 applicants have been granted access to the payments system to operate in the areas defined by the new regulation. The Central Bank has established a working group to discuss further modifications to regulations (chapter 3).
Establish a one-stop-shop for business registration and licensing. Introduce performance targets. Continue to improve the insolvency regime and trade facilitation.	Single window mechanisms are gradually being deployed. The new insolvency law is being discussed in the Legislative Assembly. Costa Rica is establishing joint custom facilities with Panama, and is increasing information exchange and coordination for border control activities with Nicaragua. The National Committee on Trade Facilitation (CONAFAC, by its Spanish acronym) was created, comprising public and private stakeholders, to improve conditions at borders, ports and airports and to streamline procedures.
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.	The authorities are identifying a portfolio of priority projects in railway, port, sanitation and health infrastructure and implementing new methodologies to identify infrastructure gaps and better control times and costs incurred when developing public infrastructure.

Box 1.8. PPPs: maximizing the value for money and avoiding contingent liabilities.

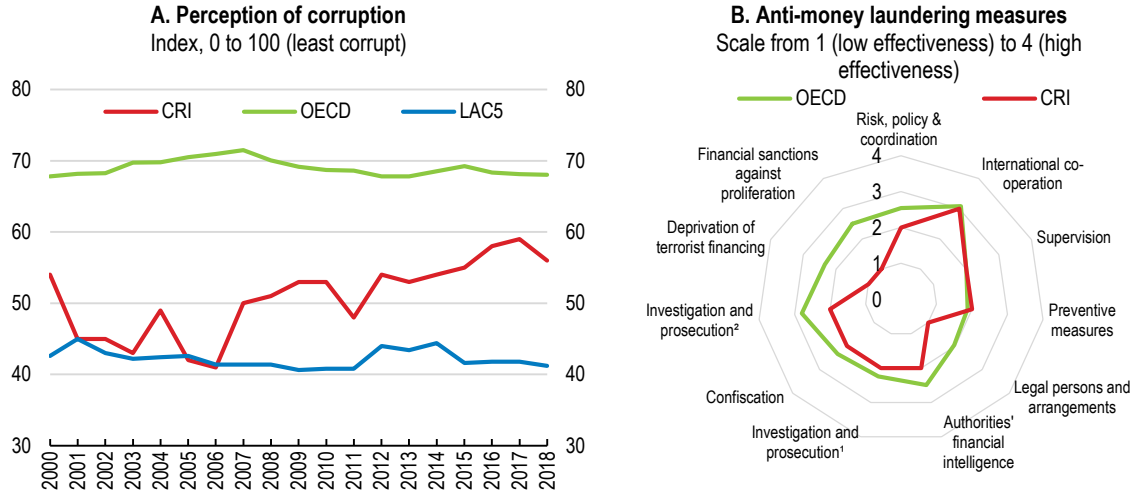
To attract private participation in financing and execution of infrastructure projects, both concessions and public-private partnerships (PPP) can be useful models. In the case of PPPs, projects should be chosen which represent good value for money. The literature and international experience suggest a number of factors that can ensure that a PPP is the right delivery model and maximises value for money. These include specifying contracts in terms of outputs instead of inputs to maximise benefits of private sector technical expertise and management skills; an ex ante evaluation of PPP versus public-sector comparators to identify the best way of contracting projects; and proper fiscal accounting of PPPs, including recording them as contingent liabilities in the budget. The latter is particularly important to avoid the build-up of off-balance sheet liabilities, which may end up jeopardising public finances, as experienced in several OECD countries. In that sense, it is crucial that the assessment and accounting of the budgetary implications of PPPs is timely and transparent and covers their whole life-cycle.

Corruption undermines confidence in institutions and fair competition, hampering productivity. It also hampers fiscal revenues and government's ability to deliver quality public services. Corruption also erodes trust in government and can lead to social and political instability. Perceptions of corruption in Costa Rica are lower than in other Latin America countries (Figure 1.39), but they have recently increased and are higher than in OECD countries. Policy efforts to reduce and prevent corruption are therefore warranted.

Whistle-blower protection is an essential tool for safeguarding the public interest and promoting accountability and integrity in public and private institutions. OECD countries are increasingly adopting whistle-blower protection legislation. Costa Rica has a number of protection mechanisms for whistle-

blowers, victims and witnesses of acts of corruption that apply at the criminal and administrative levels. However, there is currently no dedicated law that would provide protection of employees in the public sector from discriminatory or disciplinary action once they have disclosed wrongdoing (OECD, 2017[20]). Enacting a whistle-blower protection law or legal provision related specifically to protected reporting or prevention of retaliation against whistle-blowers would be an effective step to boost corruption prevention. In the private sector, protecting whistle-blowers can help businesses prevent and detect bribery. In the public sector, it can make easier to detect the misuse of public funds, waste and fraud.

Figure 1.39. Corruption perceptions are relatively low



Note: Panel A: LAC5 refers to a simple average of Argentina, Brazil, Chile, Colombia and Mexico. Panel B shows ratings from the FATF peer reviews of each member to assess levels of implementation of the FATF Recommendations. The ratings reflect the extent to which a country's measures are effective against 11 immediate outcomes. 1. Refers to money laundering. 2. Refers to terrorist financing.
Source: Transparency International Corruption Perception Index; and OECD calculations based on Financial Action Task Force (FATF) data.

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Transparency and an effective exchange of information are crucial to counteract and prevent corruption. Costa Rica has strengthened its compliance with the international standards on transparency and exchange of information to assist in the global fight against tax and financial crimes (OECD, 2019[44]). In particular, Costa Rica has recently enacted a new law aimed at implementing a centralised register for collecting identity and beneficial ownership information for all legal entities and arrangements. Ensuring full implementation of the law and improving the timeliness of providing requested information to partners are the next priorities.

Costa Rica recently strengthened its anti-bribery laws by introducing corporate criminal liability. Recent legislation on corporate liability comprehensively addresses issues such as the standard of liability, sanctions and procedure. The available sanctions against natural and legal persons have increased and the provision of mutual legal assistance to foreign countries has been prompt and effective. Despite these achievements, loopholes in the definition of the foreign bribery offence and its enforcement raise significant concerns (OECD, 2020[45]). Costa Rica's foreign bribery offence does not address some of the most common means of committing this crime. The offence's onerous intent requirement could leave most cases of foreign bribery committed through intermediaries unpunished. A briber may escape liability if a foreign official solicited the bribe. Foreign bribery enforcement has not received sufficient resources and priority. The Public Prosecution Service and the Attorney General's Office are both involved in foreign bribery enforcement, which may duplicate efforts and jeopardise cases. Costa Rica also needs to ensure that

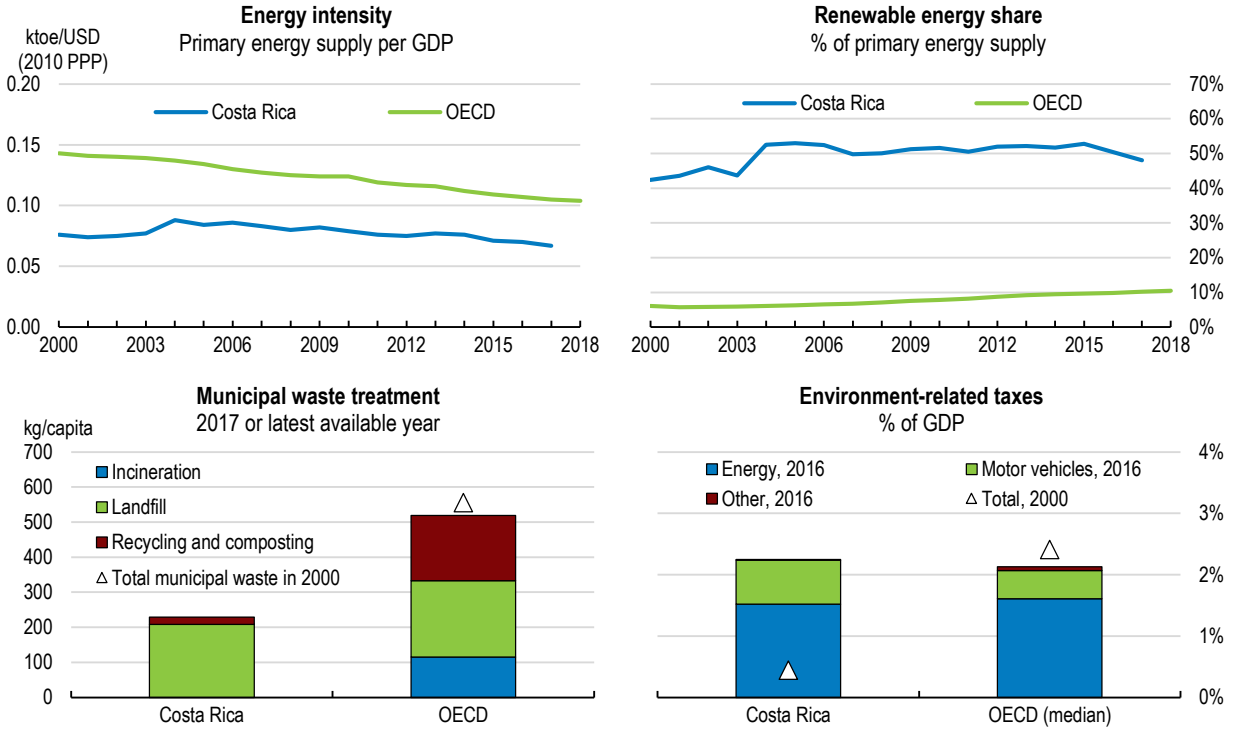
factors such as national economic interest do not influence the sanctioning of foreign bribery cases. It should also improve guidance and transparency for non-trial resolutions and collaboration agreements.

Green growth

Costa Rica has built a world renowned green trademark, centred on conservation, reforestation and national parks. This has been an important engine of economic growth and well-being for Costa Ricans. Costa Rica is also renowned for its biodiversity, holding almost 4% of the world's species. Protected areas, which cover 26% of the country, have contributed to reducing poverty in local communities, mostly through new job opportunities afforded by tourism (Ferraro and Merlin, 2014[46]); (Robalino and Villalobos, 2015[47]). Costa Rica exemplifies that protecting national resources pays off and can be an additional source of growth and jobs.

Costa Rica has recently adopted an ambitious plan to be a zero net emissions economy by 2050, in line with the objectives of the Paris Climate Change Agreement. With the goal of reducing greenhouse gas emissions, the plan includes significant measures in public and private transport, energy, industry, agriculture, waste management and rural, urban and forest management. Costa Rica is well positioned to achieve this target, as its economy is less energy intensive than the average OECD economy (Figure 1.40), and half of its primary energy supply is renewable, mostly hydro, geothermal and wind power. However, significant additional policy action is required particularly in the transport sector. The transport sector is the major source of greenhouse gas emissions, accounting for 54% of all CO2 emissions, and is also responsible for the increasing use of fossil fuels. Traffic congestions in the metropolitan area of San José are large and their cost is estimated to reach 4% of GDP (Estado de la Nación, 2018[48]).

Figure 1.40. Green growth indicators (selected)



Source: OECD Green Growth Indicators.

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The authorities aim at having 30% of the public transport fleet electric by 2035, with the goal of 85% electrification by 2050 and a shift of 95% of private cars to zero-emission vehicles. The authorities consider that the current electricity matrix, which has a 99% share of renewables, would enable that shift. This will, however, require substantial investment, which can be financed with green bonds (see also fiscal section).

Environment-related tax revenues have risen strongly, to some extent reflecting the increase in car use. There is scope to improve incentives to reduce pollution and emissions more cost-effectively. Diesel, fuel oil for processing and heating, natural gas and coal are taxed at low rates or not at all (OECD, 2017[49]). Aligning the rates of the fuel tax with the carbon content of the underlying fuels would be a step forward to develop the Costa Rica carbon market. Electric and hybrid cars benefit from reduced rates and exemptions from purchase and ownership taxes. While Costa Rica is an early stage of deploying electric mobility, over time it could also follow the example of Chile or Israel, where taxes are modulated according to pollution or emission performance, helping to limit air pollution. More generally, cars using petrol could be taxed by weight and emissions, as in Norway, to minimise environmental impacts as well as regressive distributional effects.

As zero-emission vehicles become widespread, Costa Rica will eventually need to move to comprehensive road use charging to internalise costs of car use and substitute transport fuel tax revenues. Well-designed policies for the use of revenues from higher energy taxes are key for citizen support. Research in some OECD countries suggests that it may be sufficient to use one-third of the revenues for transfers to low-income households to avoid real income losses (Flues and van Dender, 2017[50]). Costa Rica could also benefit from establishing smart metering and high-resolution pricing to encourage the use of energy when it is cheap.

Costa Rica has slightly improved wastewater treatment, in line with previous recommendations (Table 1.14), although there is still a critical need for further progress, as only 14% of wastewater is treated, while the world average is 60% (Estado de la Nación, 2018[48]). There is also a need to improve municipal waste treatment, as it is almost entirely landfilled, despite a greater promotion of waste recovery in the last decade. Enhanced producer responsibility schemes, which encourage waste prevention and recycling, can help. Costa Rica implements these schemes for 15 waste streams (OECD, 2020[51]). However, producers and importers are not required to meet targets for collection, recovery or recycling. Furthermore, municipalities could require separate waste collection or introduce pay-as-you-throw schemes. These link waste management fees to the amount of waste produced, with higher charges for unrecycled waste. Separate collection by municipalities was indeed foreseen in the 2016 National Strategy for waste separation, recovery and valorisation.

Table 1.14. Past OECD recommendations on green growth

Past recommendations	Actions taken since the 2018 survey
Improve public urban transport and wastewater management facilities.	No significant improvement in public urban transport. There are ambitious plans to move to electric transportation as part of the carbon-neutrality project. Wastewater treatment has increased slightly to 14%. It is expected to reach 35.5% in 2023.
Continue efforts to develop the carbon market and other climate change mitigation schemes.	No major actions taken on the carbon market. In 2019, Costa Rica launched the National Decarbonisation Plan, which aims to make the country one of the world´s first decarbonized countries.

MAIN FINDINGS	RECOMMENDATIONS
Further improving macroeconomic policies	
The fiscal deficit remains large and continues to increase. Fiscal space remains limited, making Costa Rica vulnerable to possible shocks. If the fiscal reform is not fully implemented, public debt will grow without bounds. Addressing the coronavirus outbreak is the overarching priority in the short-term.	**Any support to firms and households during the coronavirus crisis should be temporary and targeted to the most affected sectors.** **Prepare for increases in healthcare demand, including by boosting testing capabilities.** **Ensure that the fiscal reform is fully implemented without exceptions.** **Establish clear guidelines for the implementation of the fiscal rule.** **Eliminate tax exemptions benefiting more affluent tax payers.** **Allow that all spending categories can be adjusted when public debt exceeds 50% of GDP.**
Growth has decelerated, economic slack has widened and inflation is below the 3% target. As a response to the coronavirus outbreak, the central bank has cut interest rates by 150 bp, and deposit rates have fallen to a historically-low level. Prudential regulation has been adapted so that banks can re-profile loan repayment of borrowers facing difficulties.	**Be ready to ease monetary policy further to support the economy during the coronavirus outbreak.** **Continue to provide liquidity to the banking system to preserve its integrity and support confidence and continue to adjust prudential regulation as required during the coronavirus outbreak.**
The share of public spending subject to public procurement is low. A large share of government purchases is undertaken by state-owned enterprises.	Bring all purchases by all public entities to the central procurement system and limit the use of exceptions for direct contracting.
Public employee remuneration is complex, contributes to income inequality and accounts for half of total revenues.	**Adopt a single salary scale, streamline incentives schemes and make them performance-based.**
For placing its public debt, Costa Rica relies heavily in local investors, thus putting upward pressure on interest rates. Instruments in foreign currency may provide some short-term savings but entail exchange rate risks.	**Create a public debt management agency.** **Target attracting foreign investors to instruments issued in local currency.**
Regulatory distortions fragment the banking market, hamper competition and efficiency and translate into high interest rate spreads.	Improve transparency of banks' health, including by publishing individual stress tests. **Gradually reduce existing regulatory distortions affecting public and private banks, including, in due time, phasing out the public guarantee of state-owned bank liabilities.**
Pension system assets are highly concentrated in government debt. This creates risk of adverse feedback loops.	Adopt a more diversified investment strategy, reducing the share of government securities.
Improving equality of opportunities	
Poverty remains high despite increasing social programmes.	**Improve targeting and focus social spending programme on low-income individuals.**
Female labour participation is very low.	**Continue to increase the supply of affordable childcare.** **Introduce a paid leave entitlement reserved to fathers.**
At more than 45% of workers, informality is high. Social security contribution rates are high in international perspective.	**Establish a comprehensive strategy to reduce informality, including shifting part of the tax burden from social security contributions to property taxes and strengthening enforcement mechanisms.** Simplify further the minimum wage system.
Skill mismatches are large. Recent increases in universities budget have been channelled mostly to increase salaries of administrative staff. **PISA results are low and declining.**	**Link part of universities funding to responding to current and future labour market needs.** **Strengthen teacher recruitment, selection and training based on regular teachers evaluations.**
The demographic bonus is ending and the pension system will run operational deficits in 10 years.	**Devote all social security contribution charges to finance the social security system.** Use the average lifetime wage to calculate pension benefits. **Link the retirement age to increases in life expectancy.**
Boosting productivity	
Innovation outcomes outside the free trade zones are weak. Interactions between universities and the business sector are scarce.	Finance public research based on competitive and performance-based criteria and establish independent evaluation mechanisms.
Corruption perceptions have recently increased.	**Enact a law or legal provision related specifically to protect reporting or prevent retaliation against whistle-blowers in the public sector.**

Strengthening green growth	
The transport sector is the major source of emissions. The planned full electrification of public transport requires substantial investment.	Issue green bonds.
As zero-emission vehicles become more frequent, Costa Rica will eventually need to substitute transport fuel tax revenues.	Modulate vehicle taxes according to pollution or emission performance. Introduce road use charges.
Waste is a significant source of emissions. Costa Rica has slightly improved wastewater treatment but only 14% of wastewater is treated, while the world average is 60%.	Require separate waste collection by municipalities and improve wastewater treatment.

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2 Enhancing business dynamism and consumer welfare with regulatory reform

Regulations of product markets serve legitimate objectives but, when ill-designed, can impose unnecessary restrictions on competition, and therefore on business dynamism, productivity and ultimately well-being. A recent update of the OECD's Product Market Regulation indicator for Costa Rica shows that there is ample room to improve regulations. Costa Rica's economic development is hindered by heavy state involvement and high barriers to entry, compared to both OECD countries and regional peers. This chapter discusses options to improve product market regulations, based on international best practices. Regulatory reform can improve consumer welfare by boosting competition and thus lowering prices of key goods and services, which in turn increases the purchasing power of low-income households and reduces poverty. By raising productivity, stronger competition will also allow higher wages. Reducing barriers to entry can facilitate firm creation, boosting investment and jobs.

Pro-competition regulation in product markets helps to boost living standards (Koske et al., 2015[1]). Competition raises output per capita by increasing investment and employment as well as by encouraging companies to be more innovative and efficient, thereby lifting productivity (e.g. (Bouis and Duval, 2011[2]); (Égert and Gal, 2016[3])) and the ability to pay higher wages. Competition reduces prices of key goods and services, boosting households' purchasing power and firms' competitiveness. Thus, OECD countries have gradually made their regulations in product markets more competition friendly over the past decades, reduced state involvement in business sectors, thereby making it easier to create and expand firms, and facilitating the entry of foreign products and firms. In some cases regulations were phased out, whereas in others regulations were modified with a view to enhance competition.

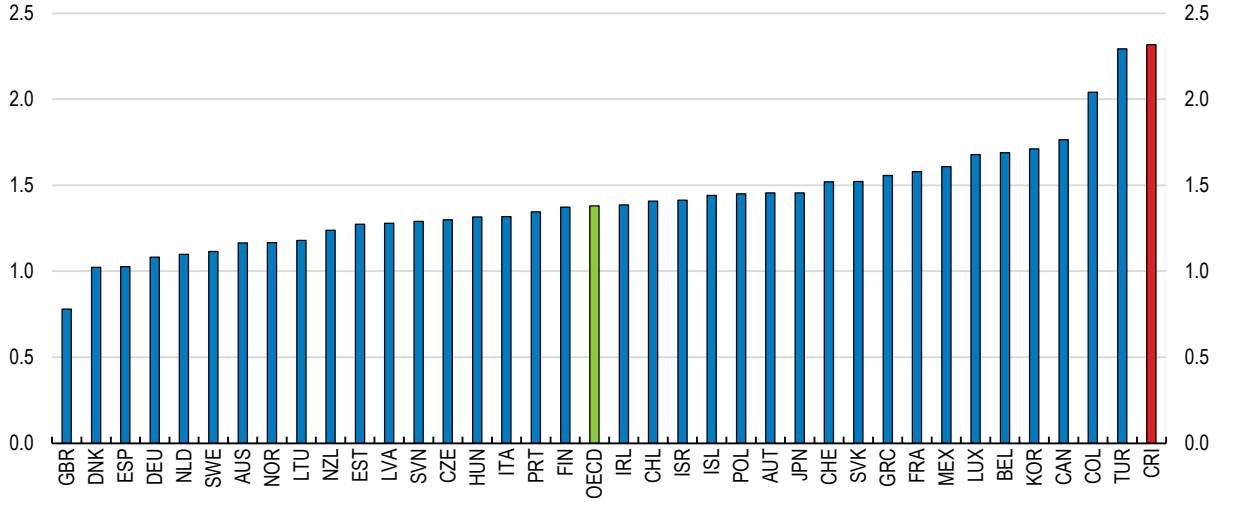
Costa Rica itself can attest to the benefits of having a market-friendly regulatory stance, as this has been a building block for its successful foreign direct investment framework. As a result, Costa Rica hosts in its free trade zones modern and highly productive firms operating in high value added sectors, such as services and medical devices. There is abundant evidence of positive spillovers between firms in and outside the free trade zones (OECD, 2018[4]), (Alfaro-Urena et al., 2019[5]), (Sandoval et al., 2018[6]). But firms productivity in the non-exporting sector clearly lags behind. Productivity is hampered by multiple factors, such as skills and infrastructure gaps or weak innovation, as described in Chapter 1. But one critical factor hampering productivity is the costly and burdensome regulatory framework faced by local firms. This chapter examines this issue in detail through the lens of the OECD's Product Market Regulation indicator.

Regulations are burdensome

According to a recent update of the OECD's Product Market Regulation indicator (Vitale et al., 2020[7]), Costa Rican markets are subject to regulations more stringent than in any OECD country (Figure 2.1). Latin American peers, such as Chile, Mexico and Colombia, perform significantly better than Costa Rica.

Figure 2.1. Costa Rica has more stringent regulations than any OECD country

Overall PMR score, index from 0 to 6 (most restrictive)



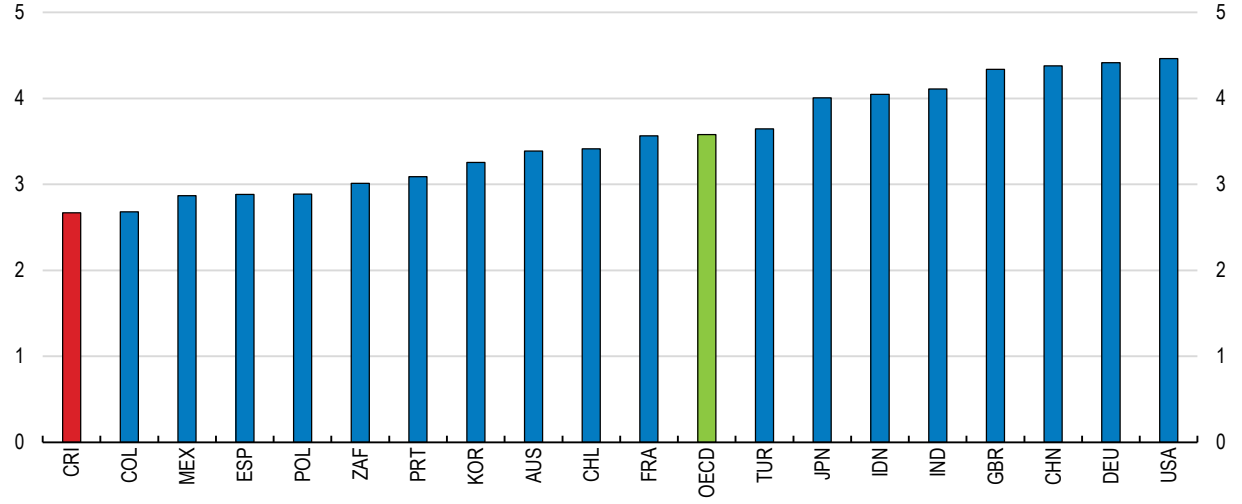
Note: Data refer to 2018.
Source: OECD Product Market Regulation database.

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Other rankings examining the regulatory stance confirm that regulations in Costa Rica are among the most burdensome in advanced and emerging economies (Figure 2.2). Costa Rica has also been slipping positions in the World's Bank doing business rankings, and its current position (74th) is below other peer countries in Latin America, such as Chile (59th), Mexico (60th) or Colombia (67th), as well as other emerging economies, such as Thailand (21st) or Morocco (53th).

Figure 2.2. The regulatory burden is perceived to be very high

Index from 1 to 7 (best), 2018



Source: World Economic Forum Global Competitiveness Indicators.

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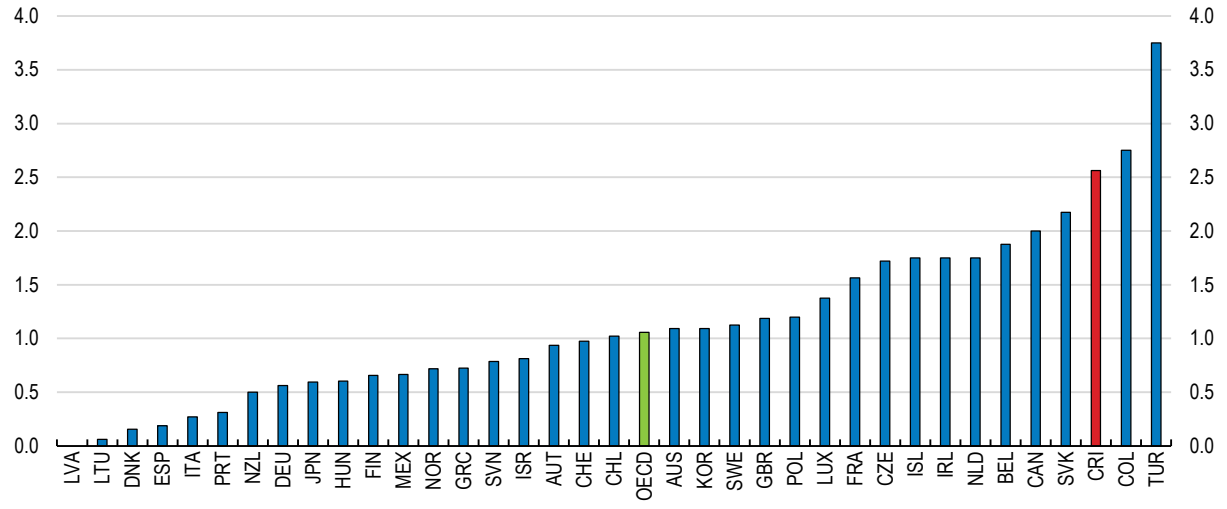
Examining the Product Market Regulator indicator results at sub-indicator level provides further valuable insights. Only two OECD countries have higher barriers administrative burdens than Costa Rica (Figure 2.3). Large barriers to entry are due to a combination of lengthy and costly licencing and permits systems and administrative burdens on small firms. These barriers to entry particularly affect SMEs. Dealing with regulations involve fixed costs, which are a bigger burden for SMES than for large firms, as SME's turnover is smaller. Entry barriers protect existing activities and firms at the cost of new dynamic and productive firms and jobs. This hampers competition, which in turn, creates rents and lowers the share of wages in value-added, worsening income distribution. Higher prices for consumers reduce purchasing power, affecting disproportionally low-income households.

State controls are particularly restrictive in Costa Rica (Figure 2.4). The scope of the state-owned enterprises sector is very wide, with significant room to improve governance. The mobile telecommunication sector was opened to competition following the adoption of the Central America Free Trade Agreement. A significant number of other sectors remain state monopolies or state-owned enterprises play a dominant role. This includes key sectors, such as electricity, transport, banking, insurance and petroleum products.

Costa Rica fares somewhat better in terms of barriers to trade and investment (Figure 2.5), reflecting the transparency and accountability of its trade and investment framework. Costa Rica's tariffs are on average 4% higher than in the OECD. The top 20 highest tariffs apply to some agricultural products, such as meat, dairy products, sugar and rice.

Figure 2.3. Administrative burdens on start-ups are high

Index from most (0) to least (6) competition-friendly regulation

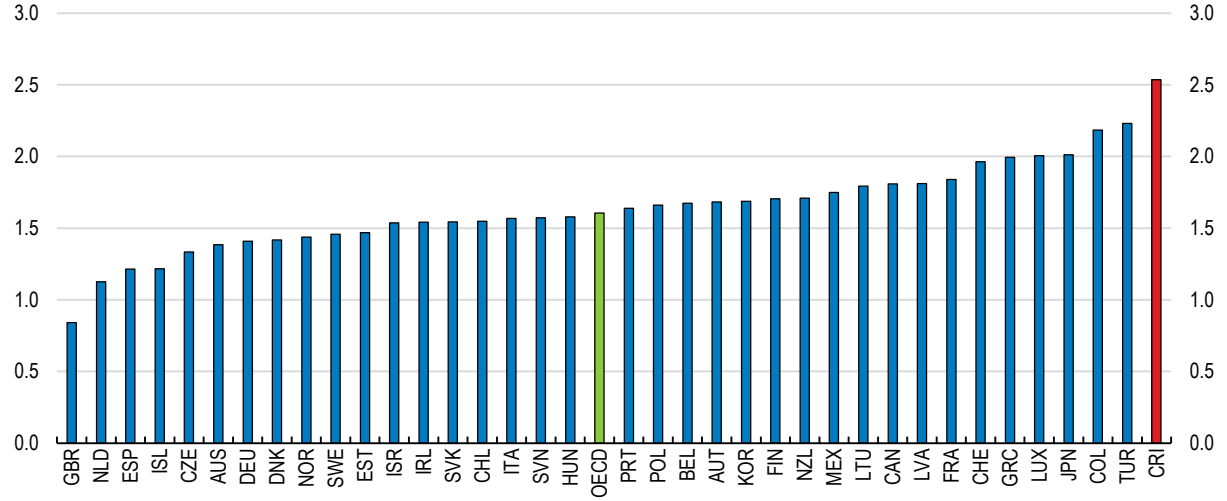


Note: Data refer to 2018.
Source: OECD Product Market Regulation database.

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Figure 2.4. Distortions induced by state involvement are large

Index from most (0) to least (6) competition-friendly regulation

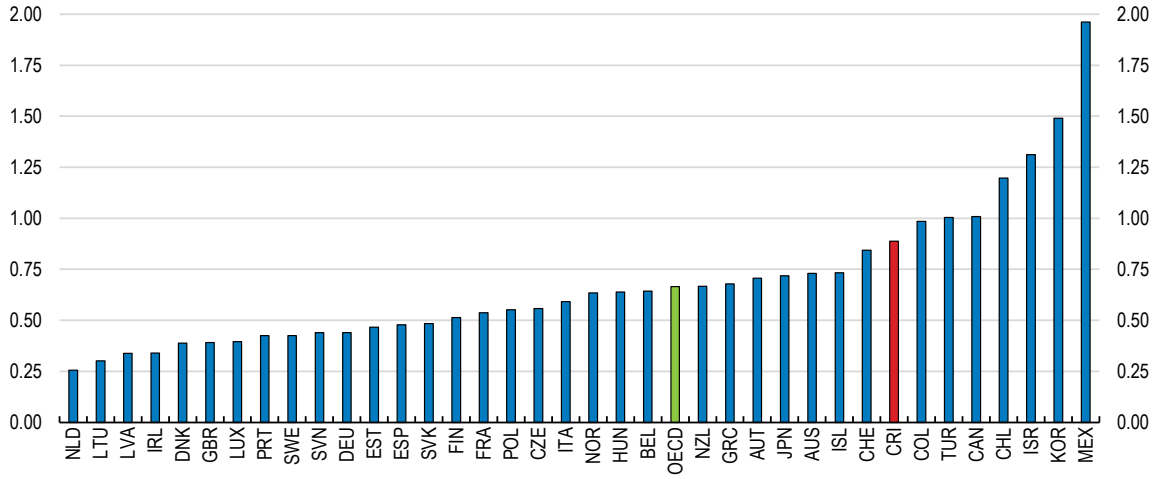


Note: Data refer to 2018.
Source: OECD Product Market Regulation database.

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Figure 2.5. Barriers to trade and investment are closer to the OECD average

Index from most (0) to least (6) competition-friendly regulation



Note: Data refer to 2018.
Source: OECD Product Market Regulation database.

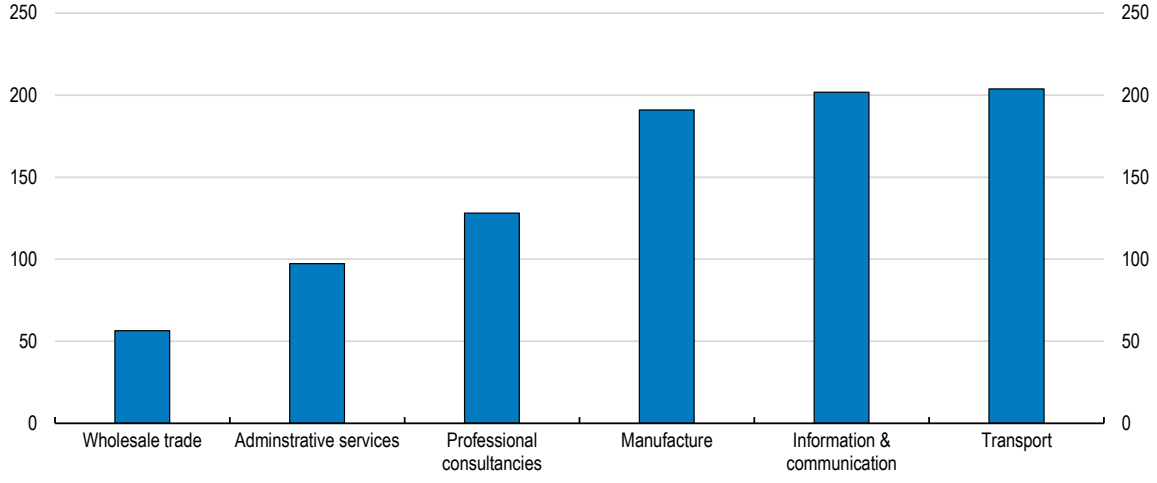
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Costa Rica is a dual economy

Costa Rica remains a dual economy. Highly productive exporting firms in high value added sectors, predominantly located in free trade zones coexist with a non-exporting sector, mainly composed of local SMEs, which clearly lag behind in terms of productivity (Figure 2.6). As a consequence, overall, Costa Rica has lower labour productivity than most emerging economies, including China, or regional peers such as Chile and Mexico (Chapter 1).

Figure 2.6. Firms outside the free trade zone lag behind

% difference in median labour productivity between firms within free trade zones and the non-exporting sector



Note: The bars show the percentage difference in median labour productivity (expressed as value added per worker) of firms in and outside free trade zones; some sectors are not reported because of no or too low number of firms operating in free trade zones.
Source: OECD calculations; and Central Bank of Costa Rica.

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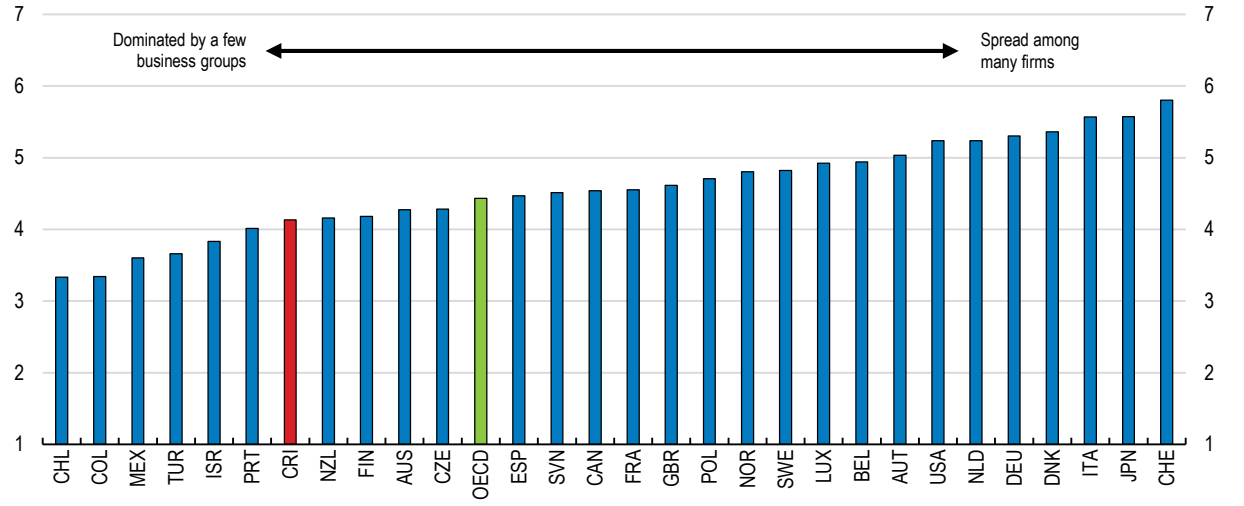
Two factors help explain the productivity gap in Costa Rica. On the one hand, a high proportion of resources are used in firms of lower productivity, such as micro and informal firms. On the other hand, even the average and typical firm is less efficient than the average firm in other economies (Monge-González and Torres-Carballo, 2014[8]). The lower productivity of the typical firm can be linked to lower growth over the life cycle, as few Costa Rican firms grow over time (Figure 2.7). This hinders investment, jobs, knowledge spillovers, and specialisation of employees.

These features are typical of economies where competition is not strong enough to create an environment in which the disciplining effect from new entrants prompts incumbents to become more efficient (Klapper et al., 2006[9]), allowing resources to flow to their most productive uses. Competition has been weak in key sectors of the Costa Rican economy, such as banking, food, electricity or transportation (OECD, 2016[10]), contributing to low productivity, low wages and higher prices to consumers. A relatively small number of large firms dominate the economy (Figure 2.7), indicating the need to improve regulations to promote a more competitive business environment. Computations undertaken for this survey signal that mark-ups are higher in Costa Rica than in most OECD countries (Box 2.1).

Weak competition tends to translate into relatively high prices of goods for consumers and of inputs for firms. Both features can be found in Costa Rica (Figure 2.8). This has led to a general categorization of Costa Rica as an expensive country, where a basic basket of goods and services costs significantly more than in neighbouring countries (Angulo, 2014[11]). Private firms report that rising costs is the main barrier to their operations (UCCAEP, 2019[12]), particularly in the agriculture and manufacturing sector. This is hampering Costa Rica's competitiveness in low-value added sectors (World Bank, 2015[13]).

Figure 2.7. A few firms dominate the markets

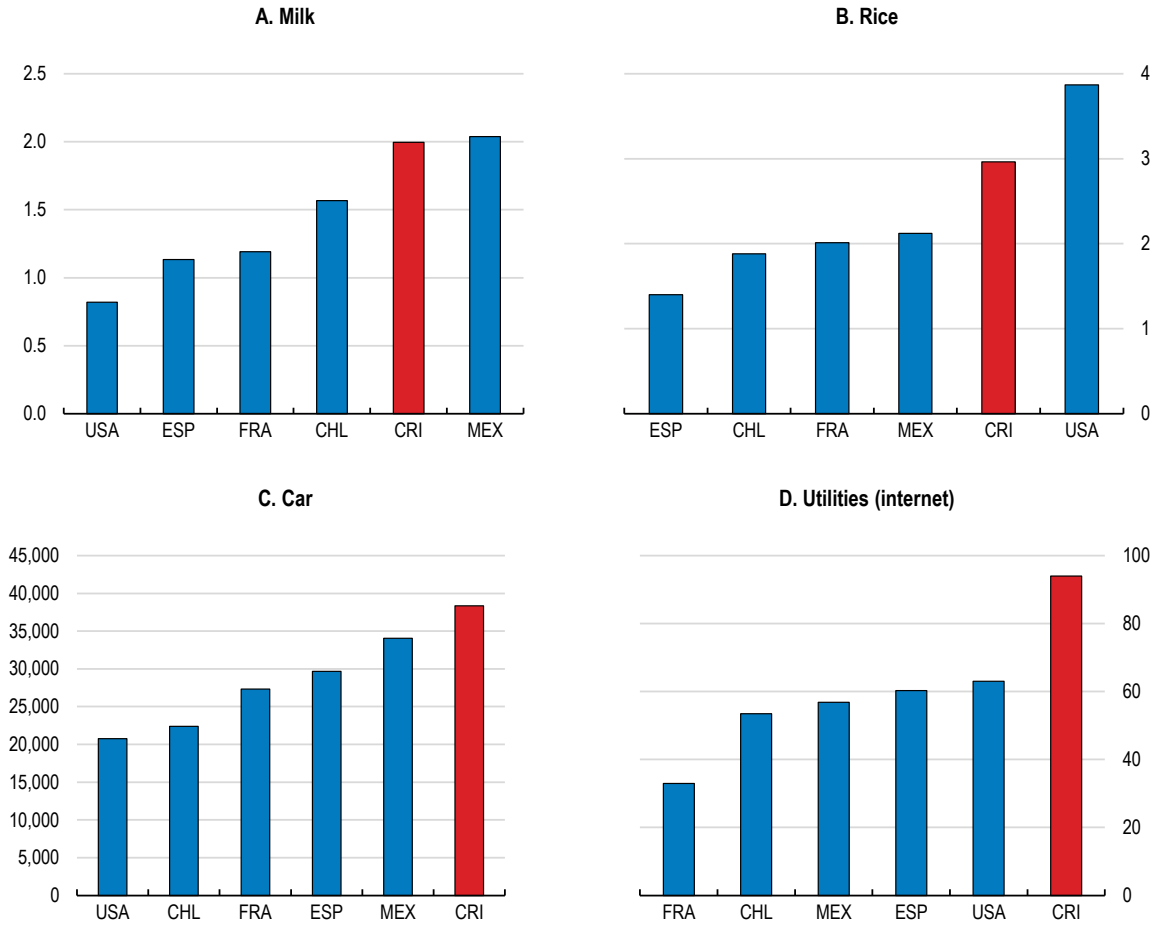
Extent of market dominance, 2019



Note: This indicator shows the extent of market dominance, 1-7 (best).
Source: World Economic Forum, The Global Competitiveness Index 4.0 2019 dataset (version 04 October 2019).

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Figure 2.8. Prices are high



Note: Car prices are proxied by the price of a Toyota Corolla or equivalent new car. Mobile prices are those of 1 min. of prepaid mobile tariff local. Prices are converted to PPP dollars by using 2018 conversion rates.
Source: OECD computations based on Numbeo; and OECD data.

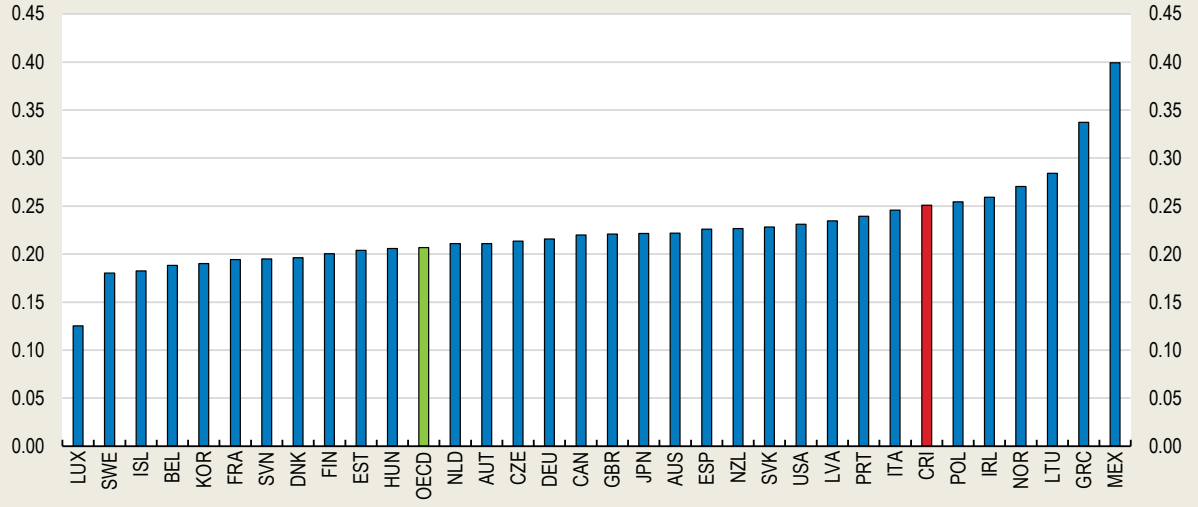
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Box 2.1. Measuring market power in Costa Rica

The pressure of competitors and new entrants leads firms to set prices that reflect costs, which is to the benefit of consumers. In the absence of competition, firms gain market power and command high prices (De Loecker and Eeckhout, 2017[14]). Measuring market power can thus provide valuable insights about the degree of competition. Mark-ups measures help to assess to what extent firms are able to price their goods above their costs. High mark-ups can indicate weak competition in an industry or sector. Mark-up indicators have advantages over other measures aimed at measuring market power such as market concentration measures, which can lead to misleading results. For example stronger competition may lead to more productive firms gaining market share resulting in higher, not lower, concentration (IMF, 2019[15]). Measures of mark-ups at sectoral level, computed for this Economic Survey (Gonzalez Pandiella, Rodriquez Vargas and Tusz, 2020[16]), suggest that mark-ups in Costa Rica are higher than in most OECD countries (Figure 2.9). Transportation, manufacturing and food and accommodation are among key sectors where mark-ups indicators are highest and larger than in OECD countries (Figure 2.10)

Figure 2.9. The average mark-up at sector level is relatively high

Index from 0 to 1 (highest mark-ups)

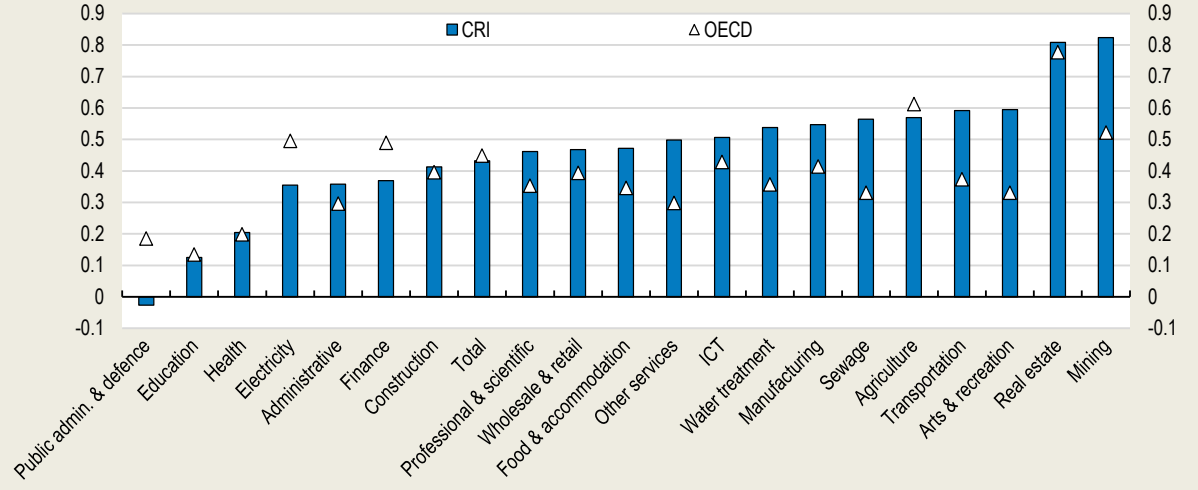


Note: Mark-ups are defined as gross output divided by gross operating surplus, following the methodology presented in (Nordas and Ragoussis, 2015[17]) and (Egert and Vindics, 2017[18]).
Source: OECD calculations based on OECD Structural Analysis (STAN) database; and OECD Economic Outlook database.

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Figure 2.10. Most sectors have larger mark-ups than the OECD average

Index from 0 to 1 (highest mark-ups)



Source: OECD calculations based on Structural Analysis (STAN) database; OECD Economic Outlook database.

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Low income households could benefit the most from enhanced regulations and competition

Strengthening competition can boost living standards and welfare, by increasing productivity and product quality and lowering product prices (OECD, 2016[10]). Reinforcing competition can also make growth more

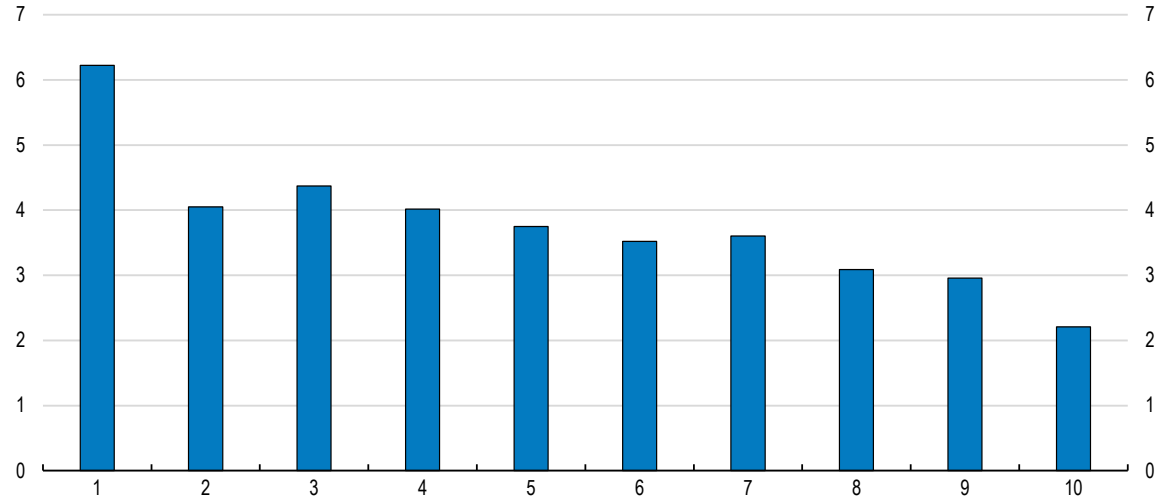
inclusive by reducing income and wealth inequalities. In the absence of competition, market power drives prices above costs; these higher prices increase everyone's consumption expenditure and redistribute the extra money spent towards business owners and financial asset holders, who are concentrated at the top of the income distribution (Ennis and Kim, 2017[19]). This increases the income of the upper deciles and reduces consumption power and savings for the rest of the population. In the long run, this helps upper deciles to accumulate wealth and raise their income, while at the same time it is more difficult for lower deciles to build savings.

Regulations can create unnecessary barriers to competition thus leading to situations where key sectors of the economy show high prices and low productivity (Philippon, 2019[20]). The lack of competitive pressures permits incumbents in a given market to extract rents from consumers in the form of high-mark ups. At the same time, these incumbents, sheltered from competition, have no incentive to boost productivity. This leads to highly inefficient outcomes, not only in terms of consumer welfare of inclusiveness but also in terms of productivity and economic growth.

Costa Rica's experience in the telecommunications and rice sectors exemplifies the significant impact that the competition stance can have on consumers' welfare. The legal monopoly in the mobile telecommunication sector was effectively abrogated in 2011, as one of the requirements for the signing of the Central American-Dominican Republic Free Trade Agreement with the United States. Today, four private companies, in addition to the former state monopolist, operate in the mobile-phone market and more than ten companies are active in each of the fixed telephony and internet-access markets (SUTEL, 2018[21]). This drastic increase in competition resulted in a large expansion of telecommunications services and lower prices (OECD, 2016[10]). Costa Rice nowadays is one of the leaders in the region in terms of mobile penetration), which creates huge potential for financial inclusion (Chapter 3). OECD computations undertaken for this survey, show that lower income households benefited particularly from the lower prices (Figure 2.11). The reform had also a positive effect on employment, which grew in the telecommunication sector four times more than for the whole economy (OECD, 2016[10]). The opening up has also a positive effect in favouring a higher degree of digitalization among more vulnerable households (Box 2.2 and (Lang and Gonzalez Pandiella, 2020[22]).

Figure 2.11. Opening the telecommunication sector to competition benefited particularly low-income households

Gains in purchasing power by income decile, %



Note: This scenario shows the impact across the income distribution of the fall in prices following the opening of the telecommunication sector.
Source: OECD calculations based on Costa Rican Households and Consumption surveys.

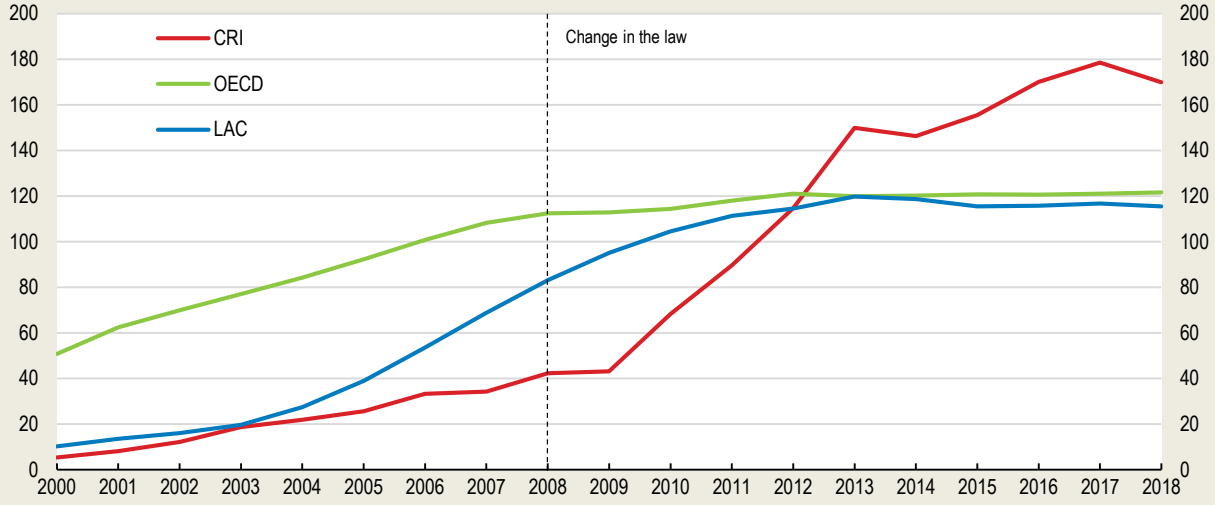
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Box 2.2. Assessing the impact of the opening of Costa Rican mobile telecommunication sector: a machine learning approach

The opening of Costa Rica mobile telecommunication sector started in 2008, after a long and polarized national debate. The opening process was gradual. Private providers started to offer telecommunication services such as fixed internet connections in 2009. Two years later two private companies officially entered the mobile services market. The increase in competition resulted in a large expansion of mobile telecommunication services. Costa Rica, who lagged behind Latina America in terms of mobile-cellular subscription before the opening, has now higher mobile penetration than in Latin America and OECD averages (Figure 2.12).

Figure 2.12. Mobile penetration has increased

Mobile-cellular subscriptions per 100 people

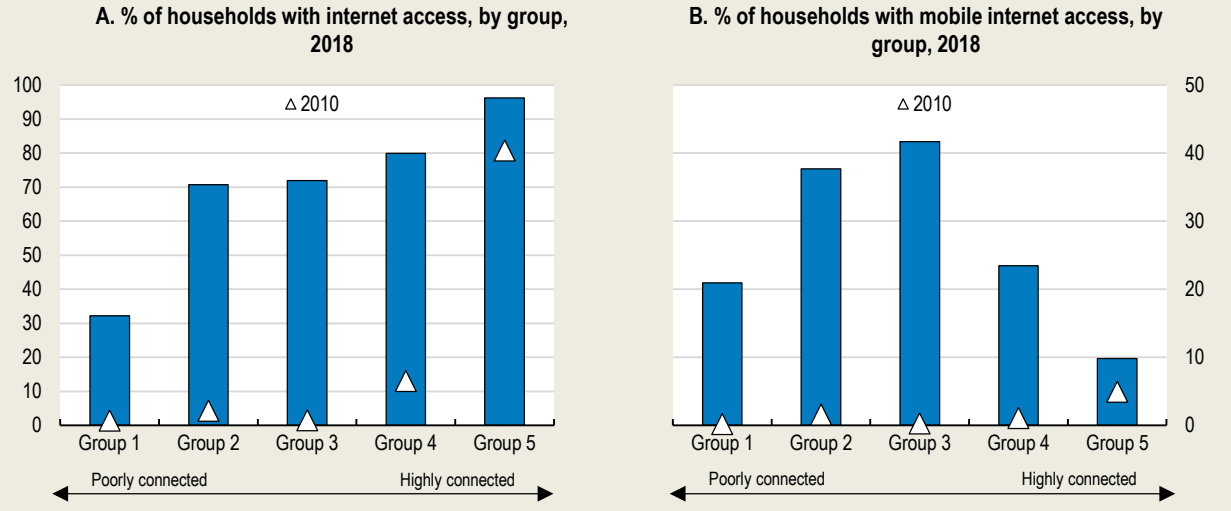


Note: LAC refers to the simple average of Argentina, Belize, Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Panama, Peru, Uruguay and Venezuela.
Source: ITU World Telecommunication / ICT Indicators Database.

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Machine learning techniques can help to assess whether the benefits of the opening of the sector in terms of access was concentrated in certain segments of the population, or whether the opening also facilitated the access by individuals in more disadvantaged situations (Lang and Gonzalez Pandiella, 2020[22]). Using clustering techniques, particularly Hierarchical Ascending Clustering and K-means, households can be grouped according to different characteristics, such as type of internet access they have (fixed or mobile), labour status, income level or whether they are located in a rural or urban area. This results in five categories, which can be ranked according to their level of digital connectivity. The results of the analysis suggest that, over the period of 10 years following the opening of the sector, all groups increased access to Internet technologies (Figure 2.13), helping to close connectivity gaps.

Figure 2.13. Opening the mobile market helped to close connectivity gaps



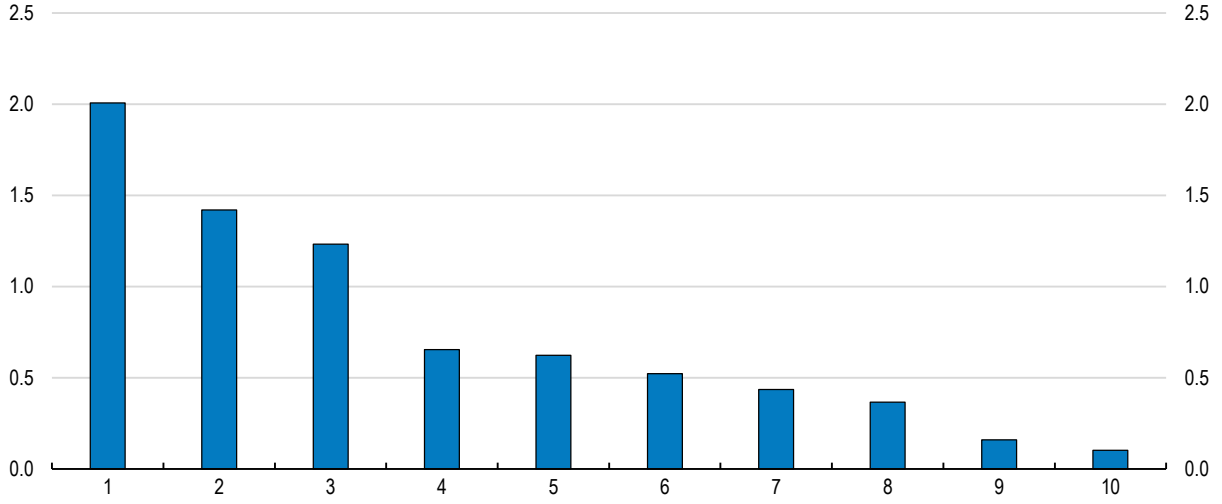
Source: OECD calculations based on Household Survey (INEC, 2010-2018).

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At the other side of the spectrum is the rice sector. Rice is at the same time a staple item in the food basket of the poor and the most protected commodity in Costa Rica (OECD, 2017[23]). 70% of the population consume rice everyday (Mata and Santamaría, 2017[24]). Import tariffs for all types of rice is currently 35%. It was 58% for processed rice with the application of a general safeguard which is no longer active. Costa Rica has maintained an administered minimum price for rice over recent decades. Reforms to the minimum price took place in 2015, when it became a reference minimum price for rice; however, in reality, the reference price continues to function as a minimum price (OECD, 2017[23]). The reference minimum price is based on a domestic production costs analysis by the National Rice Corporation (CONARROZ). These policies have brought prices well above international prices, creating rents that benefit a handful of large producers. The rice market is highly concentrated (Mata and Santamaría, 2017[24]), with 19 large farmers accounting for more than half of the rice produced in Costa Rica. Large producers also benefit from tariff-free import quotas, assigned proportionally to their processing capacity. Thus, they can purchase rice at international market prices, and sell the processed rice domestically with a high profit. Some estimates suggest that the current regulations in the rice market entail a transfer from consumers to producers, which for the poorest households represents 8% of their income (Monge-Gonzalez et al., 2015[25]). Current policies have done little to improve productivity among rice producers or improve the economic well-being of the small producers (Barquero, 2017[26]); (OECD/BID, 2014[27]), but have created incentives to maintain the status quo. All this suggests that the current regulatory setting in the rice market is regressive and contributes to higher poverty and income inequality. Increasing competition, so that domestic prices get closer to international prices, would particularly benefit individuals in lower income deciles (Figure 2.14).

Figure 2.14. Boosting competition further would benefit low-income households

Potential gains in purchasing power by income decile, %



Note: This illustrative scenario shows the impact across the income distribution of a decreased by 40% in rice prices.
Source: OECD calculations based on Households and Consumption surveys.

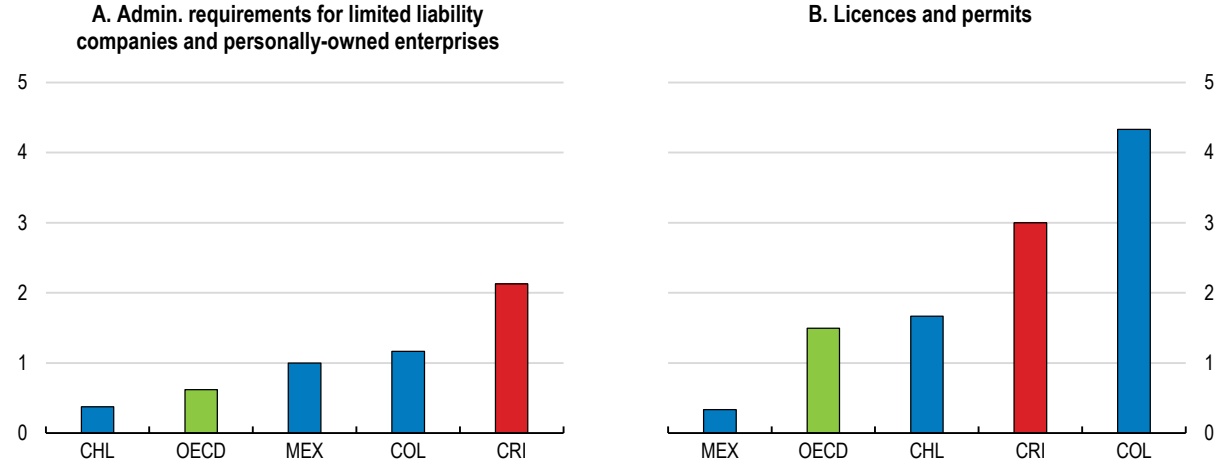
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Reducing administrative barriers to firm entry

Before a firm can compete in a market, it has to be able to enter it. OECD countries have been facilitating entry, as a way to boost competition in their goods and services markets. Costa Rica has ample to room to follow suit. The OECD's Product Market Regulation index can serve as a diagnosis tool to detect which issues need to be addressed. Among barriers hampering entry, administrative burdens and the license and permits system are the most problematic in Costa Rica (Figure 2.15).

Figure 2.15. Complex requirements hamper firm creation

Index from most (0) to least (6) competition-friendly regulation



Note: Data refer to 2018.
Source: OECD Product Market Regulation database.

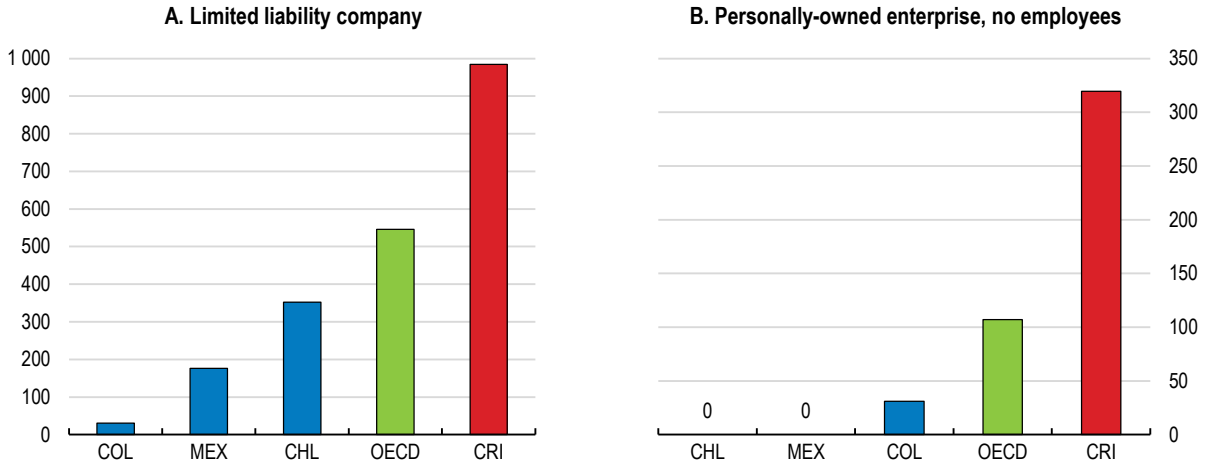
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Reducing the cost to start up

Establishing a company in Costa Rica is significantly more costly (Figure 2.16) and burdensome than in OECD countries and in peer Latin American countries. The largest cost to start a business in Costa Rica relates to the requirement to use a notary, who is in charge of drafting and notarizing public deeds and, upon signature by the entrepreneur, submits the deeds for registration. Notary fees are regulated, have been increasing and amount currently to CRC 185,000 (World Bank, 2020[28]). Costa Rica requires the use of a notary both for personally-owned firms with and without employees and for limited liability accompany. Both OECD and emerging countries have been phasing out the need for a notary as a way to reduce the cost of start-up (World Bank, 2016[29]). Currently, very few OECD countries require the use of a notary to establish a small firm (Figure 2.17. Phasing out this requirement in Costa Rica would reduce the cost to start up significantly. Other administrative requirements to start up are certifying that all social security charges are paid, having the tax office certifying the account books, applying for tax identification number, obtaining mandatory pension and civil insurances or notifying the social security office. These are administrative steps not required in most OECD countries to start up a company, particularly if they are personally-owned.

Figure 2.16. Establishing a company is relatively costly

PPP-adjusted USD

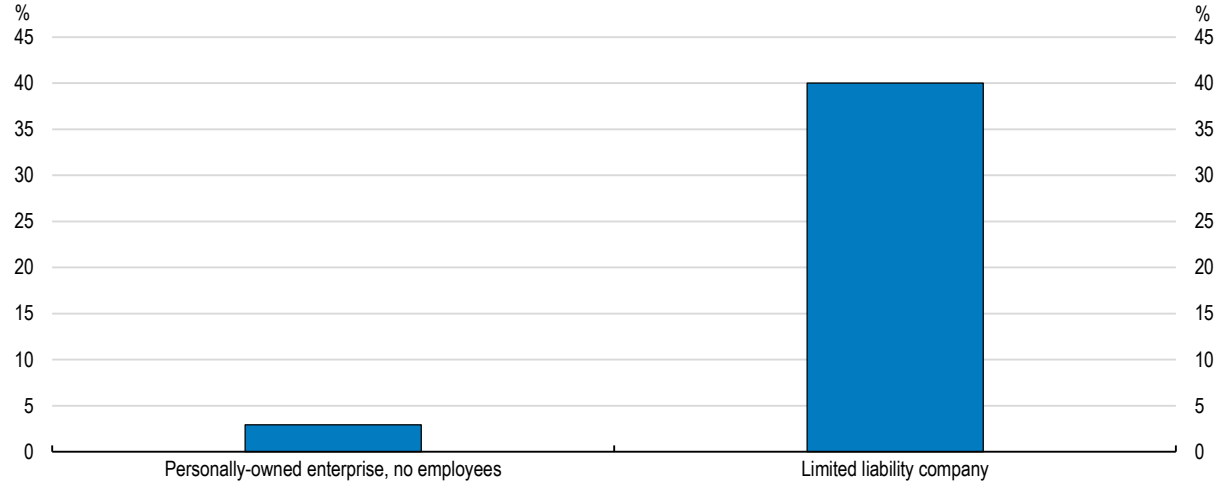


Note: Data refer to 2018.
Source: OECD Product Market Regulation database.

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Figure 2.17. Few OECD countries require a lawyer or notary to register a company

Share of OECD countries requiring a lawyer or notary when registering a company



Note: Data refer to 2018.
Source: OECD Product Market Regulation database.

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Reducing administrative burden and improving licences and permits

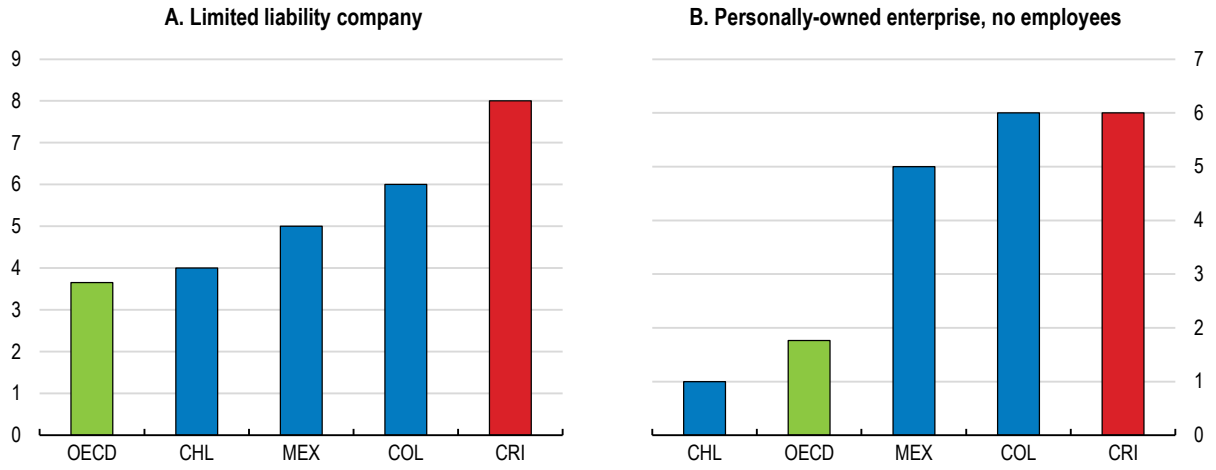
Starting a company in Costa Rica also entails a higher administrative burden than in most OECD countries (Figure 2.18). It takes 23 days to start a business, the majority of which are accounted by the issuing of business license (*patente municipal*), which takes 15 days and can cost up to CRC 100,000 depending on the type of activity, number of employees or location (World Bank, 2020[28]). OECD countries have succeeded in reducing administrative burden by establishing virtual one-stop shops, where all administrative requirements can be met at once and online. Costa Rica is also moving in that direction. The Costa Rican Export Promotion Agency (PROCOMER) has made good progress in simplifying and digitalising all business processes for firms operating in the free trade zones. This includes the registration phase and licences and permits (such as construction, health or environmental), which can now be completed online. There is ongoing work to extend this also to firms outside the free trade zones. Physical one-stop shops have already being established in 21 municipalities. But they do not allow for solving all licences and permits. An online facility has been launched, but it does not cover all administrative requirements and is available only for firms having a digital signature and operating in certain economic sectors. Keeping a complete count of all licences and permits required, which is currently lacking in Costa Rica and available in many OECD countries, would also facilitate enacting reforms aimed at reducing red tape.

OECD best practices also indicate that adopting the “silence is consent” rule can significantly reduce administrative burden related to obtaining permits and licences. Accordingly, if permits and licences are not issued within the statutory time limit, the activity is deemed to be approved. Costa Rica legislation allows for silence is consent since 2012. It covers permits, licences and authorisation, but not those related to health, animal health, phytosanitary and environmental, some of which are among the authorizations entailing a higher administrative burden. Moreover, applicants need to request the “silence is consent”, which involves submitting a paper application which confirms that all the necessary paperwork had been filed and that the statutory response time has elapsed (OECD, 2018[4]) and (Meehan, 2018[30])). The administration has then three days to either certify that “silence is consent” is granted or provide reasons why it does not apply. These requirements augment themselves administrative burden and are likely to

hamper and limit the use and effectiveness of the rules. Removing them would increase the potential role of "silent is consent" rule to speed up authorisation processes.

Figure 2.18. Establishing a company is burdensome

Number of bodies to be contacted



Note: Data refer to 2018.
Source: OECD Product Market Regulation database.

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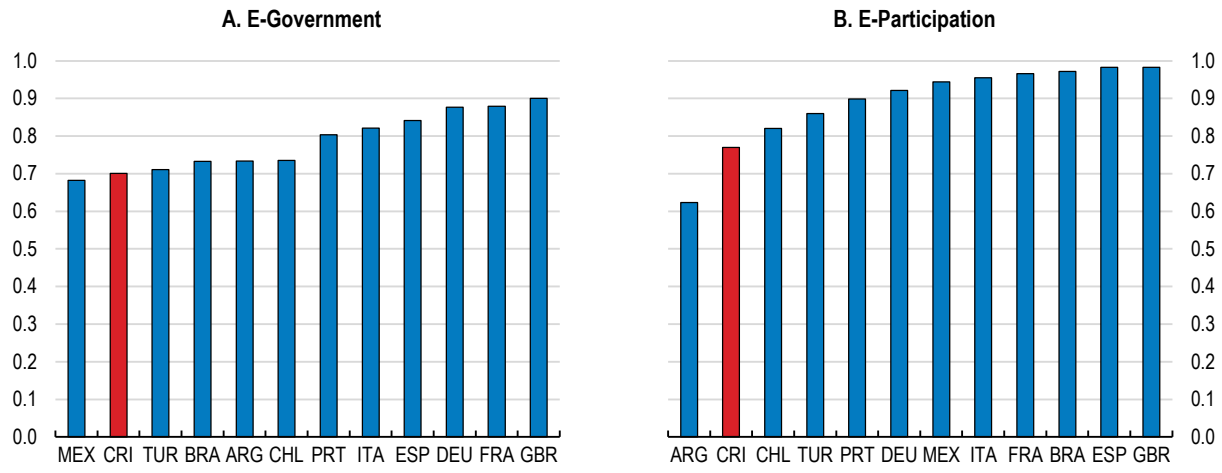
Reducing red tape would also be key to improve productivity in the agro sector, whose productivity is hampered by slow and complicated bureaucratic procedures (OECD, 2017[23]). Shortening the registration process for agrochemicals is critical, given the very low rates of approval and complaints by both trading partners and domestic producers about lengthy, onerous and unpredictable processes (OECD, 2017[23]). Authorities are working towards a better legal framework, improving coordination among the ministries involved in the registration process (Ministry of Agriculture and Livestock, Ministry of Environment and Energy and the Ministry of Health) and aiming at a more streamlined registration process.

Boosting digital government

Embracing e-government can be a powerful means to reduce the regulatory burden and facilitate firms compliance with needed administrative procedures at a minimal cost. Thus, OECD countries are increasingly making use of digital tools to interact with citizens and firms. Costa Rica lags behind in this area (Figure 2.19), both in comparison with OECD countries and other emerging economies. (Figure 2.20). Authorities have recently launched a web portal, *Pura Vida Digital*, which widens the number of transactions with government agencies that can be resolved online. Until recently only transactions involving the Foreign Trade Agency could be fully resolved online, with three other agencies (the Ministry of Environment, The Ministry of Culture and Youth and the SOE in charge of water) offering the possibility of completing some of the iterations online (Pastrana Torres, Jiménez Fontana and Segura Carmona, 2019[31]). The Ministry of Economy maintains a national catalogue of all procedures that individuals and firms have to undertake with government agencies, including information on which ones can be resolved online. This is a valuable tool which should help to monitor Costa Rica's progress towards a more digital government.

Figure 2.19. Costa Rica lags behind in digital governance

E-Government Development Index, 0 to 1 (best), 2018

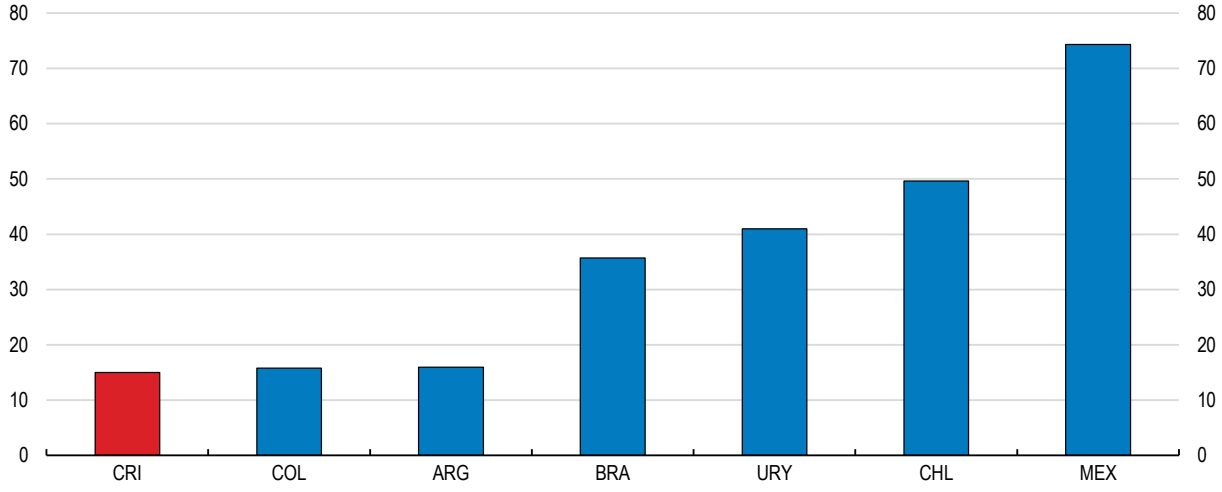


Note: The E-Government Development Index is a composite measure of three dimensions of e-government: provision of online services, telecommunication connectivity and human capacity. The e-participation index focuses on the use of online services to facilitate provision of information by governments, interaction and engagement.
Source: United Nations 2018 E-Government Development Index.

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Figure 2.20. Few administrative transactions with government can be completed online

Share of government transactions that can be completed online, %



Source: IDB 2018 publication, "Wait no more: Citizens, red tape, and digital government". Benjamin Roseth, Angela Reyes and Carlos Santiso.

StatLink https://doi.org/10.1787/888934149341

A key obstacle for increasing the use of digital tools by government, citizens and firms is the existing digital signature mechanism. Costa Rica was a pioneer in establishing a digital signature legislation, which dates back from 2005 and gives electronic signatures the same legal recognition than a handwritten one. In order

to electronically sign the documents, the citizen or the firm must have a card with a chip, specially configured for them. A reader is needed to read the card, send the information to a computer and sign the documents with the information in it. Citizens and companies can obtain their digital signature through different entities authorized by the government; most of them are banks. The digital signature must be renewed every four years. It became available in 2009 but it is hardly used, as only 6% of citizens or 20% of business have it. The low use can be partly explained by the low number of procedures, government or commercial services allowing digital signature. Those attempting to use it also face difficulties to get the same validity than a handwritten signature by public institutions. This stems from difficulties for public institutions to develop software to facilitate the use and validation of digital signatures. As a response, the Central Bank has developed a central signature (*Firmador Central*). There are also technical difficulties, such as limitations regarding mobile solutions or difficulties to replace a lost card (Saso, 2018[32]); (Barahona, Elizondo and Santos, 2015[33]). The Central Bank is currently working towards a solution that would enable the use of the digital signature together with bank credit cards. OECD countries such as Estonia (Box 2.3) exemplifies the cathartic effect that a widely accepted and user-friendly digital signature mechanism can have to reduce red tape and facilitate compliance with administrative requirements by firms and citizens.

Box 2.3. The Digital Signature: the building block of e-government in Estonia

The key element for the development of e-government in Estonia was the Digital Signature Act in 2000. The Act recognised digital signatures as being fully equivalent to hand-written signatures, both in commercial transactions as well transactions with the public sector. The Estonian national identification became the building block for the development of e-government in Estonia. The national digital ID allows for the authentication and authorisation in digital transactions, i.e. electronic signing. The digital signature can be used directly through the ID-card, as the cards embed a chip that can be used as definitive proof of identification in an electronic environment. The signature can be used also through Mobile-IDs, which allow people to use a mobile phone as a form of secure digital ID, or Smart-IDs, which provide an identification solution for anyone that does not have a SIM card in their smart device but needs to securely prove their online identity. The dual use for commercial and public sector transactions, as well as the obligation for the public sector to recognise the national digital ID, created an environment that stimulated the development of compatible public services as well as their take-up by the general population (OECD, 2015[34]). All digital public services can be accessed using the national digital ID, including registration of businesses, electronic voting, electronic prescriptions, electronic health records, declaration of residence and social benefits claims. The use of digital signatures in Estonia is estimated to save 2% of GDP every year (OECD, 2019[35]). Estonia and Costa Rica have recently signed a memorandum of understanding in the field of digital government (MICIT, 2019[36]).

Strengthening competition

Costa Rica's competition framework has critical weakness, as presented in previous Economic Surveys (OECD, 2016[10]); (OECD, 2018[4]) and thoroughly analysed in the OECD competition accession review (OECD, 2020[37]). These weakness have been addressed in the new competition law. A key concern is the lack of independence and resources of COPROCOM, the competition authority, which contrast with the situation of other agencies with responsibilities in the competition area in Costa Rica (Box 2.4). Lack of resources have prevented COPROCOM from fulfilling its roles. Since 2016, Costa Rica's competition authorities have only sanctioned one instance of anticompetitive conduct (OECD, 2020[37]).

Box 2.4. Key agencies with responsibilities in the competition area

The agencies shaping the Costa Rican competition regime are:

- The Competition Commission (Comisión para Promover la Competencia, COPROCOM).
- The Public Services Regulatory Authority (Autoridad Reguladora de los Servicio Públicos, ARESEP). Established in 1996, its responsibilities involve regulating and setting tariffs for public services, namely water and waste, electricity, buses and taxis, fuels (petroleum and its derivatives), airports, railways and ports. The law clearly mandates that services in these sectors can only be provided upon obtaining a state concession. ARESEP is an independent institution as it was created as a decentralised agency; it has its own budget, partly funded with charges on regulated companies.
- The Superintendence for Telecommunications (Superintendencia de Telecomunicaciones, SUTEL). Created in 2008 with the liberalisation of the telecommunications sector; SUTEL has the double role of regulator and competition agency for the telecommunications sector; it is a decentralised agency from ARESEP with its own budget partly funded from fees that are charged on telecommunications operators.

Buttressing the competition framework

Costa Rica has recently approved a Competition Reform Act, a fundamental legislative step forward to buttress its competition framework and adapt it to best global standards. The reform act addresses many of the weaknesses previously identified (Box 2.5) and holds the promise of a reinvigorated and more effective competition regime in Costa Rica. However, until is implemented, existing limitations and weaknesses will remain in place (OECD, 2020[37]).

Acknowledging that a timely and full implementation of the reform is critical, the authorities have elaborated a detailed strategic roadmap for implementation organised around three pillars: regulatory strengthening; institutional strengthening; and effective application of the competition rules. Costa Rica is currently negotiating a partnership with the Inter-American Development Bank regarding its support, particularly as concerns regulatory strengthening, which would proceed gradually over the next two years and would be finalised by end 2022. The institutional strengthening would be completed in the first half of 2023. COPROCOM board members are expected to be appointed in 2020Q1 and the recruitment of staff by the first half of 2021. The effective application of the law has gradually started and would be completed by the second half of 2023.

To ensure that the improved competition framework translates into higher productivity and inclusiveness, a strong and responsive judiciary is required, as this is key to ensure the correct and effective implementation of the new competition law. International experience shows that achieving a good understanding of key competitive concepts by judges, such as those guiding the interpretation of detailed evidence, is essential (OECD, 2019[38]). Technical skills of the court's staff are also important for the development of a specialisation on economic competition matters. These skills can be developed through training for the staff working with judges, supported by a robust system of continuous judicial training in competition matters. International training is also essential to obtain better practices and experiences from other jurisdictions. External economic experts can also help judges to interpret economic evidence and assess its probative value.

Box 2.5. The Competition reform

The main lines of the Competition Reform Act are:

Scope of application. All business conduct with effects on Costa Rica will be subject to Costa Rican competition law, regardless of where those actions took place.

Independence. COPROCOM will become a de-concentrated body with instrumental legal personality" and is granted functional, administrative, technical and financial independence. A minimum statutory budget is guaranteed. Board members will be employed on a full-time basis and selected based on their expertise and character through a public procedure

Advocacy tools and regulations. It is recognised that COMPROCOM can and should pursue market studies and will empower it to request information and impose sections if those request are not met.

Investigation tools and enforcement procedures. A leniency program will be introduced and a special procedure with specific timeframes for competition investigations will be established.

Infraction and deterrent penalties. Three level of infractions are established and the penalty will depend on the total gross income of the infringer.

Merger procedures. The merger notification thresholds will be modified to allow for a more efficient use of resources. COPROCOM will become competent to review mergers in the financial sector.

International cooperation. COPROCOM will get the legal power to establish international cooperation agreements.

Harmonization between COPROCOM and SUTEL. They will have the same procedures, investigative tools and the substantive rules.

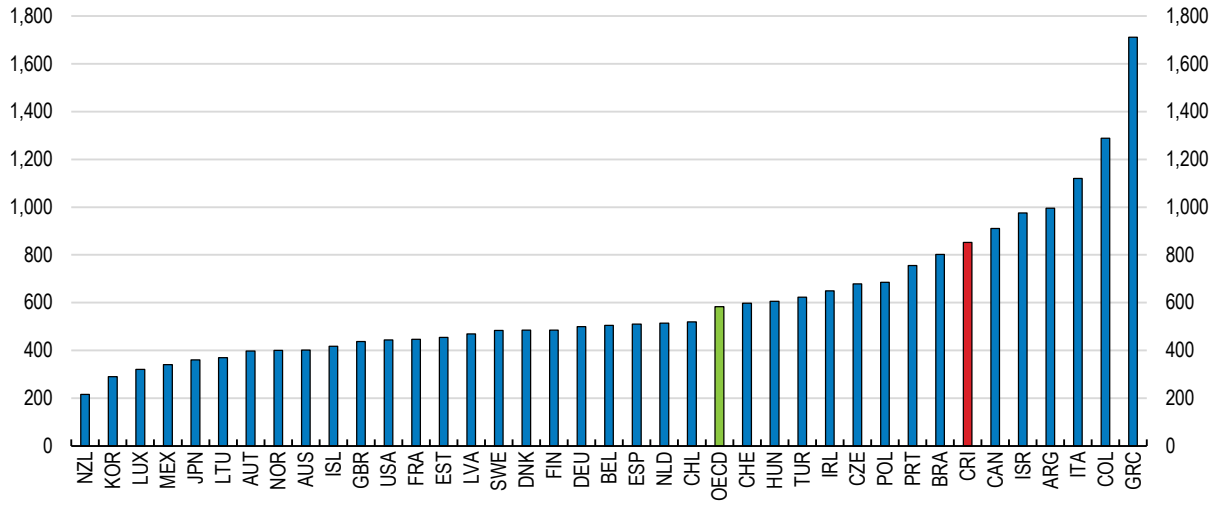
Source: (OECD, 2020[37])

An agile court structure is also an effective means to increase clearance rates and reduce the duration of litigation, which has hampered the effectiveness of competition reforms in some OECD countries. There is room to boost court agility in Costa Rica (Figure 2.21). International experience proves that investment in infrastructure and information technology helps to reduce time lags in courts responses.

Deregulating of lawyers' fees is also associated with lower litigation and a more agile justice systems (Palumbo et al., 2013[39]). Boosting competition in the legal profession can therefore reduce excessive litigation, make courts more responsive and favour a swifter application of the new competition regime.

Figure 2.21. There is room to make courts more agile

Time to enforce contracts (days), 2019



Note: OECD refers to an unweighted average of member countries with available data.
Source: World Bank Doing Business Indicators.

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Reducing exemptions from the competition law

Previous OECD Economic Surveys (OECD, 2018[4]); (OECD, 2016[10]) and competition reviews (OECD, 2016) highlighted that that many markets are exempt from competition law in Costa Rica. Submitting those markets to the scrutiny of the competition authority and to the enforcement of competition law would result in a more efficient functioning of the economy and in substantial gains for consumers and firms. Following this, Costa Rica further examined the scope of exemptions from its competition law and found they were more limited than anticipated. The 2019 Competition Reform Act has further reduced the scope of these exemptions and only acts duly authorised in special laws remain exempt from competition law. Five economic sectors have specific acts exempted from competition law: the sugarcane industry, the coffee industry, the rice market, maritime transport and professional associations (Table 2.1). COPROCOM will continue to assess the justification for these exemptions and issue recommendations. The addressees of the recommendations would need to provide reasons to the competition authority for not implementing these recommendations. Ultimately removing the exceptions will require legislative action.

Table 2.1. Sectors exempted from competition

Service sector	Exempted acts
Sugar	Setting production quotas and sales prices
Rice	Importation of rice in grain and distribution among industrialists
Coffee	Setting profit percentages for the benefiter and exporter
Maritime transport	Fare agreements and route distribution between Competitors (Maritime Conferences)
Professional services	Setting professional fees

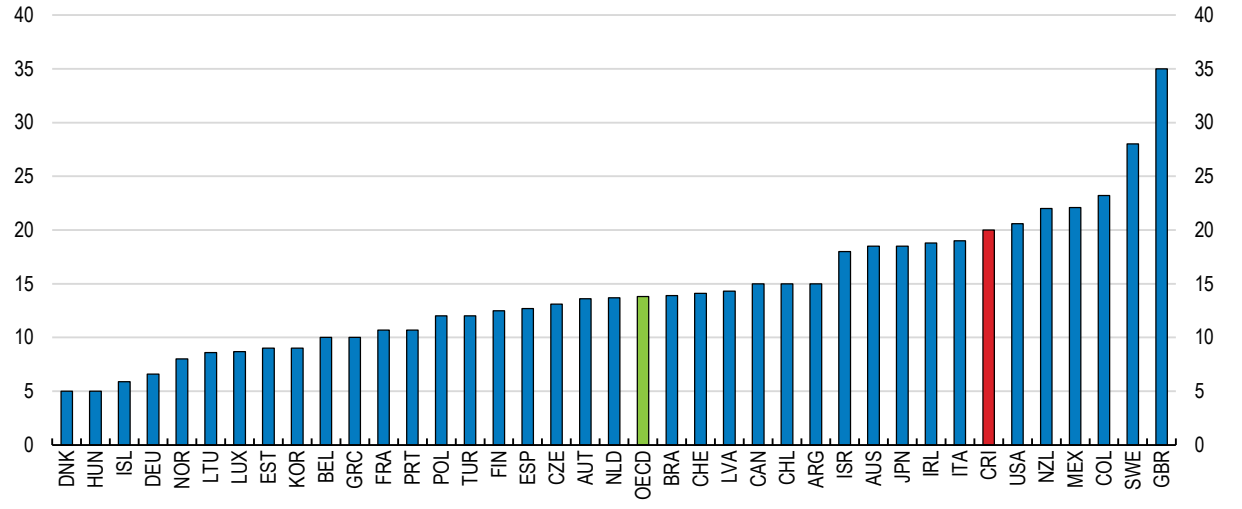
Source: (OECD, 2020[37]).

While the reduction in exemptions is a significant step forward to boost competition in Costa Rica, the remaining exceptions have a detrimental impact both on inclusiveness and productivity. COPROCOM has been for long insisting on the necessity to eliminate them by various means, including market studies and opinions.

In the case of rice and sugar, remaining exemptions are regressive, reducing the purchasing power of lower income individuals and hampering efforts to reduce poverty in Costa Rica. Maritime transport is vital for Costa Rica as a means to connect with international markets. Boosting competition in this sector would benefit particularly Costa Rican firms outside the free trade zones. The sector also suffers from an inefficient institutional arrangement (see section below). Boosting competition in professional services, by avoiding minimum fees setting, would have a wide-economy positive effect, as these services are key inputs for all firms. International experience shows that this benefits particularly SMEs, as large firms can insource these services and circumvent the fees setting. There is evidence that professional services, such as legal ones, are relatively costly in Costa Rica (Figure 2.22). Both maritime and professional services are upstream suppliers, implying that the share of the economy indirectly affected by these exemptions is much greater.

Figure 2.22. Legal fees are relatively high

Cost of attorney fees (% of claim), 2019



Note: OECD refers to an unweighted average.
Source: World Bank Doing Business Indicators.

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Improving the state involvement

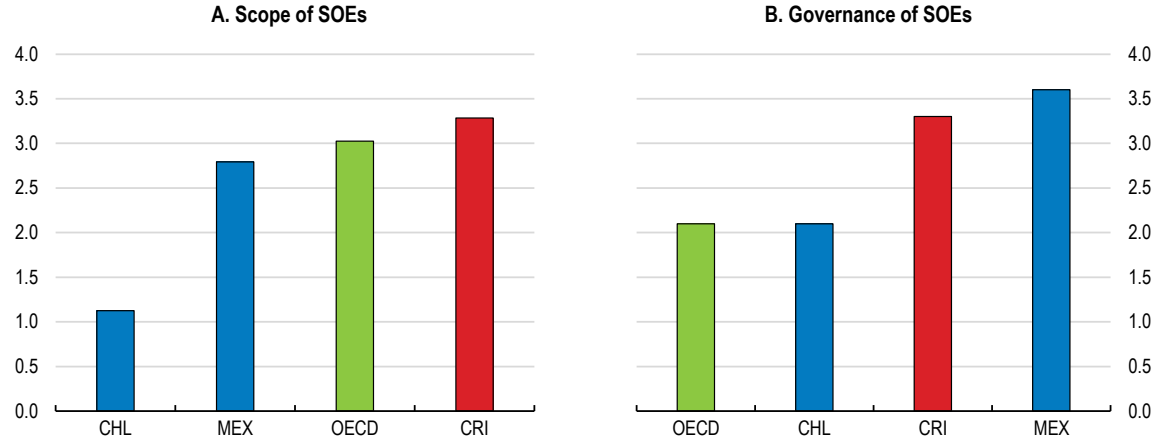
The involvement of the state in the Costa Rican economy is larger than in the average OECD economy. Policy efforts to improve this involvement are therefore warranted. Two areas deserve particular attention, as they have economy wide impact and have a direct bearing not only on economic performance but also on inclusiveness: State-owned enterprises (SOEs) and regulated tariffs.

Improving SOEs performance

The scope of SOEs in Costa Rica is relatively large (Figure 2.23), as state-owned enterprises play a dominant role in many key sectors of the economy, such as banking, network industries (excluding airlines) and petroleum products. Costa Rica has 28 SOEs at the central government level.

Figure 2.23. There is room to improve SOE governance

Index from most (0) to least (6) competition-friendly regulation



Note: Data refer to 2018.
Source: OECD Product Market Regulation database.

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There is room to boost the governance of the SOE sector. Recognising this need, authorities have embarked in promising reforms. Boards have been strengthened, by excluding ministers and high-level officials, improving nomination processes and enhancing the objectivity and independence of its members (OECD, 2020[40]). A newly created SOEs advisory unit has developed an ownership policy and has recently published its first annual report on the performance of the SOE sector.

The next step for the unit, in line with best practices, should be to establish performance indicators for each SOE, including their financial sustainability. This is fundamental to achieve a better performing SOE sector, as, historically, indicators tracked by the State focused almost exclusively on the attainment of social goals, without any monitoring of their financial health (OECD, 2020[40]). This greater attention to financial performance of SOEs would offer efficiency gains that would imply lower prices for consumers and firms.

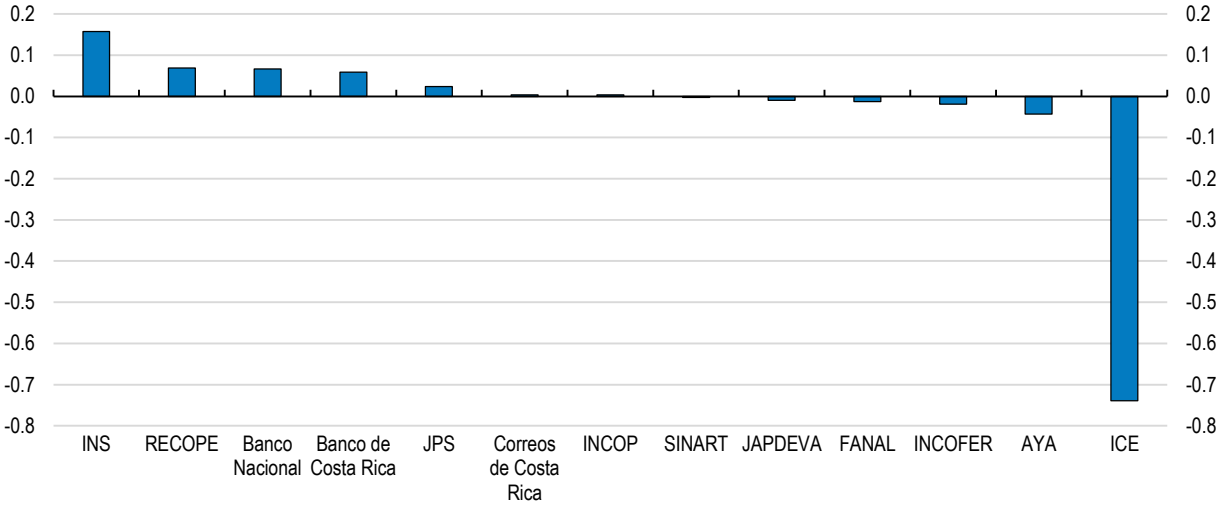
Two areas where additional efficiency gains can be achieved are remuneration of staff and public procurement. SOE's employees enjoy a relatively high wage premium, both in comparison with private sector and with other public sector entities (World Bank, 2018). In fact increases in remuneration in government entities outside the central government, such as SOEs, made the largest contribution to recent increases in inequality (González Pandiella and Gabriel, 2017[41]), (World Bank, 2019[42]). There is room to rationalise remuneration schemes in SOEs and at the same time maintain attractiveness, as the experience of the Central Bank, who introduced a single and performance-based salary scheme, attests. Bringing public procurement of SOEs within the centralised procurement scheme, lowering and streamlining their thresholds, and phasing out exemptions that give the possibility of direct contracting, can also offer significant savings and would, at the same time, contribute to boost competition (Chapter 1).

Another area where further policy action is warranted concerns the implementation of international financial reporting standards. This is key to boost transparency, accountability and efficiency. Only four SOEs were fully compliant with international standards as of June 2019 (OECD, 2020[40]). The rest, including financial SOEs, continue to report according to national standards. The electricity company reported that implementation will not take place before 2023, which goes beyond the deadlines established by the authorities. Having reliable and comparable information about the financial situation of SOEs is fundamental to assess the potential risks that SOEs pose for the State and the budget, as recent difficulties in several SOEs prove. Reinforcing efforts for a quick and full implementation is therefore warranted.

As a whole the SOE sector does not currently present a significant drain on the budget (OECD, 2020[40]), although some SOEs, such as public banks, entail large contingent liabilities (Key Policy Insights). Individual SOEs can , however, have a significant impact on the budget, as recently exemplified by the need to assist JAPDEVA, the ports administrator, in its restructuring process, which contributed to widen the budget imbalance in 2019 above own government projections. The electricity company, ICE, is the one with the weakest financial situation (Figure 2.24). Its operating performance is low when benchmarked with peer institutions (World Bank, 2015[13]). Electricity prices in Costa Rica are higher than in regional peer countries (see below). Waiting periods for new connection and duration of outages are above those of its structural peers. This is particularly detrimental for Costa Rican firms operating in sector where reliable electricity is essential, such as the high-tech industries. ICE offers firms the possibility to finance ICE's investments in exchange for lower tariffs. These arrangements may be useful for large firms, such as those operating in the free trade zones, but local SMEs are unlikely to be able to afford them. Improving ICE's performance's would be fundamental (Box 2.6) and would have economy wide benefits. OECD countries have increasingly introduced some degree of separation between electricity generation, transmission and retail supply. Effectively separating monopolistic activities (such as the operation of the transmission network) from activities that can be subject to competition (such as generation and retail supply) can bring large benefits in the form innovation, customer responsiveness and lower prices (IEA, 2001[43]). Introducing a legal separation would be a good step to boost performance, while ownership separation would offer the largest benefits. Costa Rica should also consider relaxing existing restrictions and caps on private sector participation in this sector to be able to meet upcoming challenges. Allowing private generators to compete in the market, and not only for the market would be a step ahead to boost competition, as exemplified by Costa Rican own experience in the opening of the mobile telecommunication sector.

Figure 2.24. ICE is the worst performing SOE

Net income, % of GDP



Note: The full names and economic sector of SOEs are as follows: INS: Instituto Nacional de Seguros (insurance); RECOPE: Refinadora Costarricense de Petróleo (energy); JPS: Junta de Protección Social (lottery); INCOP: Instituto Costarricense de Puertos del Pacifico (port authority); SINART: Sistema Nacional de Radio y Televisión (broadcasting); JAPDEVA: Junta de Administración Portuaria y de Desarrollo Económico de la Vertiente Atlántica (port authority); CNP: Consejo Nacional de la Producción (agriculture); INCOFER: Instituto Costarricense de Ferrocarriles (rail transportation); AYA: Acueductos y Alcantarillados (water and sewerage); Ice: Instituto Costarricense de Electricidad (electricity). Banco Nacional and Banco de Costa Rica are publicly-owned commercial banks. Correos de Costa Rica is the national postal service.

Source: Informe agregado sobre el conjunto de empresas propiedad del Estado 2019.

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Box 2.6. The Costa Rican Electricity Institute: electricity and beyond

The Costa Rican Electricity Institute (ICE) dominates the Costa Rican electricity sector, as private-sector participation is limited by statutory restrictions. It generates around 65% of the electricity (the rest is generated by municipalities, cooperatives and private companies). ICE also provides all transmission service in the country and is responsible for 44% of electricity distribution. One of its subsidiaries distributes around 32% of generated electricity while municipal companies and co-operatives cover the rest of power distribution in rural area.

Private companies are allowed only in the electricity generation and can sell their electricity to ICE only. Private-sector generators compete for the market rather than in the market, because to enter the market they must first win ICE's tendering contracts, which also specify the quantity of electricity ICE will purchase. In 1995 the share of allowed private-sector electricity generation was increased from 15 to 30%. There are also barriers to foreign participation in the sector, as 35% of the capital of the firm generating the electricity should be Costa Rican. There are also limitations to the amount of electricity that each generator can produce.

The unit in charge of operating and planning the electricity system, the National Centre of Energy Control (Centro Nacional de Control de Energía, CENCE), is an administrative unit of ICE. This means that ICE has the full control over the Costa Rican electricity market, not only as concerns generation, transmission and distribution but also in terms of operation and planning of the system. The General Comptroller Office has recommended reforming the electricity system to increase the independence of the unit in charge of operating and planning the electricity system (CGR, 2019[44]).

Costa Rica faces the challenge of addressing an increasing gap between the demand and supply of electricity with renewables sources only. This will require large investments.

The current role of ICE in the Costa Rican economy goes beyond the electricity sector. ICE also had the monopoly in the telecommunication sector until the opening in 2011 and still plays a major role in that sector. It also participates in the design, construction and supervision of public infrastructure. By making use of exceptions in the procurement law, other public agencies can contract directly ICE without running a public tender (Chapter 1). This has raised concerns by business associations, as it inhibits competition. Both the General Comptroller (CGR, 2019[45]) and the Attorney of the Republic (PGR, 2015[46]) has stated that the current state of the law does not allow ICE to build public infrastructure. The law allows ICE to sell services to other public institutions, but those should be directly related with its core competences: electricity and telecommunications (PGR, 2015[46]).

Enhancing methodologies to set regulated tariffs

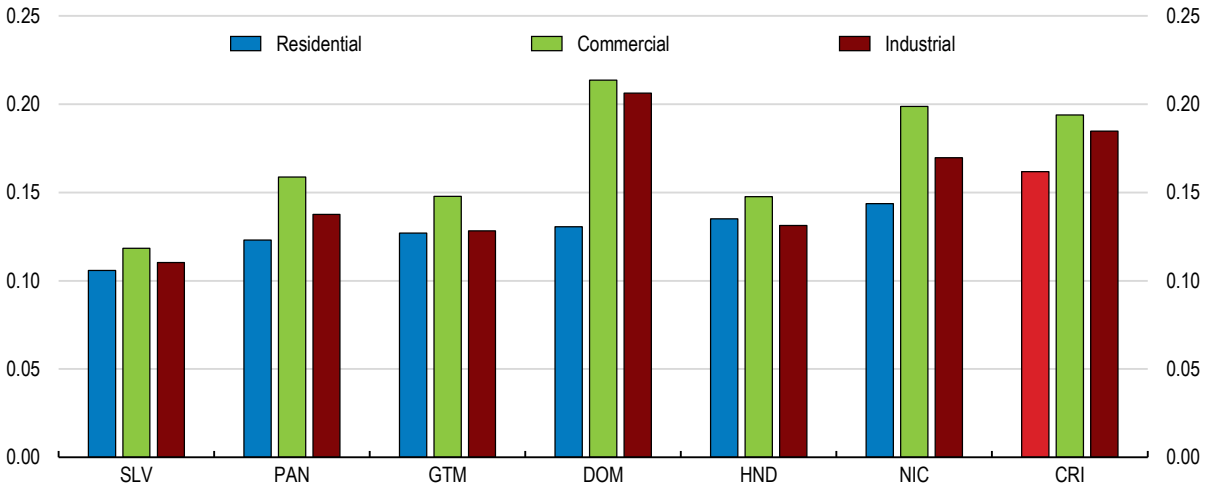
Tariffs for SOEs operating under monopoly conditions are set by the Regulatory Authority for Public Services (ARESEP), an autonomous multi-sectoral regulator. Tariffs for telecommunications services are set by the Telecommunications Supervisor (SUTEL), which is a fully independent body.

The way tariffs of regulated services – energy, transport and water – are set by ARESEP limits competitive pressures and results in fast-rising costs for users (OECD, 2020[40]). The law instituting and regulating ARESEP clearly mandates that tariffs be based on the (reasonable) costs incurred by service providers and to ensure their financial viability (i.e. cost-based pricing or rate-of-return regulation), which guarantee a certain rate of return on the capital invested. While this type of price regulation ensures tariffs are set at cost recovery levels, it provides no incentives for productivity improvements because cost increases can be easily passed onto consumers. It also implies that consumers bear the burden of higher costs caused by inefficiencies in those SOEs operating under monopoly conditions. Tariffs of regulated services have

risen more than any other business cost (CAATEC, 2014[47]). Electricity tariffs are higher than in other countries in the region (Figure 2.25).

Figure 2.25. Electricity prices are high

USD per kWh



Note: For each sector the chart shows the effective rate computing the average across different powers.
Source: Estadísticas del subsector eléctrico de los países del Sistema de la Integración Centroamericana (SICA), 2016, Table 8.

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In the electricity sector, while tariffs are meant to be based on technical criteria and verifiable data, ICE, the General Comptroller and ARESEP have come up with different computations and results. According to the General Comptroller, the use of incomplete and obsolete information in the computations by ARESEP implies that higher tariffs have been set and passed on to consumers (GCO, 2019). This case suggests, that policy efforts to update and improve the methodology to set tariffs are warranted.

Setting tariffs for public service in a way to encourage productivity improvements and the adoption of cost saving technologies would lead to lower prices, with economy-wide benefits. The experience of OECD countries, such as the United Kingdom, the Netherlands and France, shows that alternative tariff-setting methodologies – such as price- and revenue-cap regulation – strengthens competitive pressures and contribute to curtail tariff inflation (Sappington and Weisman, 2010[48]); (Mirrlees-Black, 2014[49]). By setting limits to the tariffs regulated companies may charge, or the revenues they may earn, price- and revenue-cap regulation replicate the discipline of competitive market forces and compel regulated firms to search for productivity gains (OECD, 2016[10]). The experience of OECD countries also suggests that price cap regulation coupled with independent regulators promotes infrastructure investment (Égert, 2009[50]).

Box 2.7. Providing better incentives in regulated sectors: price cap regulations

Price-cap regulation is the most widespread type of incentive regulation in OECD countries. They are the main alternative to rate-of-return regulations, where prices are set to account for the production costs of the firm and the margin that is allowed by the regulator or agreed on between the regulator and the firm. These regulations facilitate that costs can be easily passed onto consumers and can result in tariff inflation. Under price to cap regulations, the regulator initially studies the firm's capabilities and its operating environment in order to determine the revenues that would likely allow the firm to secure reasonable earnings. Unlike rate-of-return regulations, price-cap regulation does not require detailed and continuous information about costs and demands. Instead, the aim of price-cap regulation is to provide adequate incentives for the company to reveal costs and to induce lower cost techniques. With incentive-price regulation the regulator sets a cap, including an adjustment factor X, for a specified period, which the firm can charge for a defined basket of goods and services. The typical price cap regulation plan specifies a price cap period (often 4 or 5 years) and a maximum rate at which the regulated firm's inflation-adjusted prices can rise annually, on average, during this period. The firm's realized costs and earnings are usually reviewed at the end of the specified price cap period, and often employed to update estimates of the pricing restriction that would allow the regulated firm to secure a reasonable level of earnings in the next price cap period. Price cap regulations are less vulnerable than rate-of-return regulation to cost-plus inefficiency and over-capitalisation since the firm has the incentive to minimise all of its costs. Part of this expected increase in efficiency can then be passed on to consumers via the level of X.

Improving regulations in key sectors

Improving regulations in key sectors of the economy, such as network sectors, can have a large positive impact on economic growth, as the share of the economy indirectly affected is very wide. International evidence shows that inappropriate regulations in those upstream sectors impact on incentives to improve productivity downstream, decreases international competitiveness and reduces economic resilience (Monteiro, Fontoura and Santos, 2017[51]).

There is room to improve regulations in network sectors in Costa Rica (Figure 2.26). The telecommunication sector displays better regulations, thanks to the process of opening the mobile market since 2011. Even in this market there remains a gap with respect to regulations in OECD countries, as there remains a monopoly for fixed telephony. Traditional public switched telephone network (PSTN) services are still a monopoly held by ICE, and these services still represent the bulk of the fixed telephony market. Competition is only possible in Voice over Internet Protocol (VoIP) services, which represent a small share of the market. In the electricity sector, by contrast, there is a large scope to align regulations with those in OECD countries. International experience suggests that Costa Rica would benefit from introducing a legal or ownership separation between generation, distribution and retail supply and from opening up to competition so that consumers have the option to choose their retail electricity supplier. In the transport sector, the Product Market Regulations index suggests that there is room to improve regulations in all subsectors, but the need is particularly acute in rail and water transportation.

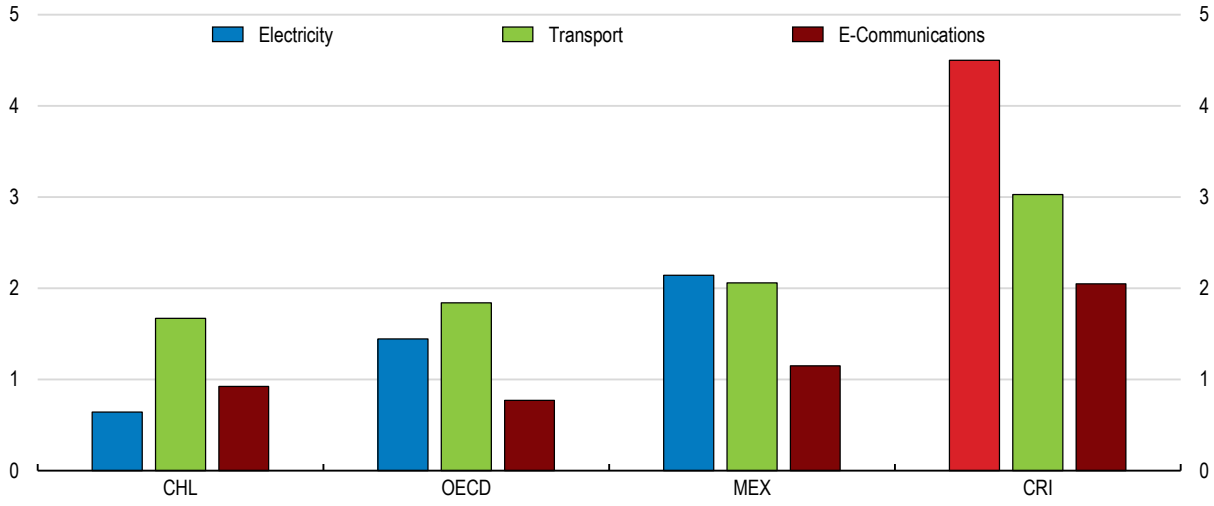
Boosting the performance of the rail sector would be key to improve logistics and reduce traffic congestions in Costa Rica. The sector, which suffers from years of underinvestment, would benefit from adopting best regulatory standards. The rail state-owned company fully dominates passenger and freight transport and is also in charge of operating the railroad infrastructure. OECD countries have been gradually increasing vertically separation and allowing for several operators competing in the same geographic area or rail

district as ways to improve performance and provide users with better services. Allowing for private participation would also help to overcome the underinvestment suffered by this sector.

Water transportation is particularly important for Costa Rica as it is key for export competitiveness. State-owned enterprises play a critical role there, as two state owned enterprises, INCOP and JAPDEVA, have the exclusive right to manage all ports on the Pacific and Atlantic coasts respectively. In February 2019, a new containers terminal (TCM) started its operations, ending with the monopoly of JAPDEVA. Both INCOP and JAPDEVA have the double role of port authorities and port operators. Despite operating under monopolistic conditions the financial situation of JAPDEVA is weak and is in the process of being restructured. Given the importance of maritime transport for Costa Rica, as a means to connect with international markets, the country would benefit from adopting the management concept of landlord port, whereby port authorities owns and manages the land and basic ports' infrastructure that are then rented or leased to different private port operators on a competitive basis. Similar changes in Mexico and other countries have resulted in significant improvements in the productivity of ports and reductions in cargo handling charges (Pisu, 2016[52]).

Figure 2.26. There is room to improve regulation in network sectors

Index from most (0) to least (6) competition-friendly regulation



Note: Data refer to 2018. Transport includes transport of freight and passengers by air, road, rail and water.
Source: OECD Product Market Regulation database.

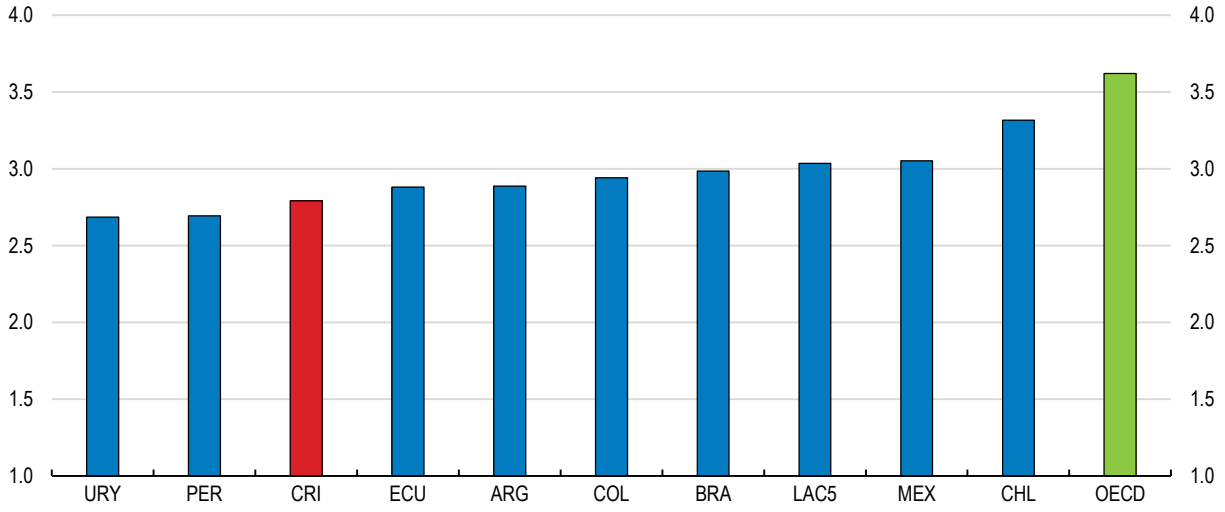
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Regulations in network sectors, such as in maritime transport, have a detrimental impact of logistics, where Costa Rica performance is lacklustre (Figure 2.27). The time needed to import is particularly large (Figure 2.28), which hampers the access of Costa Rican firms to foreign inputs, which in turn, hampers its export competitiveness. Empirical analysis undertaken for this chapter suggests that improving logistics can give a significant boost to exports (Dek and Gonzalez Pandiella, 2020[53]). Should Costa Rica have improved its logistic performance in line with improvements made by peer countries, exports would have been significantly higher (Box 2.8). Lifting existing restrictions to foreign participation in services which are key to logistics, such as cargo handling, maritime services, customs or storage, where restriction are higher than in the OECD (Figure 2.29), can help to improve logistics operations and boost export competiveness. Authorities acknowledge that logistics is a key policy area and that there is a need to improve both port and land borders. Concerning ports, efforts have been focused on improving the performance of the Port

of Limón, the most important in the country, which have been recently concessioned. Concerning land borders, the so-called Border Integration Program has been launched with the aim of modernizing infrastructure and streamlining procedure and is expected to be finalised in 2022.

Figure 2.27. Logistics operations in Costa Rica are perceived to be lacklustre

Index, 1 to 5 (best)

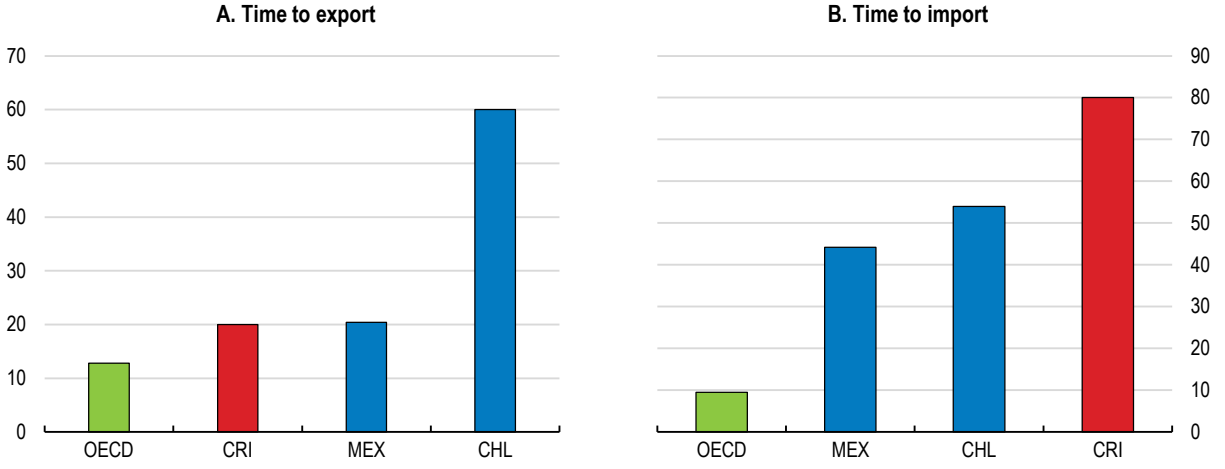


Source:World Bank Logistics Performance Index.

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Figure 2.28. Time to import is lengthy

Border compliance (hours), 2019

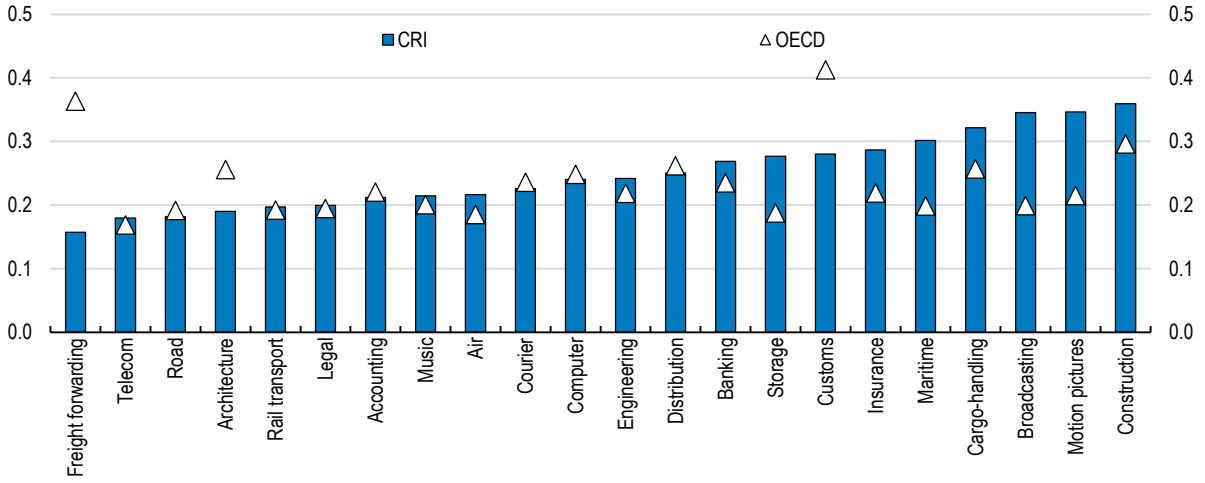


Source: World Bank Doing Business Indicators.

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Figure 2.29. Lifting restrictions in services can boost logistic performance

Index from 0 to 1 (most restrictive regulations)



Source: OECD Services Trade Restriction Index.

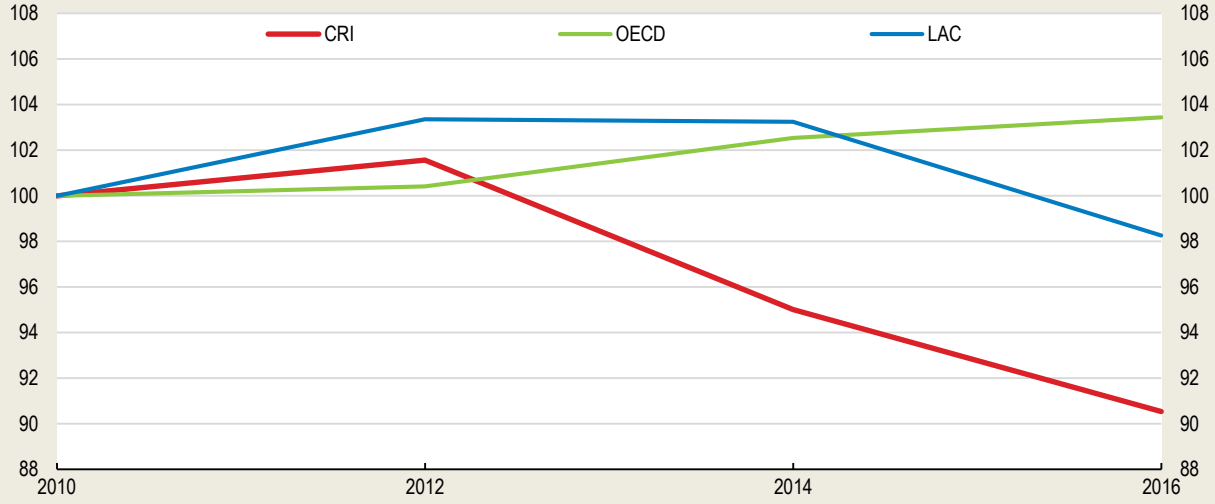
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Box 2.8. Assessing the impact of logistics on exports: a synthetic control method approach

Progress in improving logistics has been significantly lower than in OECD and regional peer countries, with logistics indexes showing a worsening since 2012 (Figure 2.30). The synthetic control method (see Abadie, Diamond, and Hainmueller, 2010, 2011, 2014) can help to gauge the impact that this weak performance in logistics has on exports (Dek and Gonzalez Pandiella, 2020[53]). The synthetic control method uses a data-driven procedure to construct a synthetic control unit, so-called synthetic Costa Rica, using a weighted combination of comparison units (other countries) that approximates the characteristics of the exposed unit (Costa Rica) before an event or intervention. The synthetic Costa Rica can then be used to simulate the development of Costa Rica after the event (in this case the lack of progress in improving logistics services). Results indicate that, had Costa Rica improved its logistic performance in line with improvements made by peer countries, exports would have been significantly higher (Figure 2.31). This highlights that, beyond physical infrastructure, logistics also matters and that policy efforts in this area will pay off in terms of higher exports and growth.

Figure 2.30. Logistics performance has deteriorated

Logistics Performance Index, 2010=100

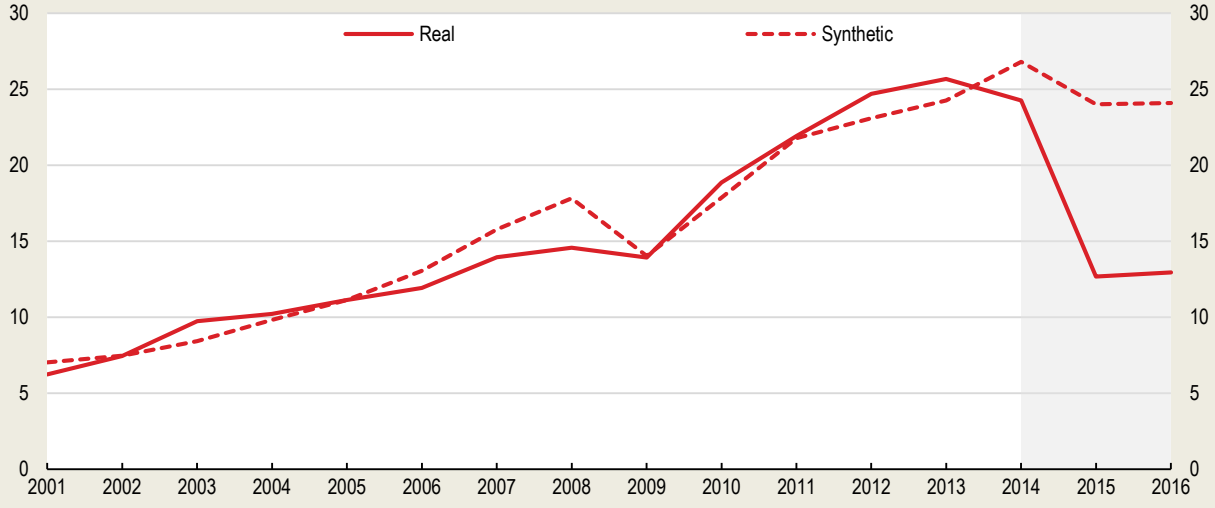


Note: LAC refers to the World Bank group of 25 Latin American and Caribbean countries (excludes high income countries).
Source: World Bank Logistics Performance Index.

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Figure 2.31. Real Costa Rican exports vs synthetic Costa Rican exports

Exports excluding oil and minerals, billions of USD



Note: The following countries were used to construct the synthetic Costa Rica values: Latvia, Lithuania, Mexico and Tanzania.
Source: OECD calculations.

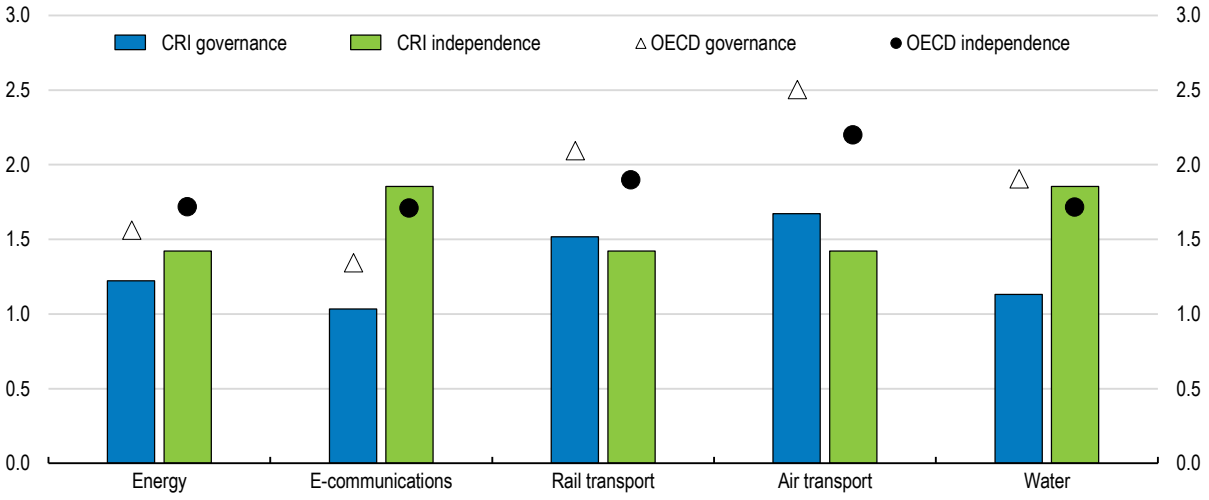
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Improving the governance of regulators

Fostering the role of regulators can also help to move to a more competition-friendly environment in network sectors. OECD indicators in this area suggest that there is room to strengthen the governance of regulators (Figure 2.32) in all sectors by fostering their independence. The independence of a regulator is an important factor in preventing undue influence in regulatory actions and maintaining trust in the regulatory system (Koske et al., 2016[54]). Adopting OECD best practices in the nomination of agency head and board members would be a promising step to increase independence in regulators in Costa Rica. This could be achieved by having these positions publicly advertised and candidates examined by independent selection panels, instead of the current practice of direct nomination by the government. There is also room to provide them with a wider scope of action, such as enforcing compliance with industry and consumer standards and regulatory commitments through legal punitive powers for non-compliance (e.g. inspections and fines) or mediating to resolve disputes between market actors and regulated entities.

Figure 2.32. Indicators on governance of sector regulators

Index from 1 to 6 (better governance)



Note: The Indicators on the Governance of Sector Regulators capture the governance arrangements of economic regulators in the energy, e-communications, rail transport, air transport and water sectors. These indicators are based on the OECD Best Practice Principles for Regulatory Policy: The Governance of Regulators and further guidance developed by the OECD Network of Economic Regulators.
Source: OECD.

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MAIN POLICY FINDINGS	RECOMMENDATIONS
Reducing barriers to entrepreneurship	
Barriers to entry are large. Setting up a firm is costly and burdensome. Regulatory burden is high. Few procedures can be resolved online.	**Introduce online one-stop mechanisms and ensure physical ones cover all licences and permits and are present in all major cities** Eliminate the requirement for using a notary to register a company
Digitalization is low in government and among firms and citizens. Few individuals and firms have a digital signature.	Make the electronic signature mechanism more user-friendly.
Silent is consent rules do not cover all key authorizations and permits. For those included, there is a need to administratively apply for the silent is consent.	Widen the scope of silent is consent rules and remove the need to require administratively its application
Competition	
The competition framework suffer from a number of limitations, which are expected to be remedied through implementation of the recently approved competition reform law.	**Ensure a full and timely implementation of the competition reform road map.**
A good understanding of competition matters by judges and courts would be fundamental for an effective implementation of the competition bill.	Deploy training on competition issues for judges and courts staff.
Remaining exemptions to competition are regressive and inefficient.	**Gradually phase out remaining exemptions to competition law in rice, sugar, coffee, maritime services and professional services.**
Costa Rica court system is relatively slow. This can prevent a swift implementation of the new competition bill, as experienced in some OECD countries.	Boost competition in the legal profession by deregulating lawyers fees.
Improving the involvement of the State in the economy	
SOEs play a dominant role in key sectors of the economy, providing key services for consumers and firms. Some SOEs entail large contingent liabilities.	Establish and monitor performance indicators for SOEs, including their financial health. Ensure full implementation of international accounting standards.
ICE's dominates the electricity market. Its operating performance is low. Private companies are allowed only in the electricity generation and up to 30%. Private firms can only 35% of the capital of the firms generating electricity should be Costa Rican. Its activities go beyond its legal mandate, as it receives direct contracts for public works from other government agencies.	Increase the share of allowed private-sector electricity generation and allow private participation in distribution and retail supply. Remove barriers to foreign participation in the electricity sector. Introduce legal or ownership separation between generation, transmission and retail supply. Focus ICE's activity in the electricity sector.
The methodology used to set regulated tariffs results in cost increases being passed onto consumers. Tariffs have been increasing above other business costs.	Introduce price-to-cap methodologies.

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3 Boosting access to credit and ensuring financial inclusion for all

Having access to credit is essential for households to address the volatility of their personal finances over time and for firms to fund their investments. Accessing financial services at affordable cost on the other hand, is crucial to ensure financial security of all economic units. Despite recent improvements, there are still large financial inclusion disparities in Costa Rica, notably across regions, by gender, and size of firms. This chapter discusses policy reforms that would reduce these disparities. Some of the key policy priorities are to improve transparency by strengthening the credit registry and allocating the development banking credit more effectively. Enhancing financial literacy could help avoid excessive consumer indebtedness. Technological innovation would also help Costa Rica: granting FinTech start-ups direct and full access to the state-of-the-art electronic payments system would increase competition, reduce transactions costs and ensure financial inclusion for all.

Financial inclusion is defined as the effective access to financial services, which are offered at a cost affordable to the customers and sustainable for formal financial service providers. Financial inclusion is essential to both poverty reduction and economic growth: It helps households deal with the volatility of their personal finance, smooth consumption over time, and invest in their human capital. Financial inclusion also allows firms to fund their investments and, therefore, increase in size and improve their productivity. In OECD countries, modern payments systems and digitalised banking services have broadened the access to financial services. This chapter examines Costa Rica's disparities in financial access, using data from household and firm-level surveys as well as credit distribution data. It then discusses what can be done to get financial inclusion in Costa Rica closer to best OECD outcomes, with an emphasis on the role of financial literacy and on what the FinTech industry can do to boost access to credit for all.

Regional landscape and recent policy initiatives

In Latin American countries, such as Argentina, Brazil, Colombia, and Mexico, access to financial services is uneven, which can hamper people's livelihoods and hinder the creation of businesses, with a particular detrimental impact on women's entrepreneurship (Fareed et al., 2017[1]). To tackle financial exclusion, Central Bank of Brazil initiated the Financial Citizenship Programme in 2013, which integrates financial inclusion, consumer protection and financial education objectives (BCB, 2018[2]). Policy makers in Mexico established The National Council for Financial Inclusion in 2011 and finalised the National Strategy for Financial Inclusion in 2016 (OECD, 2017[3]).

Costa Rica has outpaced its Latin American peers in expanding financial access during the last decade. However, large gaps remain, notably across regions and by gender, which leave behind some of the most vulnerable populations. For those who can access credit, excessive indebtedness is sometimes a challenge. SMEs face difficulties in gaining access to finance and cannot realise their productive potential.

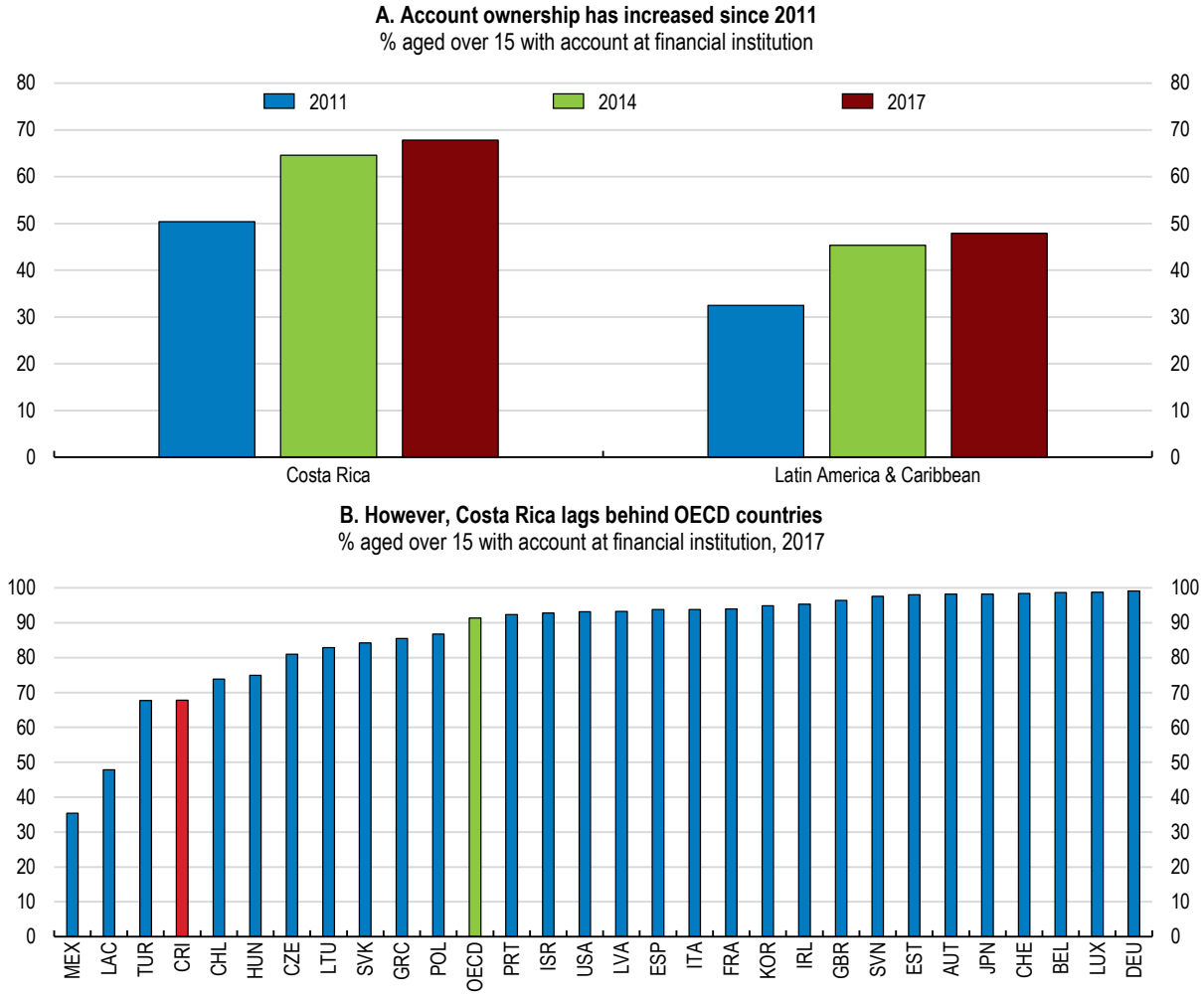
The Central Bank periodically documents the state of the national financial inclusion landscape focusing on SMEs and vulnerable populations in Costa Rica. The government of Costa Rica recently announced guidelines for state-owned banks to boost financial inclusion. These guidelines define loan issuance and intermediation margin targets, and they invite public banks to refinance the loans owed to over-indebted consumers and reduce their debt service burden. Finally, a National Financial Education Strategy, which mainly aims to reduce future excessive borrowing behaviour is launched in 2019 (PGR, 2019[4]).

Where does Costa Rica stand?

Costa Rica lags behind in terms of financial inclusion and financial market development

According to the World Bank's financial inclusion rankings, Costa Rica performed better than peer Latin American countries in account ownership rates in the last decade (Figure 3.1). Nonetheless, the recent improvements in account ownership have not been sufficient to bring Costa Rica to the levels of financial inclusion generally prevailing in the OECD. Only two OECD countries have lower account ownership rates than Costa Rica, Turkey and Mexico.

Figure 3.1. Financial inclusion in Costa Rica lags behind the OECD



Note: Latin American and Caribbean (LAC) includes: Argentina, Belize, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Haiti, Honduras, Jamaica, Mexico, Nicaragua, Panama, Paraguay, Peru and Venezuela.
Source: World Bank Global Findex database (2017).

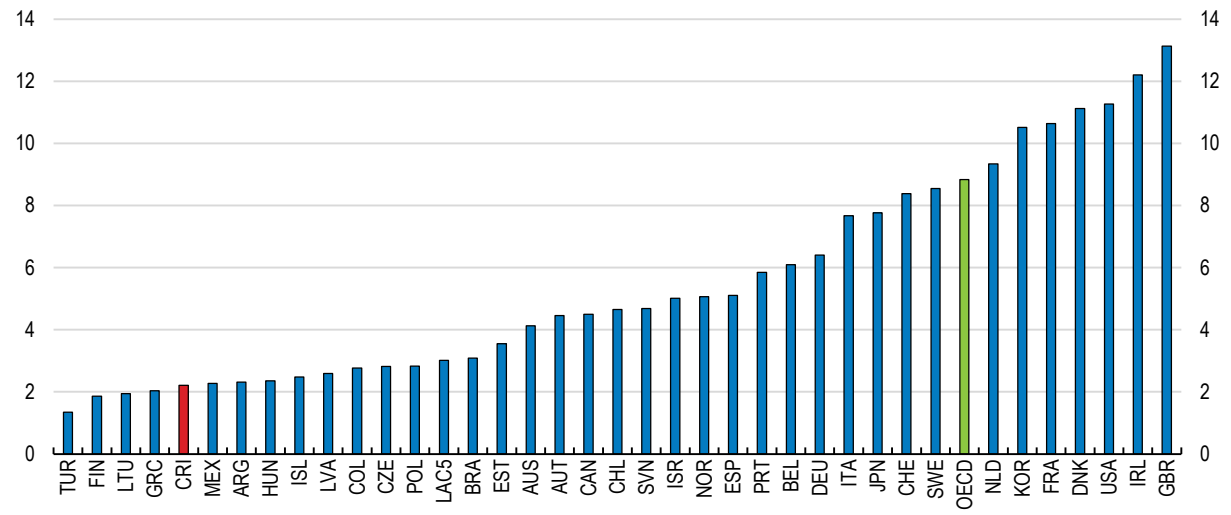
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Insurance penetration, which is measured by the ratio of gross insurance premium payments to GDP is also very low (Figure 3.2) and has not increased since 1975, despite the sector was opened to private participation in 2008 (OECD, 2019[5]). It is also below penetration levels seen in other peer regional countries such as Chile or Colombia. Because of insufficient insurance coverage, households and small firms struggle when they are hit by economic or financial shocks.

Costa Rica fares better than most of its Latin American peers in the use of mobile or internet banking, internet-based purchases, and digital payments (Figure 3.3). The number of registered mobile phone lines per 100 inhabitants has increased by 20% between 2014 and 2017 (Finnovista, 2019[6]). Central Bank estimates that 90% of the population are using a mobile phone with an internet service provider and half of the non-cash transactions are executed by contactless bank cards. Members of the FinTech Association of Central America and the Caribbean further note that 82% of Costa Rican biometrics are submitted in the digital infrastructure of the country.

Figure 3.2. Insurance penetration is low

%, 2018

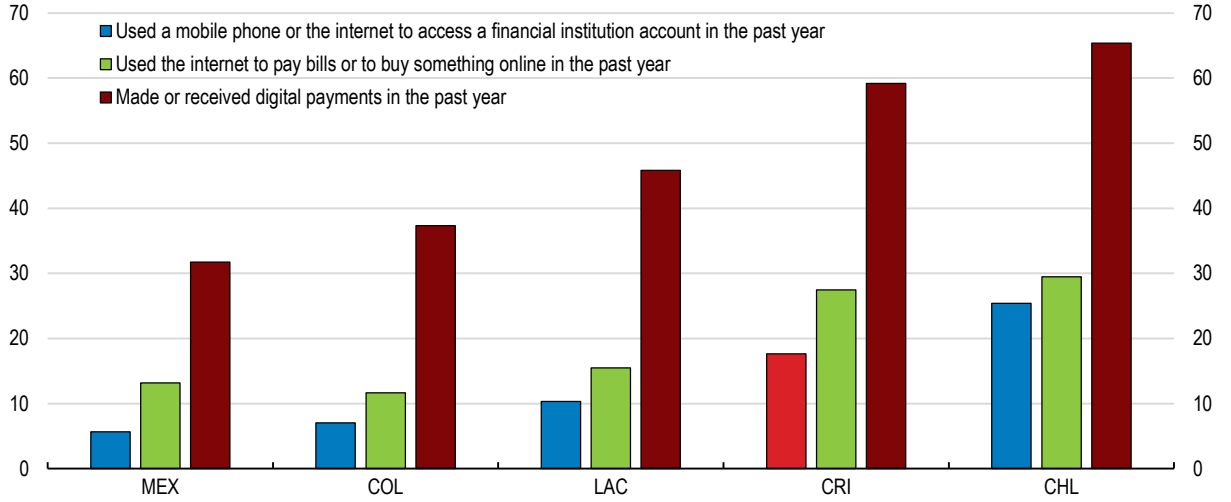


Note: Insurance penetration refers to the ratio of direct gross premiums to GDP. LAC5 country group includes Argentina, Brazil, Chile, Colombia and Mexico.
Source: OECD Insurance Indicators database.

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Figure 3.3. Mobile or internet-based financial services use is more frequent than the peers

% of population aged 15+, 2017



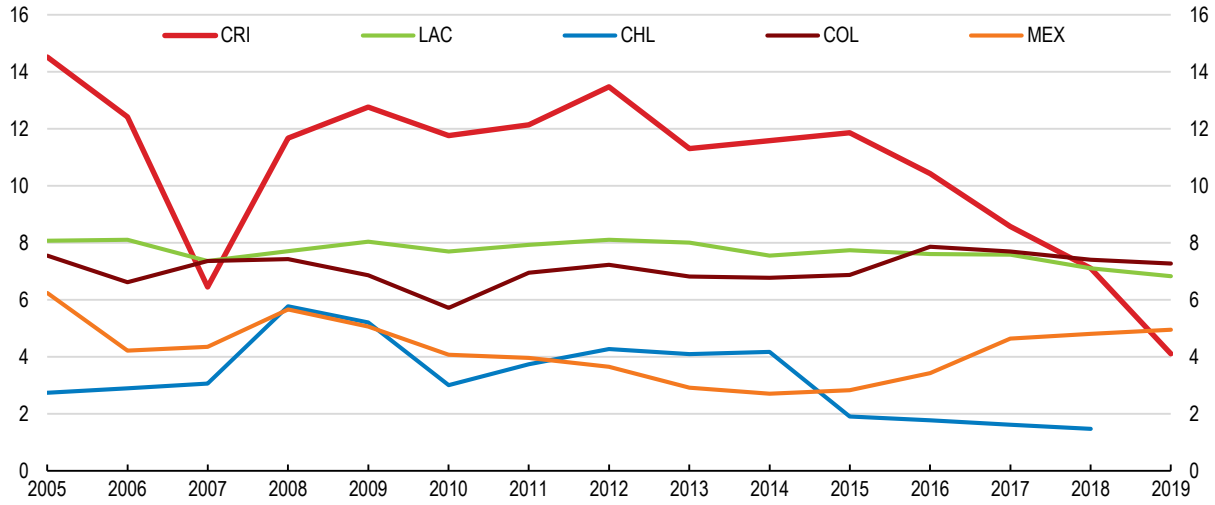
Note: Latin America and Caribbean (LAC) includes: Argentina, Belize, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Haiti, Honduras, Jamaica, Mexico, Nicaragua, Panama, Paraguay, Peru and Venezuela.
Source: World Bank Global Findex database.

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Despite the recent improvements in digital banking and the high quality of the payments system, Costa Rican financial markets display multiple inefficiencies. To give examples, intermediation margins have historically been high (Key Policy Insights) in comparison to peer Latin American countries (Figure 3.4). According to the authorities, electronic transactions cost 1.4% of annual GDP and credit card fees reach 4% of transaction amounts. Excessively high intermediation margins transfer wealth from consumers to banks and make households poorer. Higher transactions costs on the other hand, tax the consumption of goods and services and increase the prevalence of informal, cash-based trades.

Figure 3.4. Intermediation margins have historically been high

Interest rate spread, percentage points

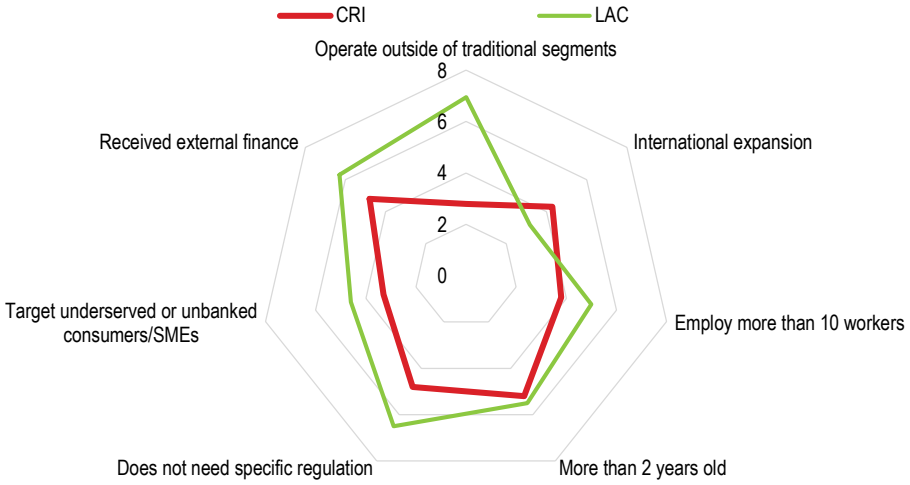


Note: Interest rate spread is the interest rate charged by banks on local currency denominated loans to private sector customers minus the interest rate paid by commercial or similar banks for demand, time, or savings deposits. LAC refers to the World Bank Latin America and Caribbean (excluding high income) grouping of 25 countries.
Source: World Bank World Development Indicators.

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FinTech start-ups in Costa Rica lag behind their Latin American peers, especially in operating outside traditional segments of provision and targeting financially excluded parts of the population (Figure 3.5). In other Latin American countries, Fintech firms have been able to reach underbanked populations more effectively, including in terms of direct lending, financial management and crowdfunding: In Bolivia, El Salvador, Honduras, Nicaragua, Panama and Paraguay all FinTech start-ups target financially excluded households or SMEs (IDB/Finnovista (2018[7]). The regulatory framework in regional peers is also more in line with the demands of FinTech firms than in Costa Rica, which facilitates the faster growth of the industry in these countries.

Figure 3.5. Costa Rica's Fintech firms lag behind their peers

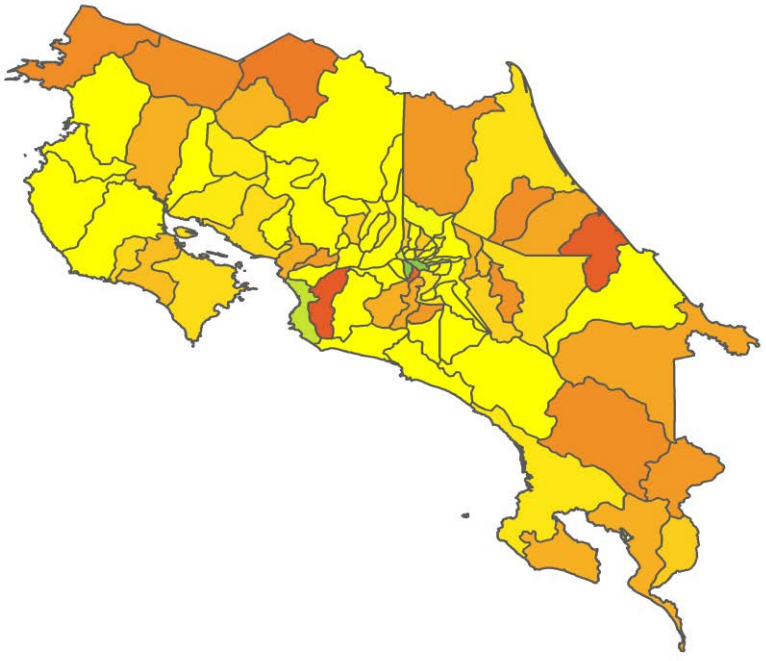


Note: Percentage of FinTech firms (normalised to an index number between 0 and 1) that satisfies the stated feature. LAC refers to the definition adopted in IDB/Finnovista (2018[7]).
Source: IDB/Finnovista (2018[7]); and Finnovista (2019[6]).

Regional disparities in financial inclusion are large

Income inequalities are large in Costa Rica (Key Policy Insights), and co-exist with regional disparities in financial inclusion. A county-level Financial Inclusion Index, especially compiled for this Economic Survey, points to large regional differences (Figure 3.6). The index takes into account the prevalence of financial services access points, credit operations, bank accounts and financial transactions (Box 3.1), following the methodology developed in the OECD Economic Survey of Mexico (Fareed et al., 2017[1]).

Figure 3.6. Regional disparities in financial inclusion are large



Index range	Frequency
0.0 - 0.05	8
0.05 - 0.1	28
0.1 - 0.2	35
0.2 - 0.3	3
0.3 - 0.4	3
0.4 - 0.8	4

Statistic	Value
Maximum	0.80
Minimum	0.02
Median	0.11
Std deviation	0.12

Note: The county of Rio Cuarto, which was created in 2017 is excluded from the analysis for consistency.
Source: Banco Central de Costa Rica; Instituto Nacional de Estadística y Censos; and Superintendencia General de Entidades Financieras.

This new index reveals that access to financial services is very limited in many counties. Costa Rica's geographical landscape is very diverse, causing sharp variations in population densities. Counties with a low financial inclusion score are mostly low population density areas. However, some counties, for example Alajuelita and Desamparados in the province of San José and San Rafael and San Pablo in the province of Heredia are highly populated and yet attain very low financial inclusion scores. Implementing urgent action plans to address the financial exclusion problem in these counties would improve the lives of many and help reduce regional disparities.

Box 3.1. Financial Inclusion Index

Financial Inclusion Index (FII) is built using data from the Central Bank of Costa Rica (BCCR), the General Superintendence of Financial Institutions (SUGEF) and National Institute of Statistics and Census (INEC) on a series of financial inclusion indicators regarding availability and usage of different financial services at the county level.

The Financial Inclusion Index takes into account five dimensions:

- Accessibility of financial services
- Depth of credit services
- Concentration of current accounts
- Concentration of savings accounts and
- Usage of financial channels.

Accessibility of financial services is measured by the total number of access points per 10 000 inhabitants. Access points include data on offices, branches, counters, kiosks or other physical spaces owned by all financial institutions regulated by the SUGEF and data on point-of-service (POS) terminals as well as automated teller machines (ATMs) provided by the Central Bank. Depth of credit services is based on the number of credit operations per 10 000 inhabitants in each county. These credit products include personal loans, car loans, housing loans, consumer durables loans and commercial loans. Concentration of current and savings accounts refers to the number of all types of current and savings bank accounts per 10 000 inhabitants in each county. Finally, usage of financial channels is measured by the number of transactions carried out using ATMs or POS terminals per 10 000 inhabitants in each county. Depth of credit services includes both consumer and commercial loans and concentration of accounts indicators do not differentiate between account owner types. Therefore, the FII would help measure the financial inclusion levels of both households and firms.

For each of the above-mentioned financial inclusion dimensions, an individual index is created at the

county level, using the formula

$$f_{ic} = \frac{a_{ic} - min_i}{max_i - min_i}$$

where, f_{ic}= Normalised index value for indicator *i* and county *c*, a_{ic} = The actual value of indicator *i* for county *c*, min_i = Minimum value of indicator *i* across counties and max_i = Maximum value of indicator *i* across counties.

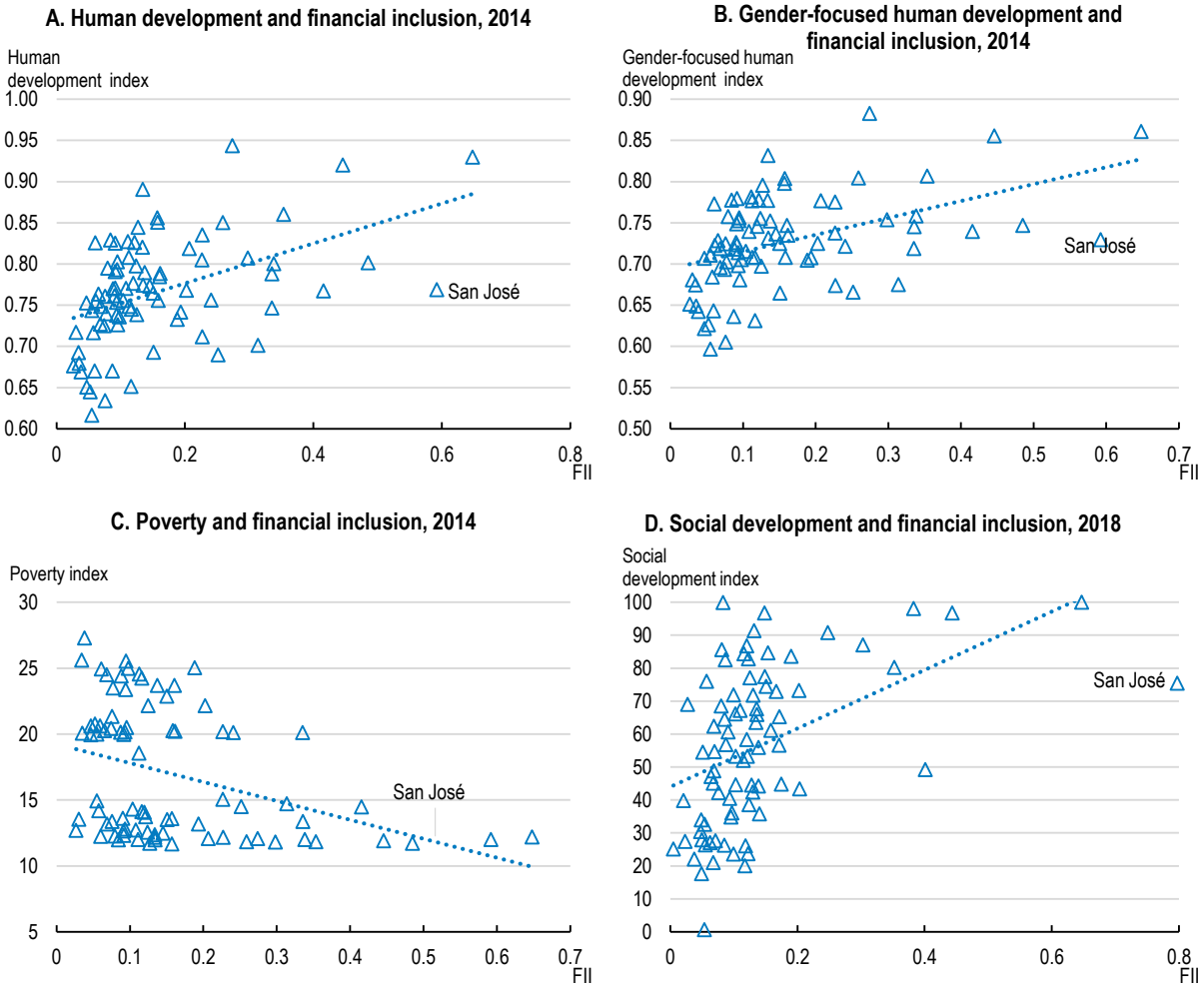
Following the methodology in Fareed et al. (2017[1]), the FII is computed by taking the arithmetic average of the dimension indices $F_c = \sum_{i=1}^{5} f_{ic}$ normalised to range between 0 and 1, where 0 refers to the lowest cross-county level of financial inclusion in the context of the relevant sub-index.

Note: Rio Cuarto, a county that was created in 2017 is excluded from the analysis for consistency. This results in 81 counties in total.
Source: Banco Central de Costa Rica, Instituto Nacional de Estadística y Censos and Superintendencia General de Entidades Financieras.

A virtuous cycle between financial inclusion and poverty reduction

Regions that show higher financial inclusion tend to display better human development outcomes and less poverty in Costa Rica (Figure 3.7). These patterns are similar to peer Latin American countries, such as Mexico, in which higher financial inclusion prevails in more affluent states (with lower poverty rates) (OECD, 2017[3]).

Figure 3.7. Poor and less-developed countries have lower financial inclusion



Note: FII levels in 2014 include sub-components of accessibility, credit service depth and financial channels. Social development index levels refer to year 2017 and include components on economic development, electoral participation, health, education and security.
Source: Banco Central de Costa Rica; Instituto Nacional de Estadística y Censos; Ministry of National Planning and Economic Policy; Superintendencia General de Entidades Financieras; University of Costa Rica; and the United Nations Program for Development.

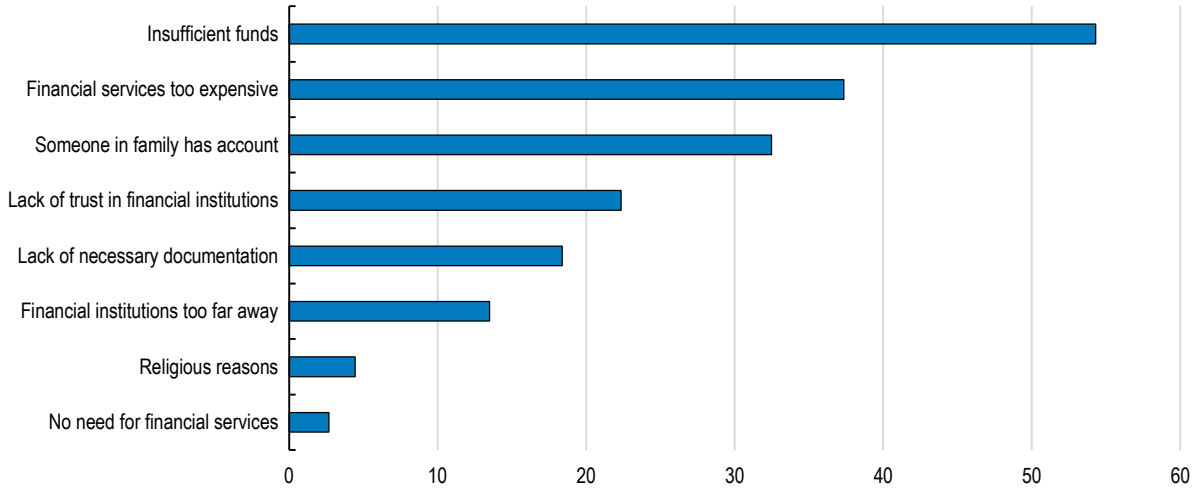
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On the other side of the coin, poverty and low financial wealth reduce access to financial services (Figure 3.8) in Costa Rica. One way to alleviate the effect of poverty on financial inclusion is to reduce the cost of these services. For example, increasing competition in the Costa Rican banking sector could reduce loan intermediation margins and the cost of financial services. This would weaken the barriers to financial inclusion, as observed in emerging market and developing countries (Beck, Demirgüç-Kunt and Martinez

Peria, 2008[8]). Therefore, Costa Rica could benefit from a virtuous cycle of boosting financial inclusion, and at the same time, reducing poverty, which are interrelated and would support each other (Beck, Demirgüç-Kunt and Levine, 2007[9]).

Figure 3.8. Costa Rican consumers deem financial services to be expensive

% of population aged 15+, 2017



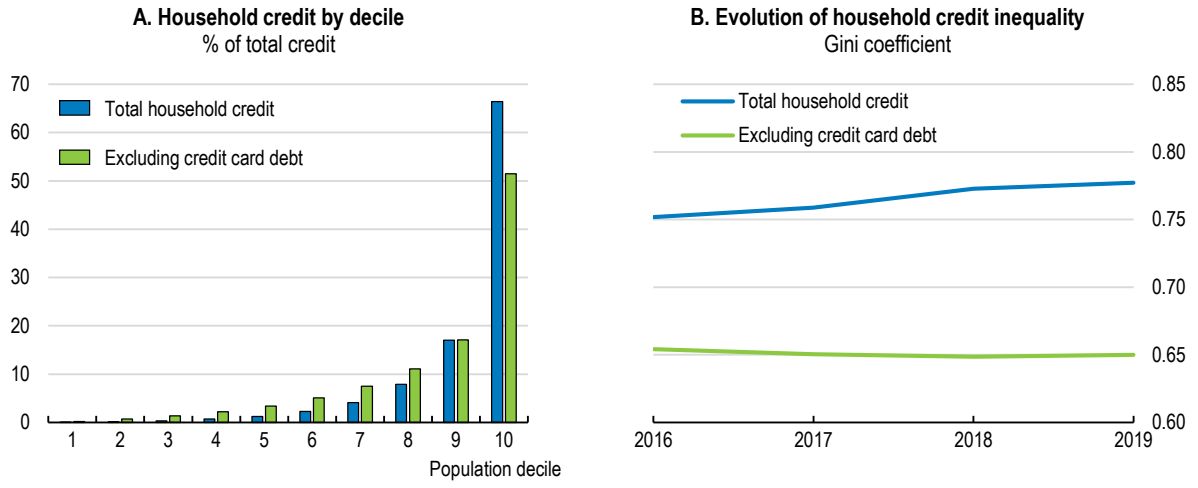
Note: Reasons quoted by individuals aged over 15, who do not hold an account.
Source: World Bank Global Findex database.

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Credit is distributed unequally among households

Inequality in the distribution of household credit is high and has recently been increasing in Costa Rica (Figure 3.9). When low-income consumers have less access to credit, it becomes more difficult for them to address the volatility of their personal finances and maintain a stable consumption level. One factor that exacerbates the inequality in consumer credit distribution is the allocation of credit card debt among households (Figure 3.9). Unequal access to credit cards tilts the consumption basket of poorer households toward goods and services that are only purchased by cash. The increased prevalence of cash-based consumption expenditures then elevates informality and makes the consumption of the poor more vulnerable to inflation (Erosa and Ventura, 2002[10]).

Figure 3.9. The distribution of credit among households displays large inequality



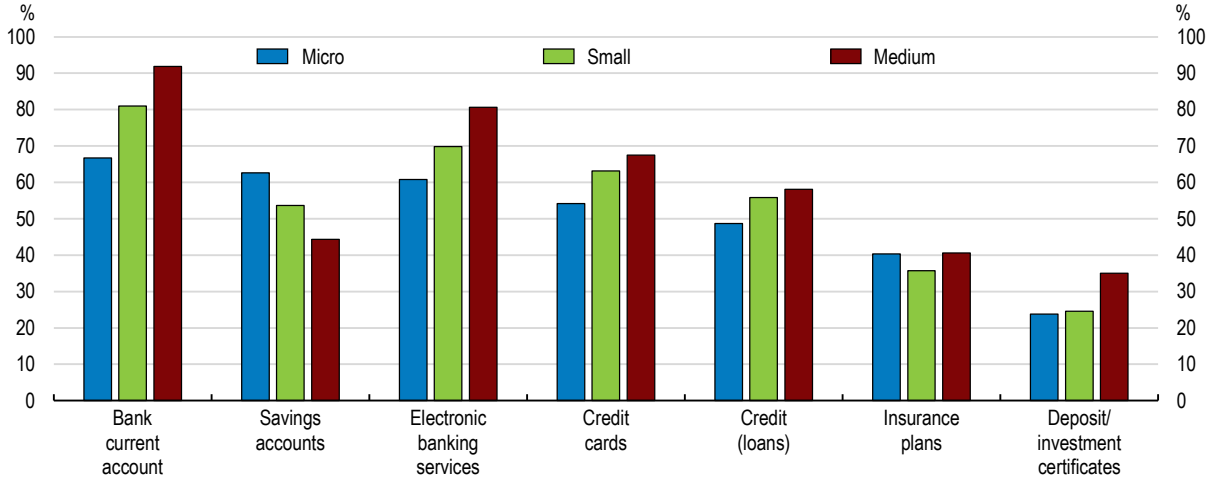
Note: Data in Panel A refer to June 2019.
Source: Banco Central de Costa Rica.

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Financial inclusion of micro-entrepreneurs is low

Most SMEs have access to at least one financial service in Costa Rica. Within SMEs, micro-entrepreneurs have lower financial inclusion than larger firms but own more frequently savings accounts and insurance plans (Figure 3.10). This shows that they either try to self-insure or look for outside insurance.

Figure 3.10. Smaller SMEs face difficulties in having access to financial services



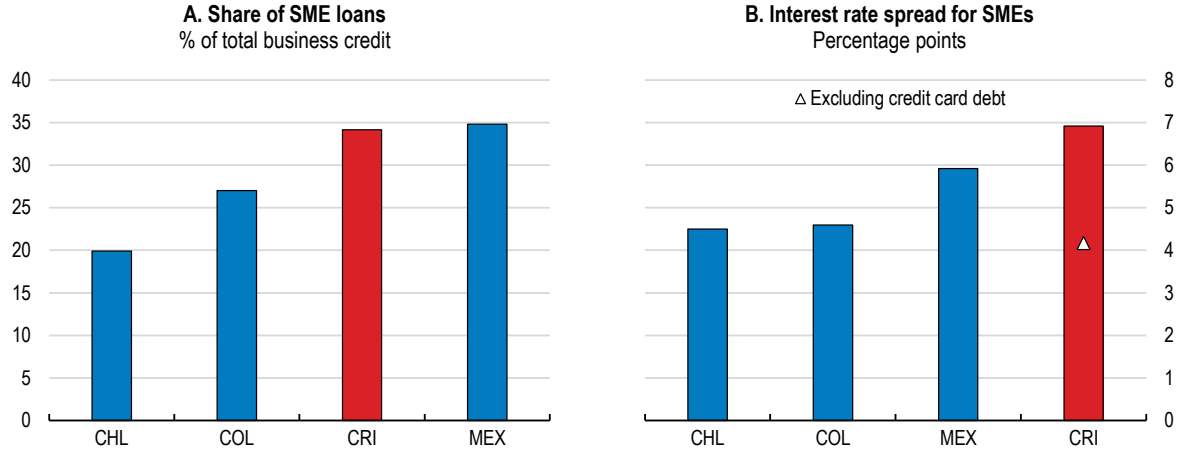
Note: Share of SMEs, who confirm the usage of the financial product of interest. Based on the results from the Survey of Performance and Business Outlook, conducted by the Central Bank. The survey has a sample of 612 Costa Rican SMEs, stratified by size.
Source: Survey of Performance and Business Outlook (2016) conducted by Banco Central de Costa Rica.

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SME credit is considerably more expensive for smaller firms

SME credit corresponds to a larger share of total outstanding business loans in Costa Rica relative to peer countries such as Chile or Colombia. At the same time, compared with their regional peers, Costa Rican SMEs pay a higher excess interest on loans relative to large firms (Figure 3.11). One reason that makes the cost of credit disproportionately high for SMEs in Costa Rica is the use of credit card debt for productive activities (Table 3.1). Many micro-entrepreneurs operate informally and therefore find it difficult to receive commercial loans from the regulated banking system. This makes them use consumer loans on their personal account to finance commercial activities, which is more costly. The effect of using consumer loans for productive activity on the cost of credit is more pronounced when SMEs borrow from private banks (Table 3.1). This limits the availability of private bank credit for SMEs and hinders their growth potential.

Figure 3.11. The interest premium paid by smaller SMEs is higher than in peer countries



Note: Panel B denotes the difference between average SME and large firm loan rates. Data for Costa Rica refer to June 2019. Data for Chile and Colombia refer to 2018 and for Mexico refer to 2017 in Panel A. Data for Chile, Colombia and Mexico in Panel B refer to 2018.
Source: Banco Central de Costa Rica; Financing SMEs and Entrepreneurs 2019, An OECD Scoreboard (2019[11]); Financing SMEs and Entrepreneurs 2020, An OECD Scoreboard, (OECD, 2020[12]), forthcoming.

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Table 3.1. Using credit card debt for commercial activities hurts smaller SMEs more

SME credit scoreboard for Costa Rica

		2016	2017	2018	2019
Outstanding business loans, SMEs	CRC billions	2,553	2,681	2,789	2,712
Outstanding business loans, total	CRC billions	6,940	7,853	7,830	7,940
Share of SME outstanding loans	% of total outstanding business loans	36.8	34.1	35.6	34.2
Outstanding short-term loans, SMEs	CRC billions	128	122	98	87
Outstanding long-term loans, SMEs	CRC billions	2,425	2,558	2,691	2,625
Share of short-term SME lending	% of total SME lending	5.0	4.6	3.5	3.2
Interest rate, SMEs	%	20.7	21.7	23.7	24.9
Interest rate, large firms	%	13.1	14.8	16.8	18.0
Interest rate spread	Paid by SMEs, percentage points	7.7	6.9	6.9	6.9
Excluding credit card debt					
Interest rate, SMEs	%	9.8	9.4	10.0	10.4
Interest rate, large firms	%	6.3	5.9	6.1	6.3

Interest rate spread	Paid by SMEs, percentage points	3.5	3.5	3.9	4.2
Credit by state-owned banks					
Interest rate, SMEs	%	14.5	14.3	15.1	15.4
Interest rate, large firms	%	10.4	10.0	11.5	11.7
Interest rate spread	Paid by SMEs, percentage points	4.1	4.3	3.6	3.7
Credit by private banks					
Interest rate, SMEs	%	26.0	27.3	29.0	30.1
Interest rate, large firms	%	13.6	15.8	17.8	19.1
Interest rate spread	Paid by SMEs, percentage points	12.4	11.5	11.2	11.0
Credit by state-owned banks					
Excluding credit card debt					
Interest rate, SMEs	%	9.7	9.2	9.7	9.9
Interest rate, large firms	%	7.4	6.6	7.2	7.6
Interest rate spread	Paid by SMEs, percentage points	2.3	2.6	2.5	2.3
Credit by private banks					
Excluding credit card debt					
Interest rate, SMEs	%	8.5	8.5	9.8	10.3
Interest rate, large firms	%	5.8	5.4	5.5	5.7
Interest rate spread	Paid by SMEs, percentage points	2.7	3.1	4.2	4.6

Note: Indicator definitions follow Financing SMEs and Entrepreneurs 2019, An OECD Scoreboard (2019[11]).
Source: Banco Central de Costa Rica.

Boosting household financial inclusion

Addressing gender gaps

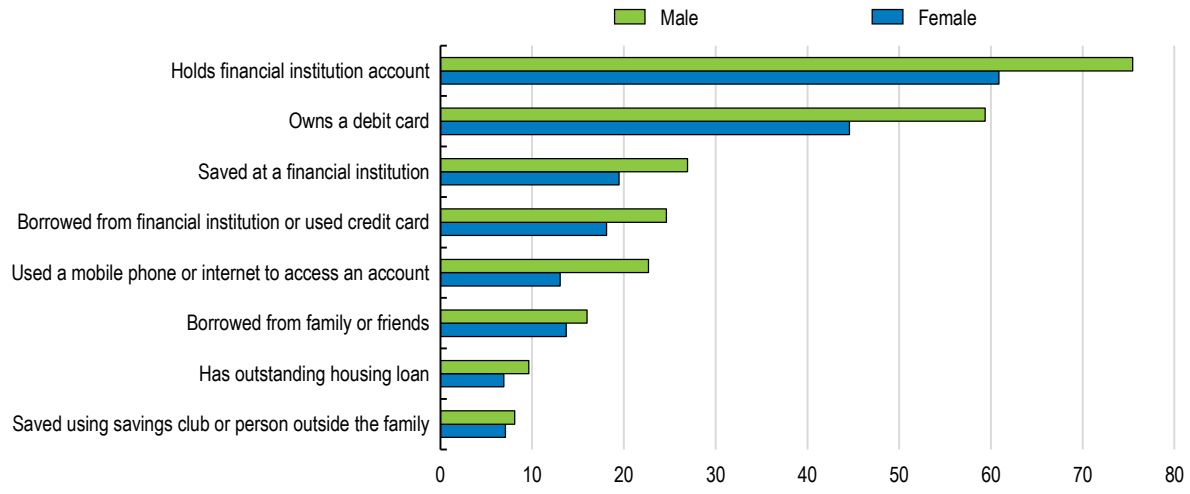
Women are less financially included than men in Costa Rica (Figure 3.12), in part due to low female labour market participation (Key Policy Insights). Tackling gender gaps in access to financial services requires action in two key areas: increasing the digitalisation of finance and enhancing financial literacy of women.

The high mobile phone penetration rates in Costa Rica (Finnovista, 2019[6]) creates room to utilise digitalisation of finance, which would help reduce gender gaps in financial inclusion. Digitalisation of finance would provide autonomy to women in their financial decision-making process and allow them to access services that are more suitable for their personality and individual needs (G20/OECD INFE Policy Guidance (2018[13])). Mitigating the necessity to travel to a physical point of service by the help of digitalisation would also benefit women asymmetrically more, as the majority of individuals who have caring responsibilities are females. In developing countries, the use of mobile money is found to be instrumental in reducing poverty and boosting women's transition from agriculture to the sectors of retail or services (Suri and Jack, 2016[14]). In addition, sending regular text messages to mobile phone users to remind them of their savings goals increased savings in Bolivia, Peru and the Philippines (Georgieva, 2018[15]).

Women's financial literacy could also be improved to tackle gender gaps in financial inclusion: A Financial Education Index recently published by the Central Bank reveals that financial literacy of women is below men in Costa Rica (BCCR, 2018[16]). South-Africa's experience shows that integrating financial education messages into mainstream entertainment media boosts the level of financial literacy of viewers and induces them to search for formal credit sources for productive use (Berg and Zia, 2017[17]). Using social media effectively would further increase these benefits. Teaching financial education to students early in their schooling life and employing women trainers would enhance financial literacy on a gender-equitable basis (OECD, 2013[18]).

Figure 3.12. Gender gaps in financial inclusion are large

% of population aged 15+, 2017



Source: World Bank Global Findex database.

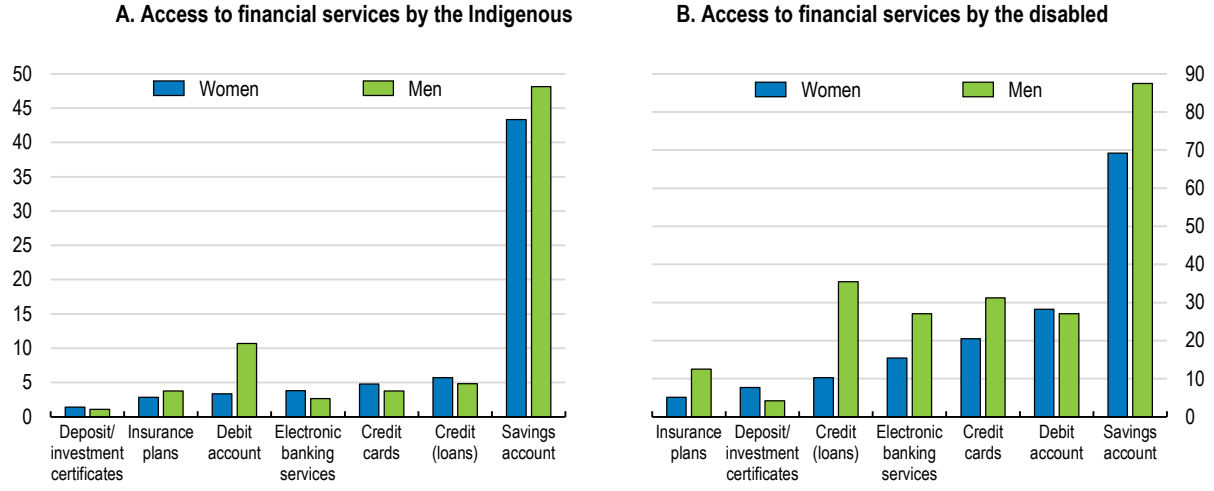
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Ensuring financial security of vulnerable minorities

Access of vulnerable minorities to finance is below that of the average Costa Rican citizen (Figure 3.12 and Figure 3.13). Complete financial exclusion is especially widespread among Indigenous populations coming from different ethnic origins (Figure 3.14). In addition, those that are barely linked with the financial system mainly own savings accounts, which are low cost to run but come with a low level of functionality. This makes addressing the volatility of personal finances extremely difficult for vulnerable minorities and creates poverty traps for them.

Figure 3.13. Priority groups mainly rely on savings accounts

%, 2016

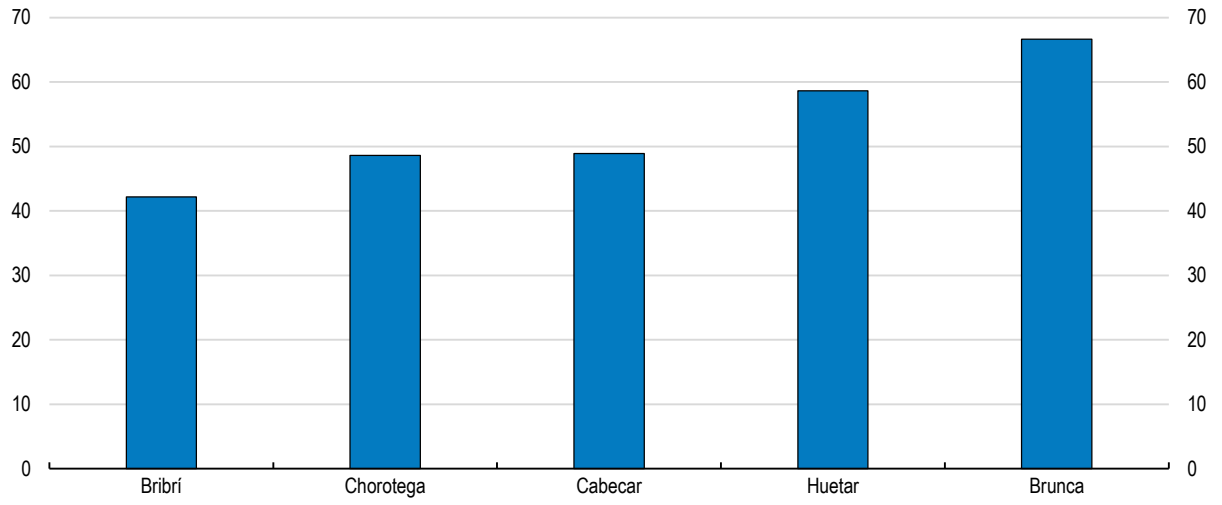


Source: Financial Inclusion Survey (2016) conducted by Banco Central de Costa Rica.

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Figure 3.14. Indigenous populations suffer from severe financial exclusion

% of total population using at least one financial service, 2016



Note: The horizontal axis lists main Indigenous ethnic groups covered by the Financial Inclusion Survey (2016). Census data indicate that Costa Rica has around a total of 100 000 Indigenous people, which represent 2.4% of the country's population.
Source: Financial Inclusion Survey (2016) conducted by Banco Central de Costa Rica.

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Maintaining better human development outcomes of Indigenous populations have also been a challenge in OECD countries such as Australia, Canada, Mexico, New Zealand, and the United States. Lack of collateral, less credit history, information asymmetry, and discrimination are among main financial imperfections faced by these populations. In Costa Rica, the institute for social assistance, *IMAS*, has recently moved more than 14 thousand prepaid beneficiary accounts under the *Avancemos* programme (the largest conditional cash transfer programme) to debit card accounts. Covering more Indigenous groups in such programmes can increase savings account penetration among communities, such as the Bribri, in which complete financial exclusion is very high.

OECD countries implemented microcredit programmes and large loan facilities supported by the governments to boost the access of Indigenous populations to credit (OECD, 2019[19]). Nonetheless, permanent improvements in the financial capacity of Indigenous populations can only be realised if Indigenous people are given the chance to come up with their own solutions, autonomously (Box 3.2). Helping Indigenous populations to build their own banking networks would make it easier for these groups to reduce information asymmetries, pool their resources, and manage financial risks (OECD, 2019[19]).

Box 3.2. Boosting financial inclusion of the Indigenous

- The Business Development Bank of Canada, a government-backed financial entity for SME credit, makes loans to existing Indigenous businesses up to CAD 250 000. The credit limit for Indigenous start-ups is CAD 150 000. These loans fund the purchase of fixed assets, franchise fees, start-up costs, export requirements and working capital requirements.
- Indigenous Business Australia provides loans that range between AUD 10 000 and AUD 5 000 000 to Indigenous entrepreneurs. These loans can be used to fund working capital requirements, purchase of existing businesses, plant and equipment, and commercial assets. The loans also come with temporary periods with no interest payment and flexible repayment schedules that take into account seasonal factors. Larger loans are used to purchase equipment, which is a pre-requisite for public procurement in some cases.
- The United States established the Community Development Finance Institution Fund in 1994. This fund supports the Native American Community Development Finance Institution Programme, which provides financial assistance, technical assistance and capacity building support to native communities. There are currently more than 70 local Indigenous financial institutions in the United States.
- Aboriginal Financial Institutions were established in Canada in 1980s and are owned and run by Indigenous populations. These local financial institutions supported 500 start-ups and 750 existing businesses on average and helped create or sustain 4 000 full-time jobs in the last five years.

Source: OECD Rural Policy Reviews; Linking Indigenous Communities with Regional Development (2019[19])

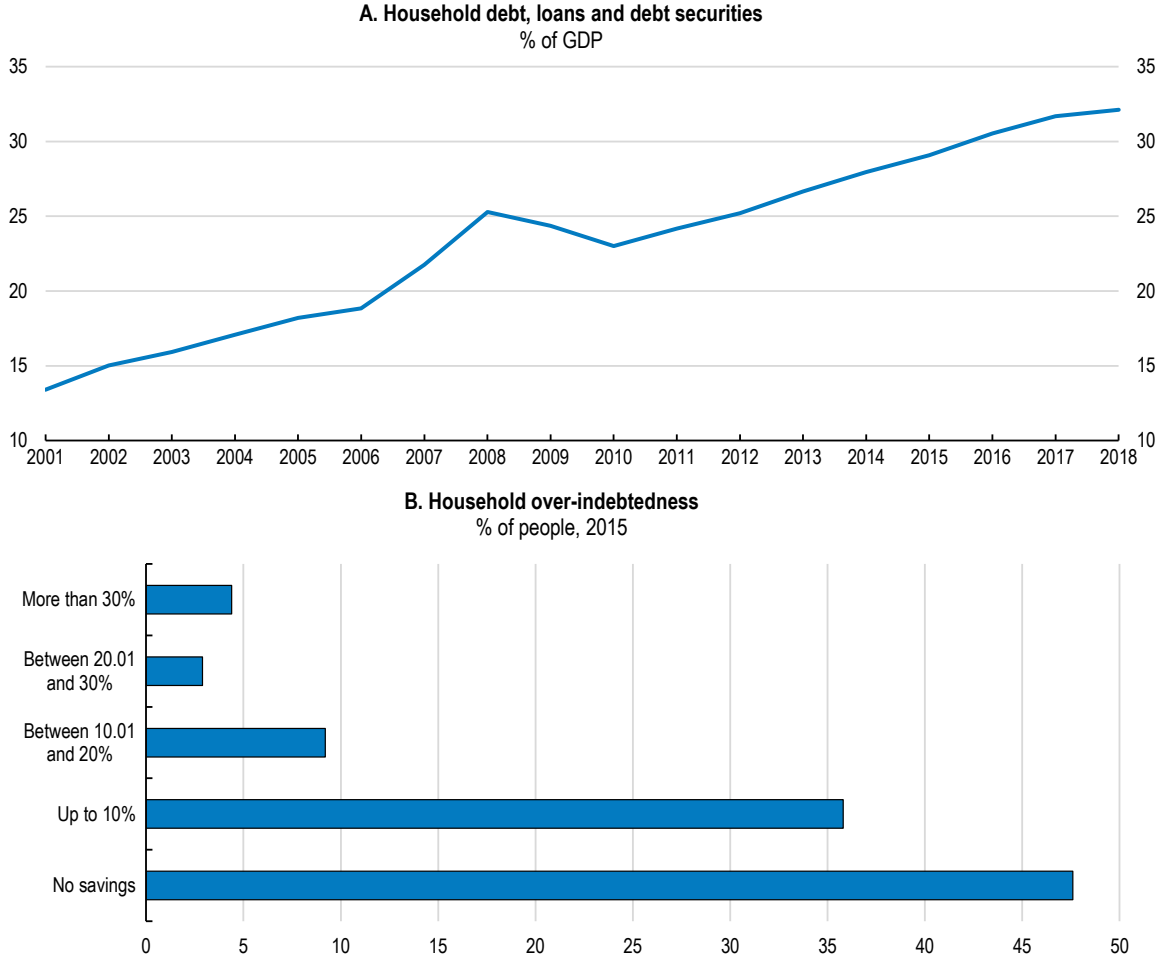
Tackling excessive household indebtedness

While many households cannot get any credit (Figure 3.9), some of the Costa Rican households who have access to the financial system find themselves at risk of excessive indebtedness (Figure 3.15), especially when they borrow large amounts through consumer loans. The Household Financial Survey conducted by the Central Bank reveals that almost half of Costa Ricans have no savings (Figure 3.15). In addition, the latest National Survey of Income and Expenses showed that around 68.9% of Costa Rican households are indebted (INEC, 2018[20]).

SME owners operating in informality sometimes finance their activity using credit card loans, which do not require pledging collateral and come with very high interest rates (Table 3.1). Failing to keep business and personal finances separate creates a snowballing effect in consumer indebtedness and jeopardises the financial security of households, when the expensive credit card debt is rolled over. The resulting excessive household indebtedness hampers consumer confidence, and therefore consumer spending, which undermines the momentum of aggregate demand.

In order to tackle the over-indebtedness problem, the government launched in October 2019, a debt exchange programme: *Creación del Programa de Créditos de Salvamento*. The initiative instructs Banco Popular and the two state-owned banks, Banco Nacional and Banco de Costa Rica to issue refinanced loans that would provide debt relief to households. The refinanced loans come with reduced interest rates and longer repayment periods. Recipients of the programme pledge at least 40% of their stable salaries as a guarantee, and are not able to borrow new loans until they repay half of their reduced balance. They will also have to enrol into a government-sponsored financial education programme during the three years that follow the receipt of the refinanced loan. All three banks have announced their version of the programme by the end of 2019.

Figure 3.15. Household indebtedness has increased rapidly



Note: Categories in Panel B refer to the ratio of savings to income.
Source: IMF Global Debt Database; and the Household Financial Survey (2015) conducted by Banco Central de Costa Rica.

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Authorities consider interest rate ceilings as another measure to curb excessive indebtedness of Costa Rican households. The interest rate ceilings are to be set by the Committee on Tax affairs, the Central Bank and the General Superintendent. Final discussions led to a rate of about 3 times the average loan rate that prevails in the domestic financial system. The methodology of the General Superintendent takes into account the cost of financial intermediation, liquidity, average administrative expenses of all financial entities and the expected risk of losses on more than 1 million credit operations that took place between 2014 and 2018.

Interest rate ceilings are not effective in bringing debt relief to over-indebted borrowers (Zinman, 2010[21]). In particular, tight ceilings ration low-end borrowers in the creditworthiness distribution and direct them to informal credit markets. Recent Chilean experience shows interest rate ceilings that are similar to those discussed in Costa Rica excluded about 10% of borrowers from the credit market (Madeira, 2019[22]). In addition, the credit-rationed typically belong to the most vulnerable: the young, the least educated and the poor. Best international practices suggest long-term and structural remedies to debt build-ups. These include improving competition in the financial sector, strengthening consumer protection schemes (Box 3.3), enhancing financial education and strengthening credit registry offices (Maimbo and Gallegos, 2014[23]).

Box 3.3. Protecting financial consumers is essential to meaningful financial inclusion

Efforts to boost household financial inclusion and increase access to credit should be accompanied by an appropriate level of financial consumer protection in order to ensure that borrowers are treated fairly, that the risks of misconduct and exploitative practices are addressed and, overall, the likelihood of repayment problems, which result in over-indebtedness are reduced. In 2019, the OECD released an updated version of the OECD Council Recommendation on Consumer Protection in the field of Consumer Credit (2019[24]). The updated Recommendation sets out a framework of recommended measures to support the protection of borrowers and promote good outcomes in credit transactions. Some of the measures set out in the Recommendation relate to:

- Disclosure of key terms and conditions in contractual and pre-contractual information in a clear, accurate and not misleading manner
- Responsible lending including assessment of a consumer's ability to meet their repayment obligations
- Treatment of consumers who may be vulnerable or experiencing financial difficulty, within responsible conduct relating to debt collection
- Promoting financial education and awareness in rights and responsibilities relating to credit, including where to seek assistance with debt problems.

Source: OECD Council Recommendation on Consumer Protection in the field of Consumer Credit (2019[24]).

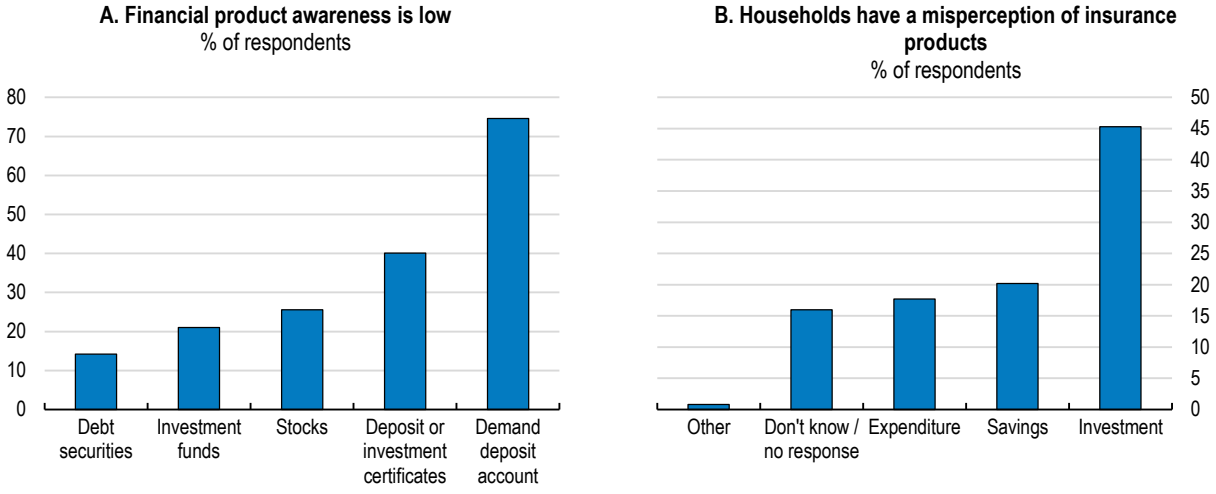
Promoting financial education to prevent excessive debt build-ups

Improving the financial literacy of households may help prevent large consumer debt build-ups (Figure 3.16) as low financial literacy is positively associated with the use of costly credit products by consumers (Gathergood, 2012[25]). Survey-based results compiled by the Central Bank reveal that financial literacy is low in Costa Rica (BCCR, 2018[16]): An assessment aimed to explore participants' understanding of basic financial concepts such as stock returns, inflation, interest rates, and the exchange rate resulted in nearly half of survey participants answering all questions of the test incorrectly. Therefore, teaching consumers how to make the right borrowing decisions emerges as a key priority to prevent excessive borrowing in Costa Rica.

Improving the financial literacy of Costa Ricans would also boost their financial inclusion. For example, many consumers think buying insurance is similar to consumption spending or saving (Figure 3.16), which partly explains low insurance penetration in Costa Rica (Figure 3.2). Cross-country evidence also shows that individuals who had recently made a financial product choice typically display higher financial literacy (Atkinson and Messy, 2013[26]).

The Ministry of Economy, Industry and Commerce (MEIC) launched the National Financial Education Strategy in January 2019, foreseeing collaborations with financial entities to boost financial literacy outcomes in Costa Rica (Box 3.4). MEIC and Banco Nacional de Costa Rica recently agreed on a financial management training programme within this initiative. The programme aims to reach out to 250 000 individuals by 2020 and entails provision of material, curriculum building and training logistics by financial entities under the supervision of the ministry.

Figure 3.16. Financial literacy outcomes are low



Note: Panel A reports percentage of respondents who stated that they are aware of the financial product in question. Panel B displays the popularity of the concept that is deemed to be most closely associated with buying insurance.
Source: The Household Financial Survey (2015) conducted by Banco Central de Costa Rica.

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Box 3.4. The National Financial Education Strategy of Costa Rica

The Government of Costa Rica issued the Executive Decree No. 41546-MP-MEIC (PGR, 2019[4]) on 30 January 2019, which provides the legal basis for the National Financial Education Strategy.

The policy objectives within the Strategy are as follows:

- Enhancing citizens' capability of applying basic financial concepts
- Boosting citizens' understanding of the effect of main macroeconomic indicators on the well-being of individuals
- Implementing actions that help the population make more autonomous and conscious financial decisions
- Promoting sectoral programmes in co-ordination with strategic partners

Target audiences of the Strategy include children, youth, public officials, women, SMEs, senior adults and vulnerable populations.

The educational topics of the Strategy focus in the following areas:

- Budgeting and personal finance
- Preventing over-indebtedness
- Savings, self-control and consumption behaviour
- Proper and responsible use of credit cards and loans
- Avoiding the misplaced use of consumer credit in commercial activities

Note: The working group that is established to define the National Financial Education Strategy of Costa Rica includes the Ministry of Economy, Industry and Commerce, the Ministry of Public Education, the Ministry of Culture and Youth, the Central Bank, the National Financial System Supervision Council, the National Council of Rectors, the General Directorate of Civil Service, the National Learning Institute, the National Women's Institute, financial sector superintendents and two representatives from the chambers and associations of the financial sector.
Source: Ministerio de Economía, Industria y Comercio de Costa Rica.

The financial education strategy in Costa Rica can be complemented with "Smarter Financial Education", which highlights the impact of behavioural insights in improving financial literacy of individuals (Box 3.5). For example, access to a savings account or credit product can be combined with enrolment to a financial education programme; sliders and graphics can be used in lender websites, which would easily inform borrowers on their future debt repayment profiles; and consumers can be provided with practical tips, which remind them to switch off regular financial marketing notifications or to cancel subscriptions that would induce them to buy goods or services on credit.

Box 3.5. Smarter Financial Education

The OECD and the International Organisation of Securities Commissions identify the main pillars of Smarter Financial Education, focusing on behavioural insights to achieve enhanced financial education and compile good international practices:

- **Make the provision of financial educational content focused, straightforward and simple to understand.** The National Plan for Financial Education of Peru includes simple rules and short messages such as "Should I buy it?" or "Can you lend me money?" in financial education materials.
- **Make financial education programmes as personalised as possible.** The Securities and Exchange Commission of Brazil developed educational series on behavioural biases that affect investments, savings and consumption.
- **Design programmes that help people take actions.** The Financial Services Authority of Denmark has designed "The Banking Game", which runs on a smartphone and helps boost consumers' understanding of negotiation with banks and financial markets in general.
- **Use digital channels to facilitate the application of behavioural insights.** The Australian Securities and Investments Commission has designed "MoneySmart Financial Advice Toolkit", an online tool that adopts a step-by-step approach in enhancing consumers' understanding of getting professional advice in finance.

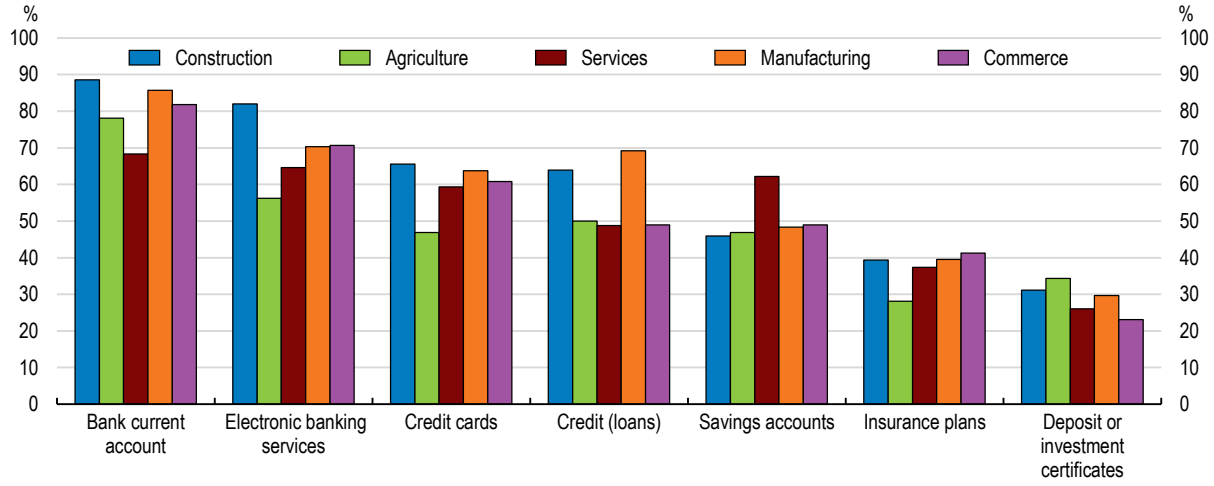
Source: OECD (2019[27]). Smarter financial education: key lessons from behavioural insights for financial literacy initiatives.

Boosting financial inclusion of SMEs

Improving insurance penetration in the agricultural sector

SMEs that operate in the agricultural sector are less financially included in Costa Rica (Figure 3.17). In particular, many farmers do not own an insurance plan, which is worrisome, as agricultural production is constantly subject to the weather risk. One factor that limits the supply of insurance in the agricultural sector is the absence of practical tools for insurers that could be used to measure farmers' performance. This creates difficulties in designing insurance contracts and limits the prevalence of insurance (Karlan and Morduch, 2010[28]). The General Superintendence of Insurance has identified the limited insurance supply in the agricultural sector and is currently conducting technical studies, which explore the capability of Costa Rican insurance firms to provide products for farmers.

Figure 3.17. Financial inclusion of agricultural SMEs is low



Note: Share of SMEs, who confirm the usage of the financial product of interest. Sectors other than these five categories are excluded as they had negligible observation numbers.
Source: Survey of Performance and Business Outlook (2016) conducted by Banco Central de Costa Rica.

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Farmers also sometimes find it hard to see the benefit of buying insurance when their local weather measurements frequently deviate from a benchmark, such as a weather station. This makes it difficult for agricultural producers to relate the insurance premium that they would pay to the severity of the weather risk and reduces their insurance demand (Giné, Townsend and Vickery, 2008[29]).

Consequently, there is room to boost insurance penetration in the agricultural sector in Costa Rica. An initial step can involve learning from the experience of Argentina, in which insurance penetration covers more than 50% of all agricultural land (OECD, 2019[30]). Adding to the sector's dynamism, a major facilitator of developed insurance markets in Argentina is the lack of government intervention in insurance provision, which allowed the development of private sector initiatives. The Agricultural Emergencies Law for instance, has limited funding, which prevents the crowding out of market instruments by disaster assistance.

OECD Food and Agricultural Reviews recommend that making use of digital technologies would reduce administration cost of insurance, improve the processing of meteorological, sensor and satellite information and further increase insurance penetration (OECD, 2019[30]). To that end, mobile applications can be used by insurers to measure farmers' productive performance and at the same time, can improve farmers' understanding of weather-related risks.

Addressing the lack of credit demand by micro-entrepreneurs

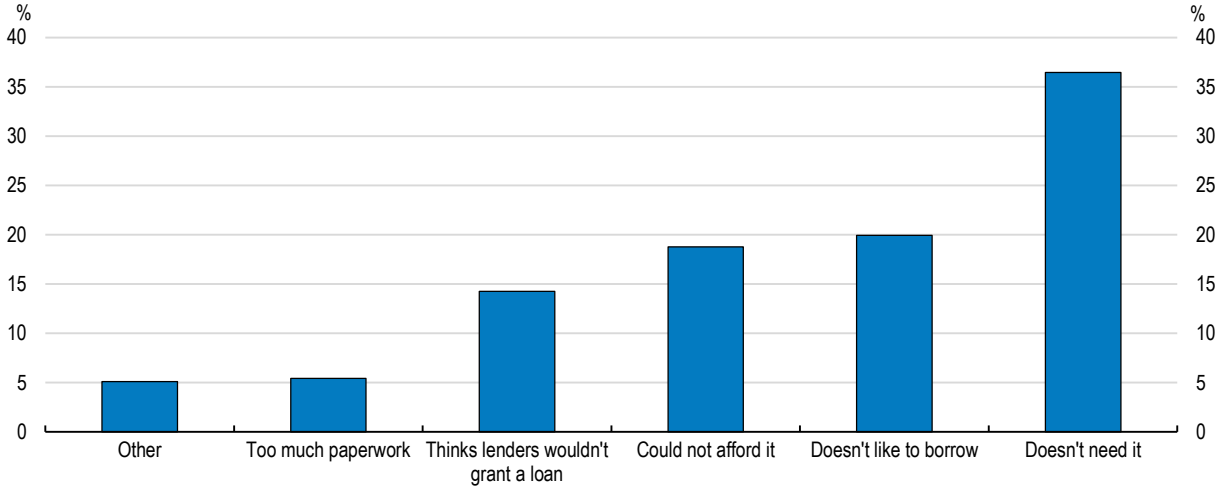
Micro-entrepreneurs account for 29% of national employment in Costa Rica, which is lower than the regional average of 41% in Argentina, Chile, Colombia, Ecuador, Mexico, Peru, and Uruguay (OECD/CAF, 2019[31]). Most micro-entrepreneurs are not registered in the national registry and do not have official accounting records (BCCR, 2018[16]). Therefore, micro-entrepreneurs face difficulties in having access to formal finance as they operate under high informality.

For example, a lack of faith in chances of getting credit or high borrowing costs create a "discouraged borrower" problem for many micro-entrepreneurs (one-quarter of all SMEs) in Costa Rica (Figure 3.18). Imperfect bank information on borrowing firms and higher loan application costs make the discouraged

borrowers problem more severe (Kon and Storey, 2003[32]). Therefore, reducing loan application fees can induce discouraged borrowers to demand credit.

Discouraged SMEs that especially refer to high borrowing costs are less transparent (Gama, Duarte and Esperança, 2017[33]). Consequently, a key priority is to boost the effectiveness and scope of the credit registry. According to the World Bank Doing Business Indicators, the credit registry in Costa Rica covered only 35% of the adult population in 2019. The coverage ratio was 50% in Chile and 79% in Brazil. This is partly linked to the fact that credit granted by non-supervised entities are not covered by the registry in Costa Rica and those entities' lending activities have increased substantially. Strengthening the credit registry system can minimise information asymmetries between borrowers and lenders and reduce interest rates. This would allow micro-entrepreneurs that previously found borrowing expensive, to demand credit.

Figure 3.18. Micro-entrepreneurs are discouraged from applying for loans



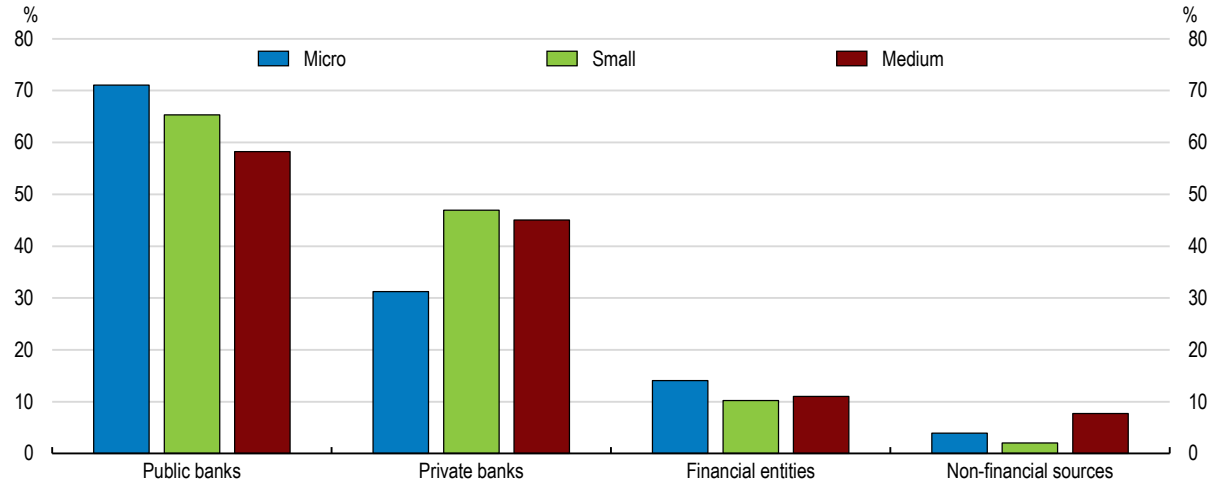
Note: Share of survey respondents that explain the reason for not getting credit. Based on results from the National Survey of Household Businesses conducted by INEC. The survey provides data on 3,500 micro-entrepreneurs. Some of the regional counterparts of this study include Encuesta de Micro Emprendimiento conducted in Chile and Encuesta de micro-establecimientos conducted in Colombia.
Source: National Survey of Household Businesses (2018) conducted by Instituto Nacional de Estadística y Censos.

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Provision of private bank credit to micro-entrepreneurs is limited in Costa Rica (Figure 3.19). This is a result of higher interest rates charged by private banks to SMEs (Table 3.1). Phasing out regulatory asymmetries between public and private banks (Loría and Martínez (2018[34]) and Key Policy Insights) would help reduce the excessive interest rates charged by private banks. This will then make private bank credit more accessible for micro-entrepreneurs.

Micro-entrepreneurs also borrow from informal sources paying unregulated and excessively high interest rates (INEC, 2019[35]). Access to formal bank credit is essential for the expansion of firms in emerging market countries (Ayyagari, Demirgüç-Kunt and Maksimovic, 2010[36]). Cost of being formal can be lowered by reducing high company registration fees (Chapter 2). In addition, microcredit programmes can be used to encourage the formalisation of micro-entrepreneurs (Straub, 2005[37]).

Figure 3.19. Smaller SMEs find it hard to borrow from private banks



Note: Financial entities include finance and loan companies, credit mutuals and credit cooperatives. Non-financial sources include private lenders, friends or relatives. Sum of financing source shares can be greater than 100% as firms use multiple sources.
Source: Survey of Performance and Business Outlook (2016) conducted by Banco Central de Costa Rica.

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According to World Bank Doing Business Indicators, bankruptcy procedures take longer, produce lower debt recovery rates and are more costly in Costa Rica compared with the OECD average. Costa Rica also scores 3 (out of 10) in the strength of legal rights index, which is lower than regional peers such as Chile and Mexico, who score 6. These impediments make the overall collateral framework less effective and induce creditors to demand collateral amounts that can be as high as 250% of requested loans (Flamini et al., 2016[38]). As a result, majority of micro-entrepreneurs who could not get credit refer to the lack of guarantees as the main reason (INEC, 2019[35]).

A draft law reforming bankruptcy practices has recently been submitted to the Congress. The proposed law aims to streamline insolvency procedures by shortening the initial appeal periods, allowing early liquidation of assets and eliminating judicial auctions. These measures would reduce both the duration and the cost of bankruptcy procedures and increase debt recovery rates, which would make the collateral framework more effective. Better property registry, improved secured transactions law and stronger bankruptcy framework would reduce the collateral-to-loan ratios and allow banks to increase their lending to micro-entrepreneurs and vulnerable populations, especially in the agricultural sector.

Boosting the supply and reach of development banking credit

The development banking system administered by Sistema de Banca para el Desarrollo (SBD) aims to fund SMEs and farmers considering their risk profile and conformity of projects with the development targets of Costa Rica. SBD also provides services to its beneficiaries to support entrepreneurial activities and innovation (Box 3.6). A key objective of the system is to help unbanked beneficiaries build a financial background and credit history. To that end, SBD grants collateral to SMEs for credit applications and contribute to the development of a credit scoring mechanism for its beneficiaries in collaboration with the General Superintendent.

Box 3.6. Promoting entrepreneurial activities and innovation in Costa Rica

Almost all of the programmes that are administered by SBD are executed through third parties or accredited entities. Services provided by SBD in the area of entrepreneurship and innovation can be summarised as follows:

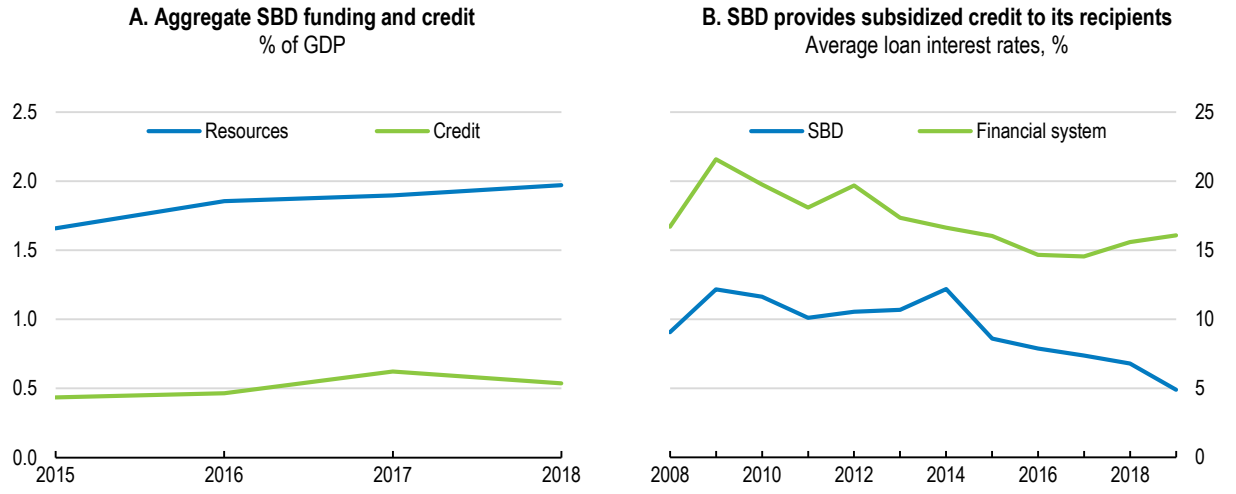
- **Promotion of an innovation and entrepreneurship culture.** SBD provides sponsorships to promotion activities, including domestic or international entrepreneurship contests and conferences with top tier expositors.
- **Business training.** In 2019, the Associative Innovation and Entrepreneurship Programme was approved and implemented. This programme aims to provide business training to entrepreneurs outside the San Jose Metropolitan Area, which will boost their incubation and acceleration capabilities.
- **Business development services.** SBD supports the *Descubre* programme, which is an initiative led by the Ministry of Foreign Trade, the Ministry of Agriculture and Livestock, the foreign trade promotion agency (PROCOMER) and includes the participation of the private sector and the universities. *Descubre* aims to increase the productivity of agriculture and fisheries by discovering new products and markets, and eliminating barriers to trade. Another example is the Coocique Business Support Programme, in which SBD provided general business consulting to more than 80 SMEs that are in the programme's credit portfolio.
- **Demand oriented support.** During the 2018-2019 period, SBD financed four participants of the innovation programme, "The Blueprint", managed by PROCOMER, in which an international company offered an innovation challenge to be solved by Costa Rican SMEs. The aim of these programmes is to link domestic SMEs to global supply chains.
- **Seed capital financing:** SBD provides seed capital by collaborating with academic institutions to emerging ventures in the form of grants or soft loans that have below-market interest rates. The seed capital financing so far targeted dynamic entrepreneurship projects aiming to promote fast growth rates for start-ups; and supported rural entrepreneurship programmes.

Source: Sistema de Banca para el Desarrollo.

SBD is integrated by three main pillars: assets from trusts and direct transfers from the public budget (The National Development Fund - FONADE); 5% of the annual net profits of the state-owned banks (The Financing for Development Fund - FOFIDE); and 17% of the demand deposits collected by the private banks (The Development Credit Fund - FCD), which are given to state-owned banks as a loan. Private banks can avoid giving this loan if they install four branches outside the San José Metropolitan Area and maintain 10% of their demand deposits directly channelled to SMEs in special lending programmes with preferential interest rates (Loría and Martínez, 2018[34]).

After the approval and full implementation of the Development Banking System Law 8634, nominal credit portfolio of SBD grew rapidly in the 2016-2019 period (PGR, 2014[39]). Nonetheless, 30% of SBD's loanable funds have not been lent, partly causing SBD credit to stagnate around 0.5% of GDP (Figure 3.20). Given that average delinquency rate of SBD's credit portfolio has been below 3% and SBD credit has been more affordable than borrowing from commercial banks (Figure 3.20), increasing SBD credit to SMEs would improve financing conditions of these firms without creating financial instability.

Figure 3.20. Development banking credit is scarce



Note: Panel B plots the evolution of weighted average interest rates that prevailed in all Sistema de Banca para el Desarrollo (SBD) programmes and the overall financial system.
Source: Banco Central de Costa Rica; OECD Economic Outlook 107 database; and Sistema de Banca para el Desarrollo.

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Another way to utilise SBD credit in full capacity is to strengthen the synergies between SMEs and private banks (OECD et al., 2019[40]). Using private banks as explicit points of contact for development credit applications would support the incentives for private banks to reduce their mandatory contributions to SBD and boost SME access to credit at lower cost. Strengthening the partnership with the foreign trade promotion agency (PROCOMER) and building partnerships with the investment promotion agency (CINDE) would contribute to SBD's efforts of linking domestic SMEs to global supply chains. There is also ample room to use mainstream media outlets more effectively to disseminate information among borrowers about SBD: More than half of micro-entrepreneurs (INEC, 2019[35]) and around a third of all SMEs (BCCR, 2018[16]) have never heard of the development banking system. Among those borrowers who know about SBD, the news emerges as the most cited medium of information.

Embracing FinTech to boost financial inclusion

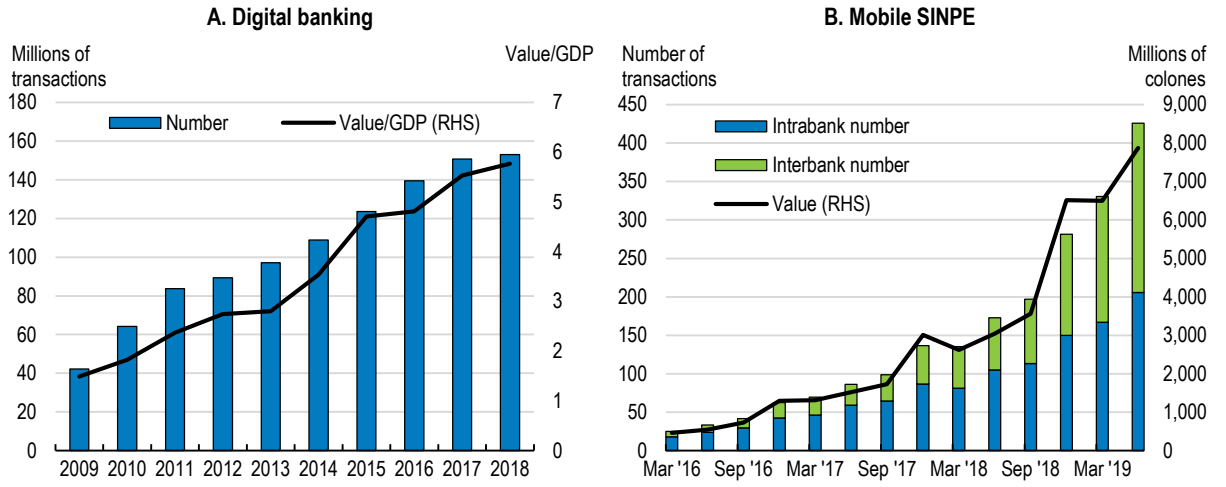
FinTech could help make the financial system more efficient

Both the digital banking (Figure 3.3) and the electronic payments system are of high quality in Costa Rica. The national payments system (SINPE) conveniently transfers colón, dollar, and euro-denominated funds without any interruptions. SINPE has also intermediated rapidly increasing numbers of digital banking and mobile transactions in the last decade (Figure 3.21). As a result, Costa Rica ranks third among Brazil, Honduras, Guatemala, Peru, Bolivia, Argentina, Colombia, and Uruguay in the real-time gross settlement transactions value-to-GDP ratio (World Bank, 2018[41]).

Nonetheless, there is ample room to make the most of the electronic payments system in Costa Rica. For example, Costa Rica takes the 37th place among 73 countries in The 2018 Government E-Payments Adoption Ranking (2018[42]). This assessment reflects the government's capability of receiving (sending) electronic payments from (to) its citizens and the businesses in a country. The increased availability of

electronic transfers between the government and the private sector would reduce costs for both consumers and firms and enhance productivity.

Figure 3.21. The payments system supports an increasing number of digital and mobile transactions



Note: SINPE covers 91 entities that include commercial banks, credit cooperatives, financial companies, mutuals, stock market firms, pension administrators, savings banks, remittance platforms, exchange houses, external liquidators, and government institutions. SINPE maintains standardised (IBAN) account operations, bank coin schemes (via SINPE Mobile) and digital signatures used by legal persons.
Source: Banco Central de Costa Rica.

StatLink https://doi.org/10.1787/888934149968

Embracing FinTech start-ups would elevate financial inclusion outcomes in Costa Rica. Given the broad-based use of mobile phones, FinTech start-ups might easily promote the use of mobile money in counties that lag behind in financial inclusion. This would reduce both regional disparities (Figure 3.6), gender gaps (Figure 3.12) and invigorate development (Beck et al., 2018[43]). Evidence from South-Asian countries indicates that returns to enhanced financial inclusion by means of improved digital finance can increase regional GDP between 2% to 6% and income of the poor between 10% to 30% (Asian Development Bank, 2017[44]). FinTech penetration can also increase competition in the financial system. Better competition in the financial markets would reduce intermediation margins (Figure 3.14) and transactions costs, resulting in higher consumer welfare.

Easing the regulatory burden would facilitate the growth of the FinTech industry

The lack of direct and full access to the electronic payments system is reported as the main regulatory barrier to FinTech entry in Costa Rica. In addition, there has been either weak or no dialogue between regulators and the industry (Finnovista, 2019[6]). Regulators acknowledge FinTech firms have to be integrated to the payments system and to that end, have initiated an agenda to make regulations more conformable for the FinTech ecosystem (Box 3.7). But, they also argue FinTech penetration would mainly promote the banking system efficiency, instead of raising the level of financial inclusion. Improving the communication between regulators and industry participants would contribute to closing the gaps between the FinTech ecosystem in Costa Rica and regional peers (Figure 3.5).

Box 3.7. Recent initiatives to promote FinTech in Costa Rica

The Central Bank, the General Superintendent and the General Superintendent of Securities have been in a dialogue in the last two years to define the roadmap to improve the integration of FinTech firms to the Costa Rican financial system.

- The Executive Board of the Central Bank approved the partial integration of FinTech firms to the national payments system as of May 2018. Currently, FinTech firms can only operate in the areas of transfer of funds to third parties, direct credit compensation, real-time debit, direct debit compensation, SINPE Mobile, fund reclaiming and automatic debit authorisation. However, any transfer service provided by a FinTech firm has to be associated with a bank account for consumer protection reasons.
- So far, 6 FinTech firms out of 65 applicants have been granted access to the payments system to operate in the areas defined by the new regulation.
- In April 2019, General Superintendent of Securities joined the launching of the regional project, "Towards the Regulatory Convergence for the Regional Fintech Ecosystem" led by the Inter-American Development Bank (IADB).
- In April 2019, the Central Bank and the IMF jointly held the international seminar "Balancing Fintech Opportunities and Risks, Implementing the Bali Fintech Agenda".
- Members of the joint group for FinTech from the Central Bank and superintendents have begun capacity building. An officer of Central Bank has enrolled in the "Asian Development Bank Institute-Cambridge University FinTech and Regulatory Innovation" online programme.
- The case study, "Overview of the Costa Rican case and the experience with identifying Fintech firms" has been sent to the Bank for International Settlements for publication in a forthcoming Fintech report.
- The Central Bank participated in the OECD Global Blockchain Policy Forum 2019 in September 2019.
- In October 2019, the Central Bank hosted an international conference on the implications of FinTech for central banking. Participants of the meeting included international central bankers, officials of international organisations, academics and private sector representatives from regional FinTech associations.
- The Central Bank has hosted informative sessions for 59 FinTech firms as of December 2019, on the IT requirements to connect to the payments system and the regulations governing it.
- In February 2020, the Central Bank received technical assistance from the Center for Latin American Monetary Studies with the participation of experts from the central banks of Chile, Spain and Mexico. These experts shared their experiences on the interaction between the FinTech industry, regulators and central banks.

Source: Banco Central de Costa Rica.

Legal, financial and operational risk management considerations constitute main parts of burdensome regulations in the FinTech industry. In particular, start-ups are expected to comply with money laundering and data protection legislations, regulations of the payments system and the registration requirements mandated by the financial supervisor. They are also required to demonstrate the ability to sustainably manage the electronic funds account within the Central Bank and comply with technical requirements. Introducing regulatory sandboxes would allow FinTech start-ups in Costa Rica to test their products temporarily, without having to comply with all regulatory requirements. Sandboxes were effectively used

by the United Kingdom and Singapore (Box 3.8), who rank very high in global competitiveness (WEF, 2019[45]).

Box 3.8. Regulatory sandboxes in FinTech

Sandboxes provide regulatory waivers and flexibility for firms and enable them to test new business models with less stringent regulatory requirements (OECD, 2018[46]). Sandboxes often ensure major regulatory objectives, most importantly including consumer protection, and are typically administered on a case-by-case basis by the relevant authorities. In Australia, Singapore and the United Kingdom, sandboxes in FinTech industry included safeguards (He et al., 2017[47]) in the form of

- Limits in customer number, transaction value or duration,
- Additional reporting requirements and closer monitoring,
- Additional consumer protection measures such as arrangements to compensate consumers and resolution of disputes,
- Risk management mechanisms to avoid cyberattacks or system disruptions,
- Definition of specific regulations, which the firms should comply at all times.

After ensuring that sandboxes entailed all types of the listed safeguards above, licencing requirements were relaxed in Australia; regulations were relaxed in Singapore and in addition to these benefits for participant unauthorised or unlicensed start-ups, explicit clarifications on regulatory expectations were provided in the United Kingdom. In Canada, Hong Kong SAR and Malaysia, regulations were relaxed and additional consumer protection or risk mitigation measures were implemented. Participants of the sandbox exercise in the United Kingdom quoted that they benefited from the close communication with the regulatory authority, which allowed them to offer more certainty to potential investors (FCA, 2017[48]). Indeed, at least 40% of sandbox exercise participants in the United Kingdom received new investment during their testing period.

Source: He et al. (2017[47]); United Kingdom Financial Conduct Authority (2017[48]); OECD Going Digital Steering Group Meeting (2018[46]).

There is also room to adapt regulations in Costa Rica to ensure the universal accession and practical use of digital certificates. Digital signatures can only be applied by the physical use of digital certificate cards, which are expensive and impractical to use (Chapter 2). Improving the digital signature mechanism would boost government, firm and consumer demand for digital tools and help the FinTech ecosystem expand, accordingly.

The investor base of FinTech start-ups is considerably smaller in Costa Rica than in its regional peers. Two angel investor networks are currently active, gathering a group of only 35 investors. Mexico on the other hand, hosts about 800 angel investors targeting the FinTech industry (Finnovista, 2019[6]). Members of the Costa Rican FinTech community report angel investors are more inclined to invest in the construction and medical devices industries, avoiding the regulatory burden faced by the industry. Levelling the regulatory playing field for FinTech start-ups would increase the profitability of the sector and reallocate finance toward it. Another obstacle regarding the FinTech investor base is the lack of venture capital. Costa Rica ranks 96th out of 141 countries in venture capital availability, with a score of 2.7 out of 7 (WEF, 2019[45]).

Tailoring the regulatory framework to the FinTech industry's needs will broaden both the client and the investor base of FinTech start-ups in Costa Rica. The synergy between FinTech companies and incumbent financial institutions could be strengthened to lay the ground for the expansion of FinTech start-ups, who face challenges that originate from scale effects and financing difficulties. This will help domestic FinTech firms catch up with their regional peers (Figure 3.5) and boost financial inclusion in Costa Rica.

MAIN FINDINGS	RECOMMENDATIONS
Improving financial inclusion of consumers with a gender-based and regional focus	
Insurance penetration is very narrow, buyers of insurance perceive it as a means of savings or consumption expenditure.	Improve consumers' understanding of insurance products via financial education.
Regional disparities in financial inclusion are large.	Increase the number of access points in densely populated counties of Alajuelita, Desamparados, San Rafael and San Pablo with very low financial inclusion.
Gender gaps are large in financial inclusion.	Improve digitalisation of finance via the FinTech industry to boost the financial autonomy of women. Integrate financial education messages into popular entertainment and social media. Use periodic text messages that remind savings goals to consumers.
Financial inclusion of vulnerable minorities lags behind the overall population.	Help Indigenous populations to build their own finance networks. Add priority groups to conditional cash-transfer programmes that are currently being transferred to debit card accounts.
Financial literacy is low and indebtedness is increasing.	Complement access to financial products with enrolment to financial education. Reinforce the recently announced financial education strategy with principles that benefit from behavioural insights.
Boosting the access of micro-entrepreneurs and SMEs to credit	
Many micro-entrepreneurs do not apply for a loan with the belief that their credit request will be rejected or because they cannot afford it.	Reduce loan application costs.
Current coverage of the credit registry lags behind regional peers.	Strengthen the credit registry framework to widen its scope.
Many micro-entrepreneurs borrow from non-institutional private lenders at unregulated interest rates.	Provide microcredit programmes for micro-entrepreneurs to help their formalisation.
Micro-entrepreneurs with rejected loan applications commonly refer to the lack of guarantees.	Approve the draft bankruptcy law and complement it with better property registry and improved secured transactions law to make the collateral framework more conformable with getting credit.
Agricultural sector SMEs lag behind in financial inclusion with particularly low insurance plan ownership.	Avoid crowding out of the private insurance market by aggressive disaster relief programmes. Enhance both insurers' and farmers' understanding of weather risks via the use of mobile applications.
Half of micro-entrepreneurs and third of SMEs have never heard of the development banking system. Credit-to-funding ratio of the development banking system is low.	Use private banks as explicit points of contact for development credit applications. Promote the dissemination of information on development banking via most commonly used media outlets. Increase the share of loanable funds in the development banking system. Strengthen the partnership of the development banking system with the foreign trade (PROCOMER) and investment (CINDE) promotion agencies.
Embracing FinTech to increase competition in the financial system	
High intermediation margins and fees in the banking sector create difficulties for both SMEs and households in access to finance.	**Grant FinTech companies full and direct access to the national payments system while preserving security and consumer protection.**
FinTech start-ups operate under burdensome regulations and lack of access to external finance.	Temporarily relax regulatory requirements on FinTech start-ups but explicitly clarify regulatory expectations in the testing period. Maintain safeguards such as limits on customer number, transaction value or duration to ensure consumer protection. Eventually tailor the regulatory framework for the FinTech industry's needs as in better performing peer Latin American countries.

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OECD Economic Surveys

COSTA RICA

Costa Rica's social and economic progress has been remarkable. Over the last 30 years, growth has been steady and GDP per capita has tripled. A strong commitment towards trade openness has been key to attract foreign direct investment and move Costa Rica up in the global value chain. Costa Rica faces substantial challenges to retain achieved successes and to continue converging towards higher living standards. The fiscal situation remains a critical vulnerability. Large deficits and rapidly rising public debt threaten Costa Rica's achievements. The fiscal reform approved in December 2018 was a historic step to restore fiscal sustainability. Boosting growth is also a key priority, as the gap in GDP per capita with advanced economies remains large and unemployment is high. Inequality and informality remain also high. The COVID-19 pandemic has significantly impacted Costa Rica, with the global economic slowdown and the necessary containment measures hampering growth prospects and fiscal accounts. Responding successfully to these substantial challenges will hinge on buttressing the fiscal framework and implementing reforms to foster inclusive growth. Further advances on living standards will hinge on raising productivity by setting the right conditions for domestic companies to thrive and maintaining and reinforcing the commitment to foreign direct investment and trade. Maintaining the commitment to preserving natural resources and biodiversity and with the decarbonisation plan will pay off in terms of growth and jobs.

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