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

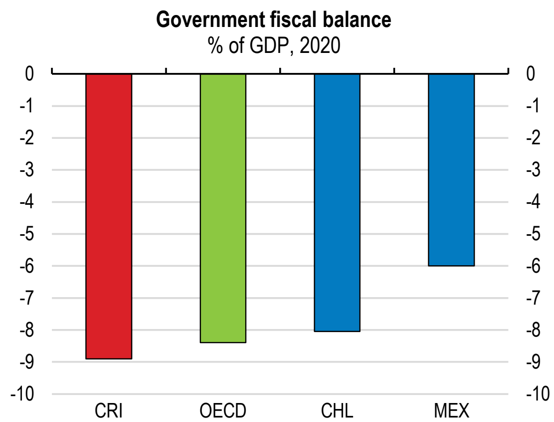
Note: GDP refers to annual percentage growth. Unemployment rate is per cent of labour force. Fiscal balances and debt are shown for central government.
1. Per cent of GDP.
Source: OECD Economic Outlook 107 database.

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.

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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.

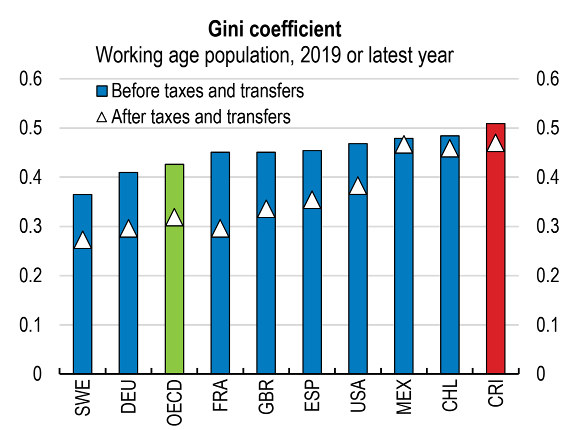
Improving debt management is key. As the interest rate bill is increasing, containing the cost of debt servicing and reducing risks become critical. Attracting international investors to local currency denominated debt can reduce both interest burden and currency risks.

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.

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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.

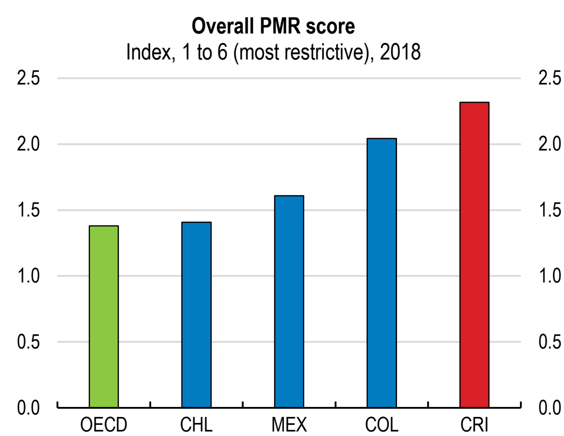
High informality contributes to inequality and hampers pension sustainability. There is no silver bullet to reduce informality. A comprehensive strategy, covering multiple policy areas, is required. This includes adapting regulations to facilitate compliance. The minimum wage system has been simplified, 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.

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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.

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