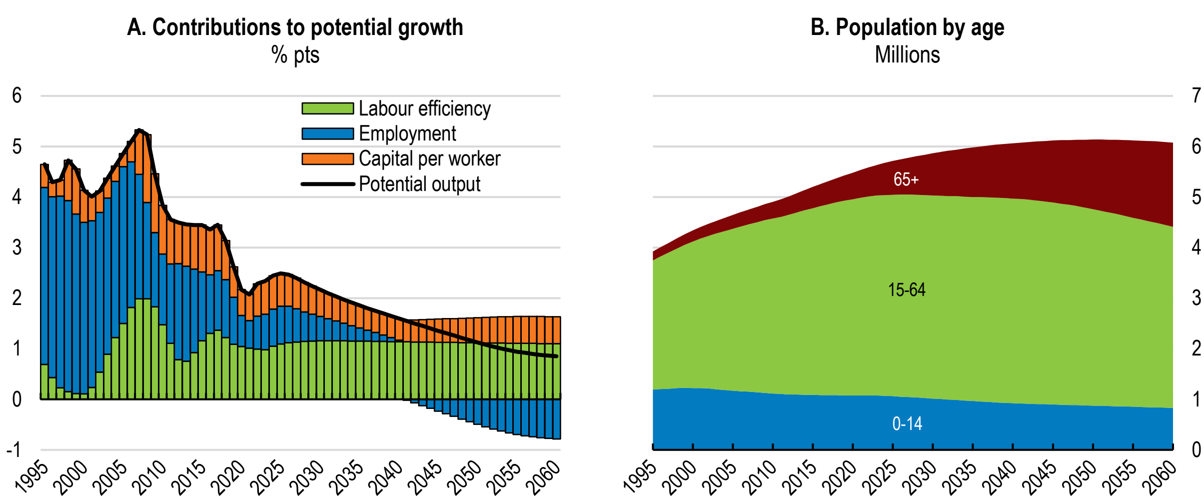
1 Key Policy Insights

Costa Rica recovered well from the pandemic-induced recession. Sustained and resilient export performance continues to support growth, while consumption is hindered by high inflation and unemployment. The fiscal situation improved but remains challenging, requiring sustained efforts to contain spending and boost public sector efficiency for several years. Maintaining and reinforcing the commitment to foreign direct investment and trade, which has been key to diversify the export basket, and improving the conditions for domestic companies to thrive are key challenges to boost living standards and formal job creation. This would require reducing the regulatory burden, improving the tax mix, fostering more competition in key markets and continuing decarbonisation and environment protection efforts. Supporting higher female labour participation and upgrading social protection will help to adapt to ongoing demographic changes and improve the equality of opportunities.

Costa Rica recovered well but faces substantial challenges

Costa Rica's economy recovered well from the pandemic-induced recession. A targeted fiscal response, ample monetary support, a successful vaccination campaign and sustained export performance supported the recovery. Costa Rica, the oldest democracy in Latin America, has displayed significant political stability over the years, thanks to its solid institutions, and a strong commitment to environment protection. However, it faces critical challenges to safeguard achieved successes and to continue converging towards higher living standards. A strong social pact has delivered some remarkable results. Most notably, life expectancy is now at par with the OECD average and the highest in Latin America. At the same time, despite increases in social spending, progress in other areas, such as education or poverty reduction, has stalled. Unemployment, at a two-digit rate since 2018, and informality, affecting nearly half of the labour force, are high. Spreading the benefits of integration in international trade across the country is a key pending challenge. Growth prospects were deteriorating before the pandemic and, in the absence of further reforms, will further erode in the medium-term, as population ageing accelerates (Figure 1.1). The fiscal situation improved in 2021, thanks to the 2018 fiscal reform, but with public debt at around 70% of GDP, public finances remain a critical vulnerability requiring sustained efforts to contain spending and boost public sector efficiency for several years. The surge in global energy prices triggered by Russia's aggression against Ukraine adds pressures on Costa Ricans real incomes.

Figure 1.1. The economy's growth potential will fall as the demographic bonus fades



Source: OECD long-term projections based on Guillemette and Turner, 2018.

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Stepping up structural reform efforts would be the best way to respond to these challenges. Reforms would spur productivity, key to help more Costa Ricans achieve higher living standards at a time when demographics are shifting. Reforms would also help to seize the new opportunities that are arising. Costa Rica's strong commitment towards trade openness has been key to attract foreign direct investment, move Costa Rica up the global value chain and diversify its exports basket. Nearshoring trends, by which companies seek reducing supply chain disruptions risks by locating closer to their final markets, are providing new opportunities. Costa Rica is a front runner in environmental protection and renewables generation, and the global transition to net zero greenhouse gas emissions can increase the country's competitiveness further. Seizing these opportunities will help to create more formal jobs, a key priority for the government that took office in May 2022 (Box 1.1). Enhancing education outcomes, boosting competition, facilitating greater female labour market participation and reducing the scope for corruption are key elements of a reform agenda that could raise growth prospects and incomes substantially (Figure 1.2). Simulations based on the OECD long-term growth model (Guillemette and Turner, 2018[1]) suggest that the right type of reforms could raise GDP per capita by an additional 26% over 20 years, equivalent to 1.3 percentage points of additional growth each year.

Box 1.1. Key features of Costa Rica's government programme and recent reform efforts

The government took office in May 2022. Among its priorities are the following:

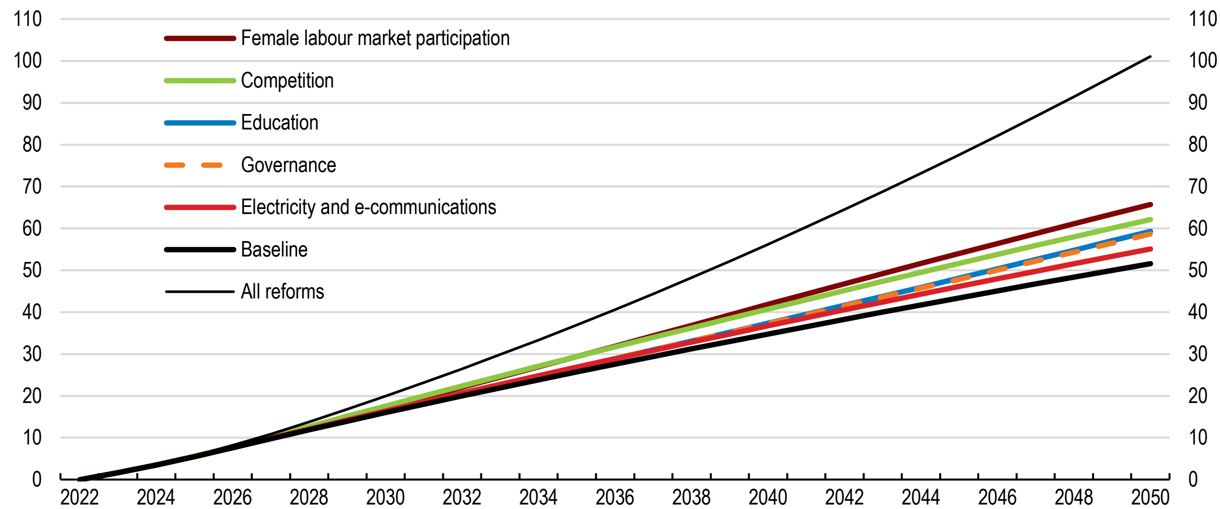
- **Reactivating the economy** by creating more jobs, simplifying procedures and digitalizing the State.
- **Fighting corruption** by incentivizing "whistle-blowers" and increasing sanctions for corruption.
- **Reducing living costs** by reducing the costs of the basket of essential goods and services.
- **Improving education** by strengthening education in STEM areas and dual learning systems.
- **Eliminating extreme poverty** by improving targeting of social expenditure.
- **Further integration into the global economy** by pursuing further trade agreements and contributing to strengthen the multilateral trade system.
- **Strengthening the pension system** by eliminating exorbitant pensions received by some workers from public agencies outside central government, equalizing the contributions of the State across the different pension modalities, and strengthening compulsory and voluntary pensions.
- **Improving the quality of the health system** by implementing transparency in the health system, modernising digital medical files and reducing waiting lines.
- **Protecting the ecosystem** by developing an interconnected public transport system and improving recycling.
- **Promoting and effective democracy** by simplifying the procedures for calling referendums and proposing new laws to congress.

Recent reforms efforts include:

- Eliminating minimum prices for rice and reducing the rice import tariff.
- Phasing out the monopoly to import medicines.
- Eliminating minimum compulsory fees in professional services.
- The 2022 laws to improve the institutional structure and policy execution in the Public Works and Transport Ministry and in the Environment and Energy Ministry.
- The 2022 law to create the Public Investment National System, aiming at strengthening and harmonising public investment processes and improving project selection across the public sector.
- The 2022 law to eliminate 15 decentralised public agencies and devolve responsibilities to the respective ministries.

Figure 1.2. Structural reforms would lift growth and incomes substantially

Simulations for the GDP per capita using the OECD long term growth model, % of 2022 GDP



Note: The "Baseline" projection depicts the increase of potential per-capita GDP in Costa Rica according to current estimations of potential growth, without any reform. The "Competition" and "Electricity and e-communications" scenarios assume adoption of OECD best practices and their impact is estimated based on OECD's Product Market Regulations index. The "Governance" scenario assumes that the rule of law reaches the OECD average by 2060. The "Female labour market participation" scenario assumes the gap with the OECD average is closed by 2060. Finally, the "Education" scenario assumes that an average of 12.5 years of education is reached by 2060 together with improvements in quality. The results suggest that without any reform GDP per capita would grow by 50% by 2050. If all reforms are implemented, GDP per capita will grow by 100% instead.
Source: OECD calculations based on OECD Long-term growth model.

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

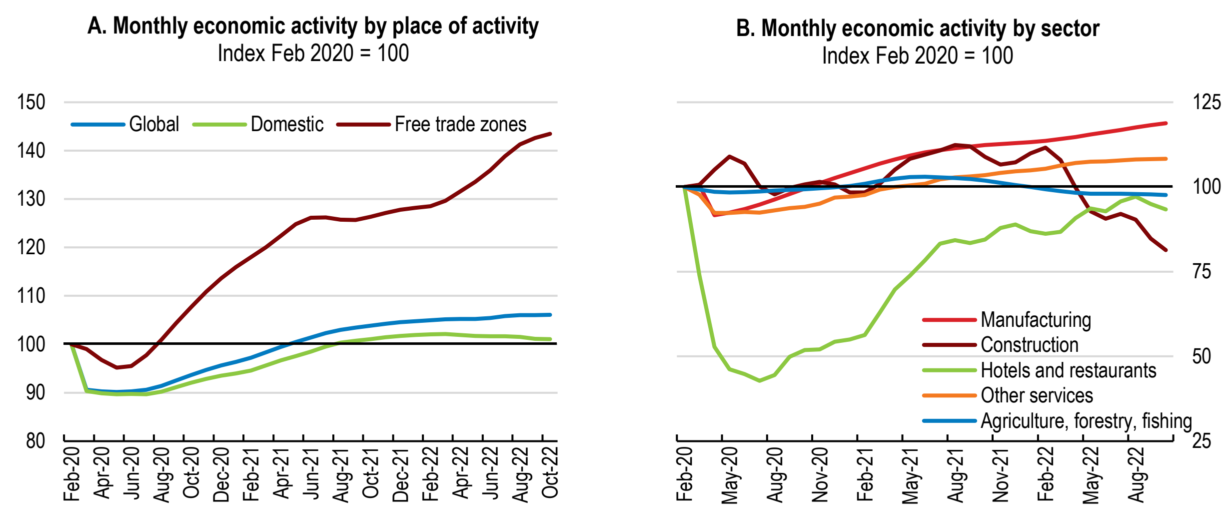
- Maintaining fiscal prudence, including by ensuring full implementation of the fiscal rule, is critical to maintain macroeconomic stability. Improving spending efficiency and enlarging the tax base would allow for a stronger contribution of fiscal policy to growth and equity.
- Strengthening productivity and creating formal jobs are fundamental priorities. This will require reducing the regulatory burden, improving the tax mix, fostering more competition in key markets, pursuing ongoing efforts to strengthen trade integration and continuing decarbonisation efforts.
- Enhancing education and training outcomes, upgrading and better targeting social protection, facilitating female labour market participation and adapting the pension system to demographic changes would be key to maintain and expand social achievements and reduce inequalities.

Growth is mitigated by high inflationary pressures and the global outlook

The recovery has further progressed

The economy continues to grow, but at a slower pace than in 2021. Activity in free trade zones, strongly linked to exports, improved very quickly after the pandemic recession, while the recovery of tourism related services was more protracted (Figure 1.3). An increasingly diversified export basket (Figure 1.4) has supported the recovery, which has also benefited from strong growth in the United States, Costa Rica's main trading partner (Figure 1.5). Trade linkages with China are relatively small, and its zero-Covid policy impacts Costa Rica indirectly, through the associated deceleration in global growth and trade. Direct trade linkages with Russia and Ukraine are negligible, but the imports of metals and fertilisers are relevant, and finding alternative sources of supply will take some time and imply higher costs. However, as a very open economy, the Costa Rican economy is hampered by the deceleration in global growth, notably in the United States, triggered by Russia's invasion of Ukraine.

Figure 1.3. Export sectors led the recovery



Source: Banco Central de Costa Rica.

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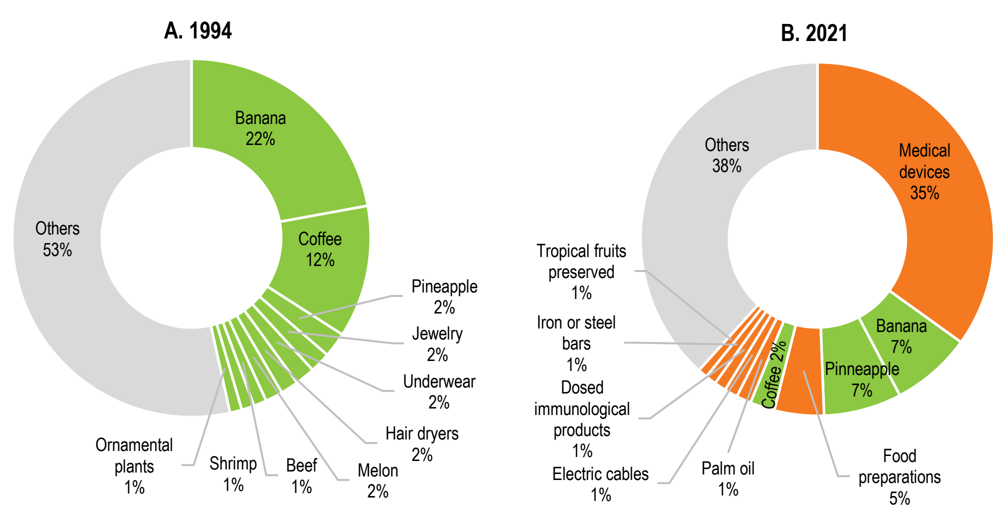
Figure 1.4. The export basket has become increasingly diversified

Main exported products, % of all exports



Note: The ten main exported products in 1994 are displayed in green in both panels.
Source: COMEX based on data from PROCOMER.

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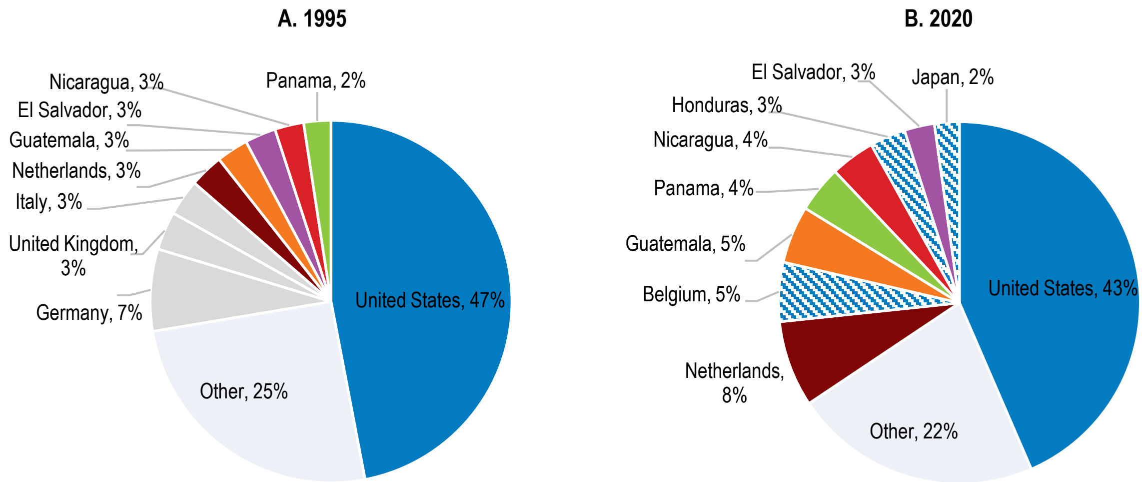
Figure 1.5. The United States and the European Union are the main trading partner

Top ten export markets in 1995 and 2020



Note: 1995 export markets no longer in the top ten in 2020 are in grey; 2020 export markets not in the top ten in 1995 are in blue.
Source: UNCTAD.

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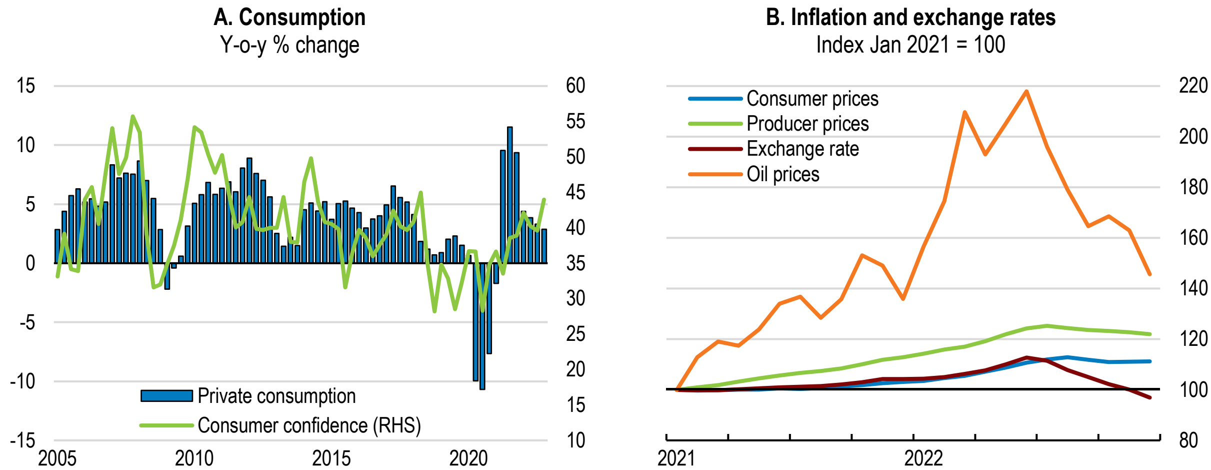
The roll-out of the vaccination campaign was very successful, and, as of December 2022, 83% of the total population had received at least a second dose. This has supported consumption, which, at the same time, is being mitigated by rising inflationary pressures (Figure 1.6). Inflationary pressures stem from high energy prices, exchange rate depreciations and cost pressures triggered by disruptions in global value chains. The war in Ukraine has exacerbated inflationary pressures contributing to further worsen Costa Rica's terms of trade (Figure 1.7). Headline and core inflation after reaching, respectively, 12.1% and 7% in August, the highest value in the last 13 years, decreased to 7.9% and 5.4% in December. Inflationary pressures affect particularly food and energy, with services remaining less impacted. The Central Bank started a hiking cycle in December 2021 and has been gradually increasing the monetary policy rate since then, delivering a cumulative increase of 825 basis points, to 9.0%.

The authorities have put in place some measures to contain increases in energy prices. The main one is a change in the formula regulating fuel prices, which will now be using actual import prices instead of some reference prices that were higher than import prices. This change should in theory result in a notable reduction of gasoline prices. However, the authorities have decided to temporarily set up a cross-subsidy and maintain gasoline prices stable and reduce instead diesel prices, as diesel is more predominantly used by transport, agriculture and fishing sectors. To mitigate the impact of the rise in energy prices, the authorities have also established in November a temporary (3-months) subsidy targeted at low-income households (*Beneficio temporal por inflación*). It will be targeted using Costa Rica's registry of beneficiaries of social programmes. This is a preferable way to provide support, as the subsidy is channelled to poorer households, whose purchasing power is being eroded more severely, and does not disincentive energy savings.

Figure 1.6. Consumption is held back by rising inflation



Note: Panel B: Exchange rate between the Costa Rican colon and the United States dollar. An increase implies a depreciation of the colon.
Source: Banco Central de Costa Rica; World Bank Commodity Price Data.

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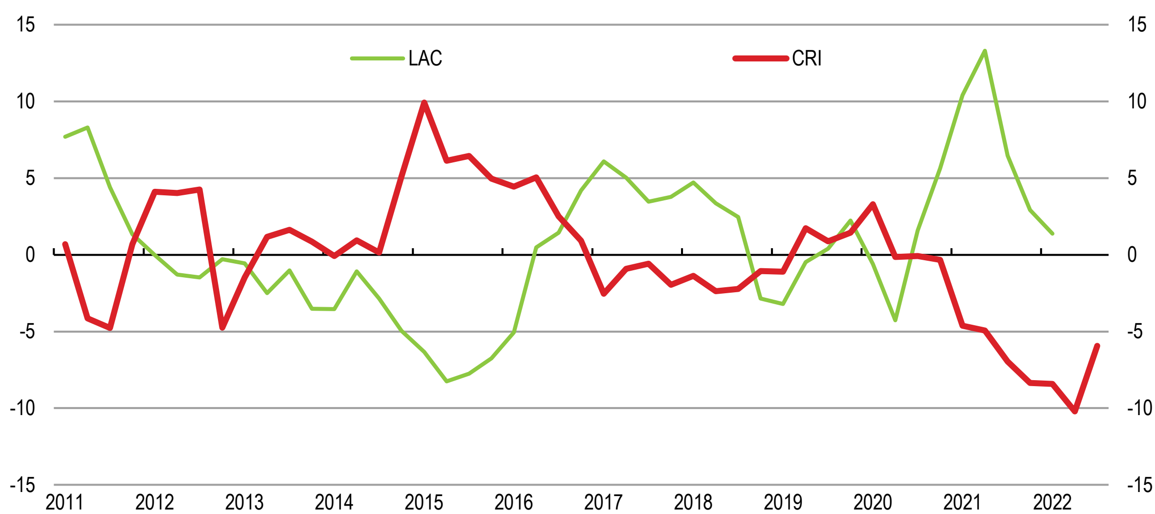
Figure 1.7. Terms of trade are deteriorating

Y-o-y % changes



Note: LAC refers to Chile, Colombia, Mexico, Argentina, and Brazil.
Source: OECD Economic Outlook Database.

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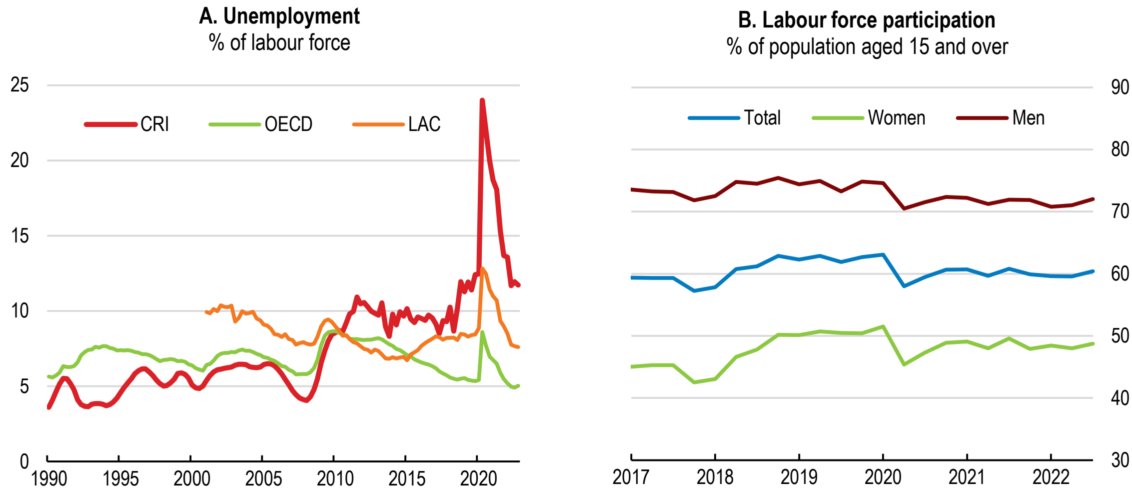
Labour market conditions are gradually improving. Employment has rebounded more slowly than activity, as the recovery in the employment-intensive tourism sector has been more protracted. The unemployment rate has recently decreased to its pre-pandemic level, but this was a historically high rate (Figure 1.8). Labour participation has not recovered its pre-pandemic level (60.3% at end-2022 versus 64% pre-pandemic). The recovery in employment shows significant heterogeneity. Employment of high-qualified workers is well above pre-pandemic levels, while employment of low skilled and medium-skilled workers has recovered more slowly. Formal employment grew back to its pre-pandemic level while informal employment is still lower than in February 2020. Informality remains high by historical standards, hovering around 45% of total employment.

Figure 1.8. Unemployment has started to fall but participation has not fully recovered



Note: LAC refers to Chile, Colombia, Mexico and Brazil.
Source: OECD Economic Outlook database; OECD Labour Force Statistics.

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The economy is projected to expand by by 2.3% in 2023 and by 3.7 % in 2024 (Table 1.1). The gradual reactivation of tourism will reinforce labour intensive sectors and improve employment. Consumption will be supported by the successful vaccination campaign and the gradual improvement in the labour market but will also be damped by high inflation and worsening terms of trade. Exports will keep benefiting from the specialisation in high value-added resilient sectors, such as medical devices, although their dynamism will be mitigated by the United States slowdown and higher import prices. Inflation will remain elevated, with oil prices expected to remain high in 2023.

Table 1.1. Macroeconomic indicators and projections

	2017	2019	2020	2021	2022	2023	2024
	Current prices CRC billion	Percentage changes, volume (2013 prices)					
GDP at market prices	34,343.6	2.4	-4.3	7.8	4.3	2.3	3.7
Private consumption	22,365.8	1.7	-6.9	7.0	3.6	2.3	2.7
Government consumption	5,618.0	5.9	0.8	1.7	2.1	0.1	0.8
Gross fixed capital formation	6,242.9	-8.2	-3.4	11.0	1.6	-0.5	5.5
Final domestic demand	34,226.7	0.6	-5.0	6.6	3.0	1.4	2.9
Stockbuilding[1]	-38.8	-0.3	0.2	1.1	-0.8	0.6	0.0
Total domestic demand	34,187.9	0.2	-4.8	7.8	1.8	1.7	2.8
Exports of goods and services	11,251.9	4.3	-10.6	15.9	12.2	8.8	9.1
Imports of goods and services	11,096.2	-2.3	-12.9	16.9	5.5	8.5	7.5
Net exports[1]	155.7	2.2	0.4	0.3	2.5	0.6	1.1
Memorandum items							
GDP deflator	-	2.6	0.8	2.0	7.8	6.4	4.2
Consumer price index	-	2.1	0.7	1.7	8.8	6.9	4.2
Core inflation index[2]	-	2.7	1.3	0.9	4.5	5.8	4.2
Potential growth	-	2.9	2.6	2.6	2.8	2.6	2.7
Output gap (% of GDP)	-	-1.3	-7.9	-3.2	-1.8	-2.2	-1.2
Unemployment rate[3] (% of labour force)	-	11.8	19.5	16.4	12.2	11.4	11.1
Current account balance (% of GDP)	-	-1.2	-1.1	-3.3	-4.0	-3.8	-2.7
Central government balance (% of GDP)	-	-6.4	-8.5	-5.0	-4.1	-2.6	-2.2
Central government debt (% of GDP)	-	56.4	67.2	68.2	67.5	66.8	66.0

1. Contributions to changes in real GDP, actual amount in the first column. 2. Consumer price index excluding volatile items: agricultural, energy and tariffs approved by various levels of government. 3. Based on national employment survey.
Source: OECD Economic Outlook database.

The economic and inflation outlook remains very uncertain. Inflation may be higher for longer, eroding purchasing power, particularly of vulnerable households, and requiring greater tightening of monetary policy. Risks of a price-wage spiral, contained so far by ample spare capacity in the labour market, could materialise. Such second-round effects would require additional increases in monetary policy rates. Costa Rica is a small, open economy dependent on foreign markets for investment and trade, which makes it vulnerable to external shocks, such as a sharp deceleration in global growth and additional increases in oil prices. Episodes of financial volatility may trigger greater risk aversion, reduce net financial inflows and increase financing costs. On the upside, near-shoring opportunities could imply stronger exports. The recovery in tourism could be quicker than anticipated. The economy may also face unpredictable shocks, with effects that are difficult to factor into the projections (Table 1.2).

Table 1.2. Events that could entail major changes to the outlook

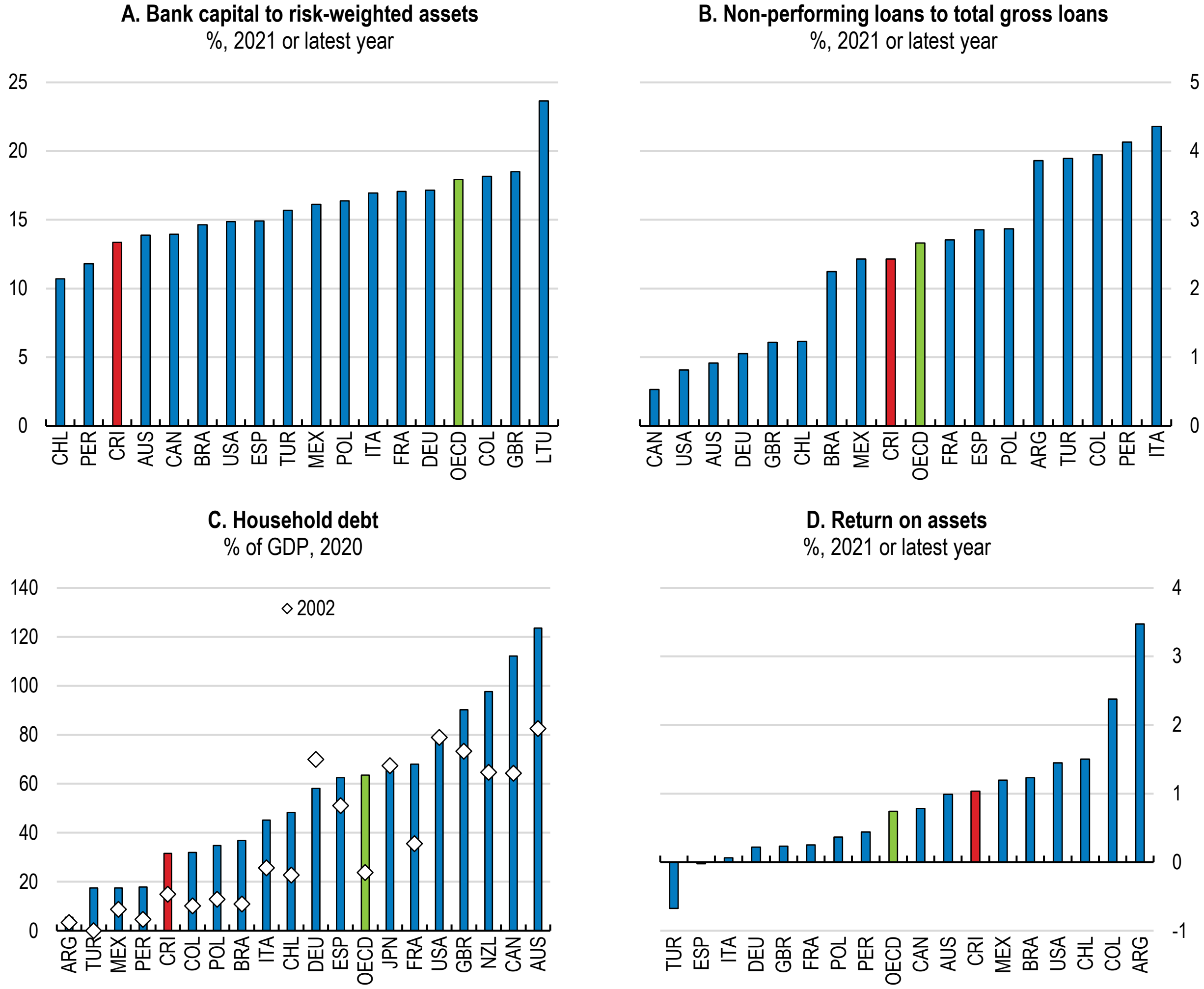
Vulnerability	Possible outcome	Possible policy action
Contagion from acute financial volatility in other emerging markets.	Large exchange rate depreciation and higher costs of financing the fiscal deficit and servicing debt.	Tighten monetary policy and active debt management to re-profile debt maturity.
Deepening crisis in Nicaragua.	Large inflows of migrants with high humanitarian assistance needs.	Provide border assistance to immigrants and flexible residence permits.
Sustained hacking and ransomware of government agencies.	Disclosure of highly sensitive information and unavailability of critical infrastructure.	Put in place stricter cybersecurity protocols.
Extreme weather events.	Seasonal and unpredictable extreme weather events, such as El Niño or La Niña, hampering the agriculture sector. Earthquakes or volcanic eruptions damaging the infrastructure.	Continue to strengthen disaster risk management and to foster climate change adaptation strategies.

Financial stability risks appear contained

The financial system has been stable and resilient so far, maintaining capitalisation and liquidity levels above regulatory requirements (Figure 1.9, Panel A). A supportive monetary policy, macro prudential measures and emergency funding for firms supported the functioning of financial markets during the pandemic recession. Almost half of the loan portfolio took advantage of temporary measures to support loan restructurings. Non-performing loans increased but remain contained (Figure 1.9, Panel B), although part of the impact of the pandemic recession on assets quality could still materialise. The latest stress tests conducted by the Central Bank suggest that the banking system, including public banks, has sufficient capital buffers and liquidity to weather extreme economic events (BCCR, 2022[2]).

Households' and firms' indebtedness remain low in international perspective (Figure 1.9, Panel C). However, households' indebtedness has recently increased, more than doubling in the past two decades. Actual indebtedness is likely to be larger than reflected in data, as loans by non-supervised creditors are not included in official statistics and pockets of households with excessive indebtedness have increased, more notably through credit card debt, which currently represents 3.4% of GDP. Strengthening the credit registry office would be key to contain excessive borrowing and avoid increasing financial stability risks. The credit registry in Costa Rica covers around 35% of the adult population, against 50% in Chile or 80% in Brazil. Boosting the scope of the registry, to incorporate information also from non-supervised entities that are performing lending activities, is a priority. Reducing information asymmetries through a more comprehensive credit registry can also help boost financial inclusion (OECD, 2020[3]). In fact, it can be more effective in facilitating access to credit than the cap on interest rates introduced in June 2020, which can constrain access to credit for the most vulnerable individuals and incentivise informal credit channels. Establishing a financial consumer protection framework, a pending OECD recommendation (OECD, 2020[4]), would also facilitate access to financial services and formal credit by a larger share of the population. In the medium-term reinforced macroprudential tools can also play a role in mitigating financial stability risks stemming from excessive households' indebtedness.

Figure 1.9. The financial sector appears resilient



Note: Panel A refers to regulatory tier 1 capital to risk-weighted assets. Panel D refers to deposit takers' efficiency in using their assets; it is an indicator of bank profitability.
Source: IMF Financial Soundness Indicators; and IMF Global Debt Database.

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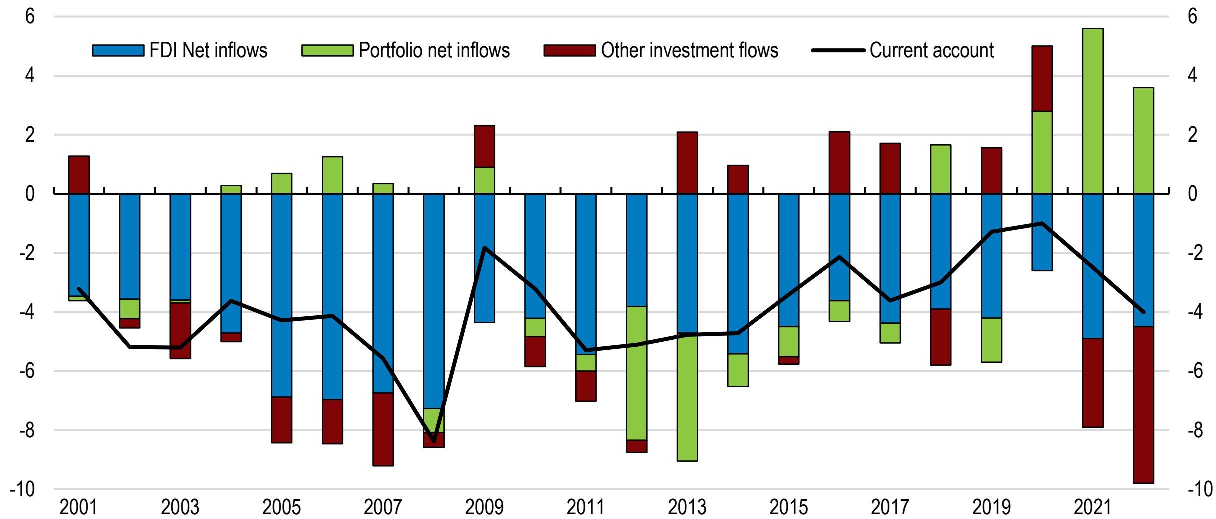
Costa Rica is vulnerable to risks from climate change and has started assessing the potential financial impact from climate change and other environmental vulnerabilities on its financial sector. Phasing in a mandatory disclosure of climate-related risks by large financial institutions would facilitate more transparent management of these risks and provide incentives for allocating resources to cleaner activities. Costa Rica could also consider integrating climate-related risks into the Central Bank risk management framework and running climate change stress tests, which have started to be conducted in several OECD economies, such as France, the Netherlands or the United Kingdom.

On the external side, the current account reached a deficit of 4% of GDP in 2022 (Figure 1.10), largely financed by a stable pipeline of foreign direct investment. However, external debt has significantly risen in the past decade (Figure 1.11), increasing vulnerability to global financial conditions. Currency reserves, of around 25% of external debt or 13.5% of 2021 GDP, are comparatively low and have recently decreased, covering around 5.3 months of imports. The Central Bank has recently announced a set of welcome measures to increase the availability of currency reserves, such as setting up a credit facility with the Latin American Reserve Fund. Accessing financing from multilateral financial institutions, such as through the IMF's Extended Arrangement in place since 2020, would also increase the availability of foreign reserves.

Figure 1.10. The current account deficit is financed with foreign direct investment

% of GDP



Source: IMF Balance of Payments database; IMF WEO database.

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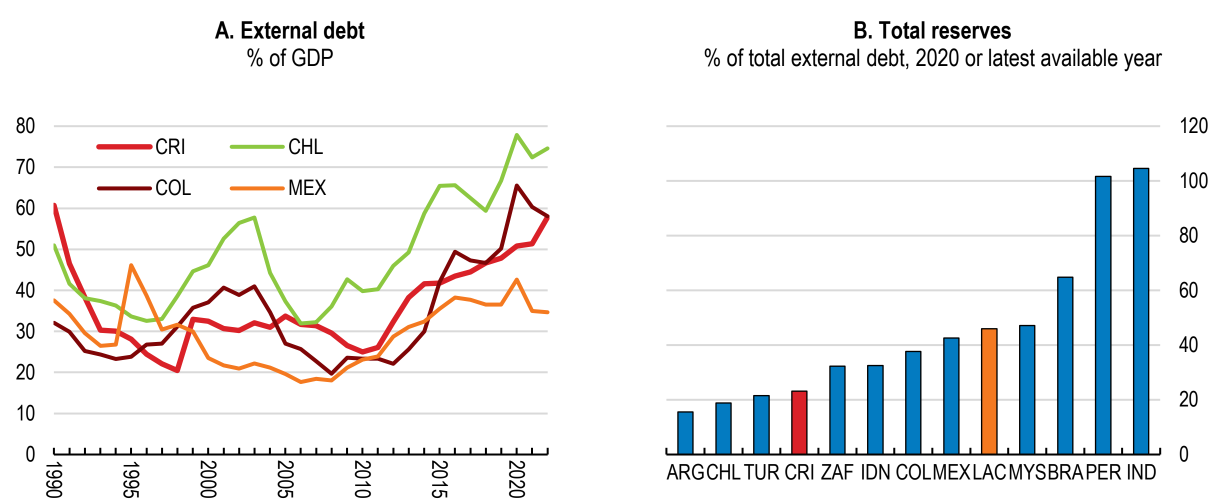
Figure 1.11. External debt has increased and foreign exchange reserves are comparatively low



Source: IMF World Economic Outlook and World Bank World Development Indicators.

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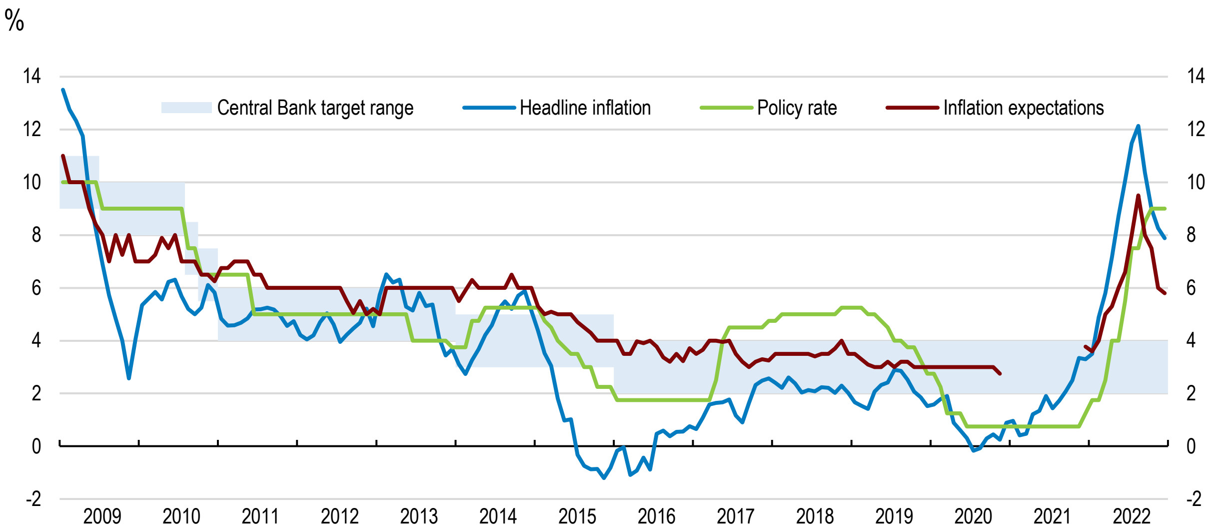
Macroeconomic policies can be further strengthened

Efforts made to improve Costa Rica's macroeconomic framework paid off during the pandemic recession. Despite limited fiscal space, thanks to the higher flexibility to reallocate spending gained through the 2018 fiscal reform, Costa Rica put in place targeted measures towards vulnerable households and reoriented more public spending towards health and social programmes. Access to the IMF's Extended Fund Facility helped to cover part of government financing needs at below-market interest rates. The Central Bank, whose independence was strengthened during the OECD accession process, supported the recovery by lowering the monetary policy rate and by providing significant liquidity, which was key to safeguarde financial stability and facilitate credit provision. More recently, it has increased the monetary policy rate to contain inflationary pressures. Looking ahead, the fiscal situation will remain challenging for some years. High inflation will have a positive impact on public debt dynamics in the short run, but at the same time, demands for higher budget allocations to support households will increase. Uncertainty in global financial and monetary markets will also remain high. Preserving macroeconomic stability in such a complex and challenging environment calls for further strengthening monetary and fiscal policy settings.

Adapting the monetary policy stance to contain inflation

As in most OECD countries, headline and core inflation have accelerated due to supply-side constraints as well as the increase in imported prices, especially energy and commodities, and the depreciation of the exchange rate. Inflationary pressures are notable in goods and more muted in services. Inflation expectations based on surveys conducted by the Central Bank suggest that expectations for the next 12 months are at 5.8% (Figure 1.12), around twice the inflation target. Expectations for the next 24 months, at 4%, are also elevated. Wages for high-skilled workers have trended up due to skill mismatches and shortages in some areas (see Chapter 2), but, for the time being, ample spare capacity in the labour market mitigates risks of a generalised wage-price spiral.

Figure 1.12. Inflation remains high



Note: Inflation expectations are the median one-year ahead expectations according to a survey run by the Central Bank. The survey was not conducted between December 2020 and November 2021.
Source: Banco Central de Costa Rica.

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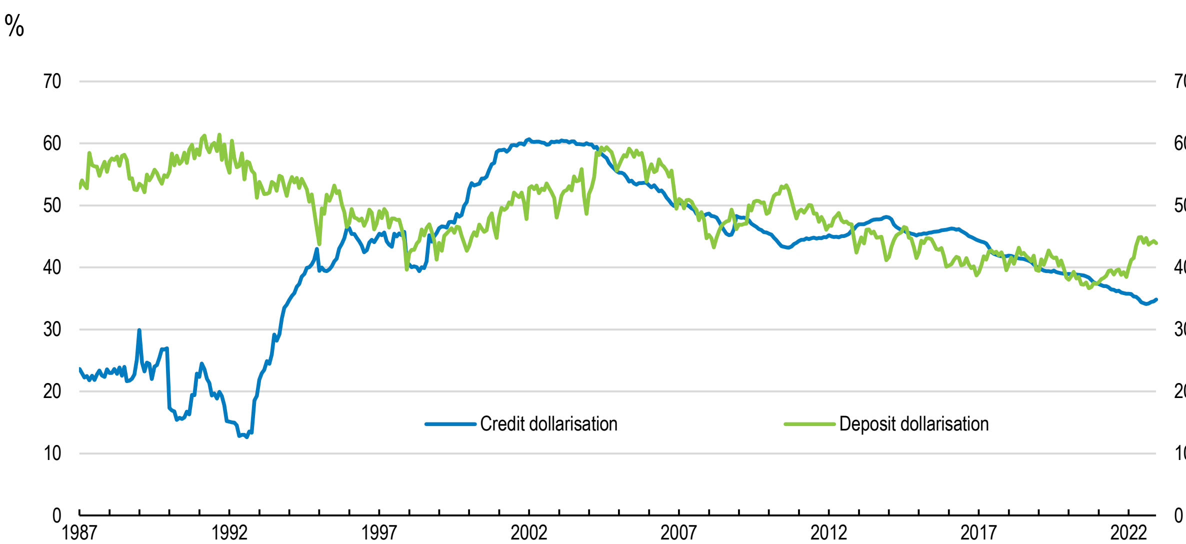
The Central Bank started a hiking cycle in December 2021 and has been gradually increasing the policy rate since then, delivering a total increase of 825 basis points, to 9.0%. The Bank also announced a gradual increase of reserves requirements for operations in national currency, aimed at reducing excess liquidity. Inflationary pressures are expected to persist, as producer prices have been increasing at two-digit rates (year-to-year) (Figure 1.6, Panel B above). Against the background of rising inflationary pressures, maintaining a restrictive monetary policy stance is appropriate to bring inflation back towards the target and anchor inflation expectations.

Maintaining exchange rate flexibility would also be key to absorb ongoing external shocks and will improve the effectiveness of monetary policy. Costa Rica has been gradually increasing exchange rate flexibility, in line with favourable experiences in other countries in the region, such as Colombia. At the current juncture, the central bank intervenes to manage foreign exchange requirements by the non-financial public sector and to avoid abrupt changes in the exchange rate. Most recent interventions aimed at satisfying foreign exchange requirements by the public sector, in the context of an increasing oil import bill, and by pension funds, as they pursue diversified financing strategies. Continuing to limit foreign exchange rate interventions to those strictly needed to avert abrupt changes and to manage foreign exchange requirements by the non-financial public sector, without seeking to alter market trends, would be the first line of defence against external shocks.

Exchange rate flexibility would also help to contain financial dollarization, which remains relatively high (Figure 1.13), with both credit and deposits in dollars representing around 40% of the total. This hampers the transmission of monetary policy and implies financial stability risks. Regulators indicate that two thirds of the dollarized debt is unhedged. Limiting interventions in the foreign exchange market would make it easier for economic agents to better internalise exchange rate fluctuations risks, reduce moral hazard and contribute to reduce large currency mismatches and unhedged positions. Eliminating the legal requirement on public institutions to deposit in state banks would reduce dollarization of deposits, as private banks currently face difficulties to collect local currency deposits and are forced to operate in foreign currency. Eliminating this requirement would also increase competition in the banking sector (see also competition section). The authorities could also consider additional prudential measures to discourage unhedged foreign exchange borrowing and lending, such as imposing an additional margin on loans to unhedged borrowers whose main source of income is in colones.

Figure 1.13. Financial dollarization remains large



Source: Banco Central de Costa Rica.

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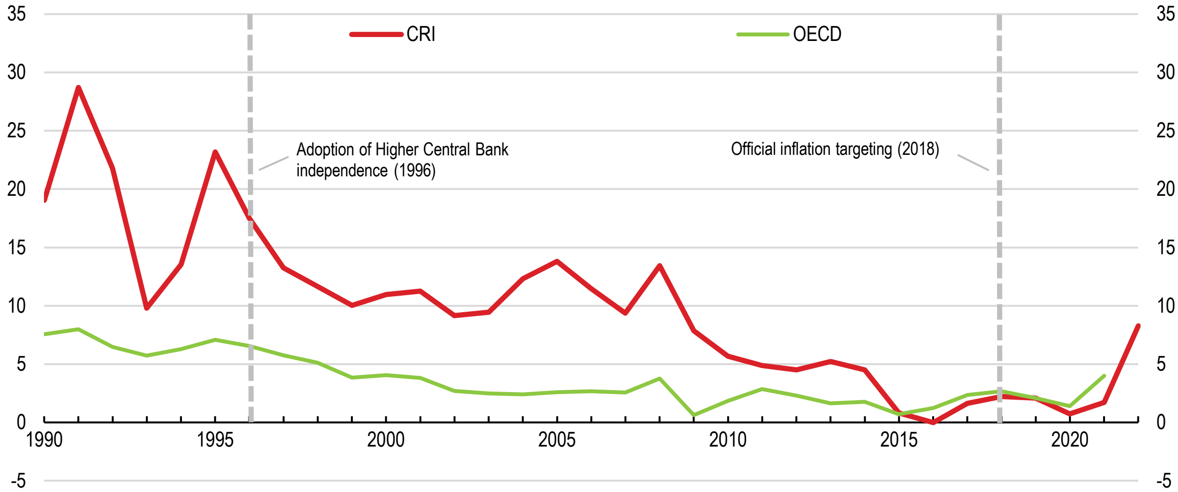
Central bank independence and a gradually stronger inflation-targeting framework have been key to reduce inflation over the past 30 years (Figure 1.14). This has brought macroeconomic stability, a key element for attracting and retaining foreign direct investment. Preserving central bank autonomy and credibility, by maintaining price stability as its principal mandate, is fundamental, particularly at the current juncture when episodes of financial volatility are likely to increase, as advanced economies withdraw monetary stimulus. A central bank focused on maintaining inflation low and stable can also play a key role in moderating economic cycles and running anticyclical policies when needed. This was illustrated by the strong anticyclical policies run by Costa Rica’s Central Bank in 2019, when the economy weakened and inflation was below target, and during the pandemic recession. Filling the current vacancy in the Central Bank board, which would put an end to the transitional possibility for the Minister of Finance to vote in board meetings while the vacancy is being filled, would buttress the autonomy of the Bank.

Figure 1.14. Inflation has fallen significantly since reinforcing Central Bank's independence

Annual consumer price inflation, %



Source: OECD Economic Outlook: Statistics and Projections (database).

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Improving debt sustainability and reinforcing the fiscal framework

After a decade of widening fiscal deficits, fiscal performance improved significantly in 2021 (Figure 1.15). The headline deficit stood at 5% of GDP, lower than foreseen in the authorities' medium-term fiscal plan and in the memorandum of understanding that was agreed with the IMF to access the three-year Extended Fund Facility. The primary deficit stood at 0.3% of GDP, 3.1 percentage points lower than in 2020. This improvement reflects the combination of stronger than expected economic activity in 2021, and that all elements of the 2018 fiscal reform were for the first time in place. This included the implementation of the fiscal rule capping expenditure growth (Box 1.2), a fully-fledged value-added tax that replaced the sales tax and strengthened taxation of capital income at personal level. Tax revenues also increased thanks to several one-offs amounting to 0.7% of GDP, such as those caused by some tax payments deferments applied during 2020 that increased tax revenues in 2021.

Box 1.2. Costa Rica's fiscal rule

The fiscal rule limits the growth of nominal spending depending on the level of public debt, as follows:

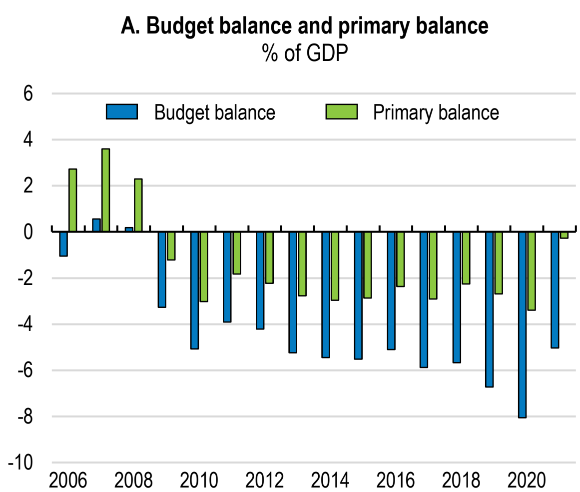
- When debt at the end of the previous fiscal year is under 30% of GDP or the current expenditure-to-GDP ratio is below 17%, the annual growth of current expenditure should not exceed the average nominal GDP growth in the past four years.
- When debt at the end of the previous fiscal year is between 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 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 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.

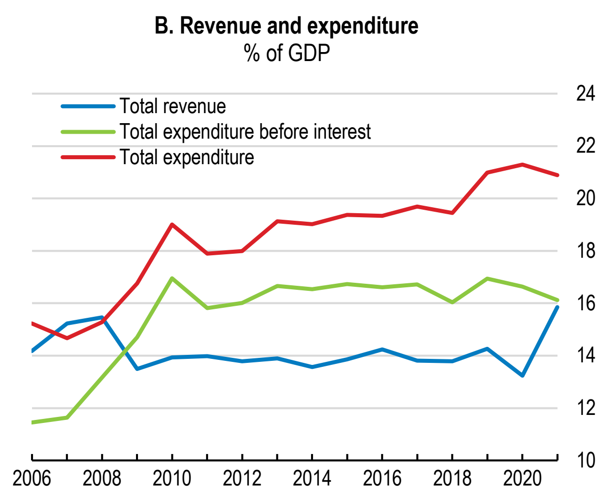
The fiscal rule law, approved in December 2018, established that the spending of all non-financial entities of the public sector is subject to the rule. This includes the central government, all deconcentrated bodies, the legislature, the judiciary, local governments or non-financial public companies. Exceptions embedded in the law are the Social Security Fund (CCSS), the non-contributory pension regime, the Refinery of Oil (Recope), concerning the oil bill, and the Institute of Electricity (ICE), concerning the part of their activities in the telecommunication sector. In May 2020 a law was approved, exempting municipalities from the fiscal rule. In June 2022 a legal change established that fiscal rule calculations will start to be based on budgeted spending instead of on executed spending.

The fiscal rule law also established different conditions under which some institutions can apply for a derogation. For example, derogations are possible in the case of the declaration of a national emergency or when the country is going through an economic recession (or projections of growth below 1%). In either case, the law allows for up to two years of derogation after each of these events. As a result of the pandemic shock, several institutions such as Health Ministry, Education Ministry, the Vocational Training Centre (INA) or the Social Protection Ministry (IMAS), were granted derogations during 2020 or 2021, which enabled them to spend above the limits established by the fiscal rule.

Figure 1.15. The budget deficit has decreased

Central government, % of GDP





Note: Data refer to central government only. Total revenues do not include social security contributions.
Source: Finance Ministry.

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Maintaining fiscal prudence is key for debt sustainability

With public debt around 70% of GDP, public finances remain a critical vulnerability and the fiscal medium-term outlook remains challenging. According to the government medium-term fiscal plan, the deficit is expected to fall to 2.5% of GDP by 2025, while the primary balance would reach a surplus of 2.1% of GDP (Table 1.3). If these targets are met, the central government debt-to-GDP ratio would gradually decline from its 68% peak in 2021 (Figure 1.16, black line). Complying with this medium-term fiscal plan will require maintaining fiscal prudence, including by ensuring a strict implementation of the fiscal rule, which caps expenditure growth (Box 1.2). As of 2022, with central government debt above the threshold of 60% of GDP, the fiscal rule entered the most stringent scenario and annual growth of total expenditure should not exceed 65% of the average nominal GDP growth in the past four years. Meeting the targets established in the medium-term fiscal plan and full implementation of the fiscal rule are critical for containing spending and ensuring debt sustainability. In a scenario with spending growing above the limits established by the fiscal rule, the debt ratio will continue to rise (Figure 1.16, orange line). An ambitious reform scenario, boosting potential output as described in Figure 1.2, above, plus the planned fiscal consolidation plan, would put debt below 50% significantly earlier (Figure 1.16, green line).

Table 1.3. Evolution of main fiscal aggregates

% of GDP

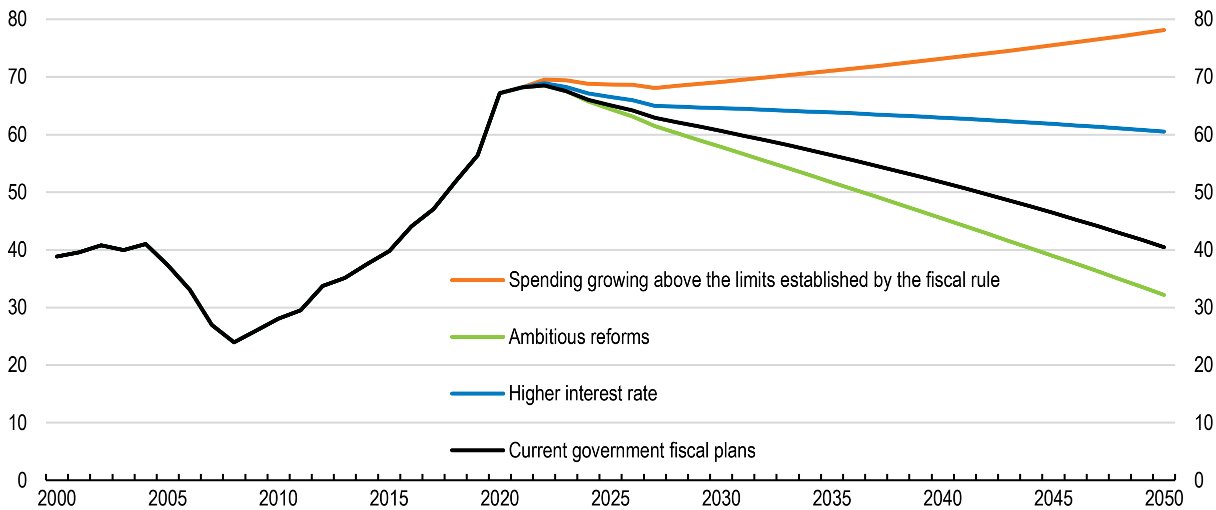
	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027
Total revenues	**14.2**	**14.8**	**13.9**	**15.8**	**14.8**	**15.0**	**14.9**	**14.9**	**15.0**	**15.1**
Tax revenues	13.1	13.5	12.1	13.9	13.3	13.4	13.4	13.5	13.5	13.7
Personal taxes	1.4	1.5	2.1	2.1	2.0	2.1	2.1	2.1	2.1	2.2
Corporate taxes	2.6	2.9	2.5	3.1	2.8	3.0	2.9	3.0	3.0	3.1
Value added taxes	4.3	4.5	4.5	5.1	4.9	4.8	4.8	4.7	4.8	4.8
Other	4.8	4.6	3.1	3.7	3.5	3.6	3.6	3.6	3.6	3.7
Other revenues	1.1	1.3	1.7	1.9	1.6	1.6	1.5	1.5	1.5	1.5
Total expenditures	**19.7**	**21.2**	**22.4**	**20.8**	**19.2**	**18.5**	**18.0**	**17.5**	**17.2**	**16.9**
Current expenditure	18.3	19.2	20.6	19.3	17.5	16.8	16.2	15.7	15.4	15.0
Wages	6.9	6.8	6.8	6.6	6.1	5.7	5.4	5.1	4.8	4.5
Goods and services	0.6	0.6	0.9	0.9	0.8	0.8	0.8	0.8	0.9	0.9
Interest	3.4	4.0	4.7	4.8	5.1	4.8	4.6	4.6	4.5	4.3
Transfers	7.4	7.7	8.2	7.2	5.5	5.5	5.4	5.2	5.2	5.3
Capital expenditure	1.4	2.0	1.8	1.5	1.7	1.7	1.8	1.8	1.9	1.9
Central government primary balance	**-2.1**	**-2.3**	**-3.9**	**-0.3**	**0.8**	**1.3**	**1.5**	**2.1**	**2.3**	**2.6**
Central government overall balance	**-5.5**	**-6.4**	**-8.5**	**-5.0**	**-4.4**	**-3.6**	**-3.1**	**-2.5**	**-2.2**	**-1.7**
Non-financial public sector overall balance	**-4.4**	**-5.2**	**-7.8**	**-4.2**	**-4.3**	**-3.3**	**-2.7**	**-2.3**	**-2.0**	**-1.2**
Government financing needs	*12.2*	*12.1*	*13.2*	*11.1*	*9.8*	*10.1*	*9.6*	*9.0*	*8.5*	*6.8*
Central government debt	*51.9*	*56.4*	*67.2*	*68.2*	*67.6*	*67.5*	*67.1*	*66.1*	*64.9*	*63.2*
Non-financial public sector government debt		*51.0*	*60.5*	*60.6*	*60.4*	*60.4*	*58.9*	*56.9*	*54.8*	*51.9*

Note: Central government unless otherwise specified. Data for 2022-2027 are projections. Other revenues include social security contributions; non-tax revenues; and transfers. Some rows may not add up due to rounding. Data for 2023-2027 are projections and based on Finance Ministry passive scenario.
Source: Medium-term fiscal and budgetary framework (*Marco Fiscal Presupuestario de Mediano Plazo*) 2022-2027.

Full implementation of the fiscal rule will require sustained policy efforts to contain public spending. The fiscal rule remains the only tool anchoring fiscal policies in Costa Rica. The implementation of the fiscal rule has met significant opposition and legal challenges and frequent requests for exceptions from different segments of the public sector. A recent legal change establishes that fiscal rule calculations will now be based on previous year's budget instead of on the previous year's execution. This change increases the room for spending, as budgeted spending tends to be higher than executed spending. It also avoids penalising those institutions achieving savings, as, at the moment, if they end spending less than budgeted, they automatically get their spending space reduced in the following budget. The government has recently published draft legislation proposing additional changes to the fiscal rule and to undertake public asset sales. Proposed changes include applying the fiscal rule to current spending instead of to total spending in the more binding scenario of the rule, and removing interest spending from calculations in all scenarios (i.e. the fiscal rule would be applied to current primary spending in all scenarios). Proposed public assets sales include a state-owned bank and 49% of the National Insurance Institute. The authorities foresee that revenues from the sale of the state-owned bank could be around 3% of GDP. Both pieces of legislation require approval by the Legislative Assembly and are subject to uncertainty about its final configuration and implementation schedule. The effects on public debt dynamics remain uncertain. While changes in the fiscal rule would imply a slower reduction of the headline deficit and public debt, the asset sales would reduce the level of public debt. In the medium-term, undertaking a careful review of the fiscal rule, taking stock of the experience gained during its implementation over the last years, could help to improve its design and to ensure that it continues to secure a prudent fiscal stance and sustainable debt dynamics.

Figure 1.16. Current fiscal policies will put public debt on a declining path

% of GDP



Note: The chart depicts central government public debt. The "Current government fiscal plans" scenario assumes GDP growth as in table 1.1 until 2023, with a gradual transition to OECD long-term model estimates of potential output thereafter. Inflation is projected as in table 1.1 until 2023 and a gradual convergence to 3% thereafter. Fiscal assumptions are those outlined in table 1.3 and remain constant until 2028 when ageing costs, in the form of higher pensions and health costs, will gradually start to kick. The "Ambitious reforms" scenario assumes the implementation of reforms described in Figure 1.2. Both "Current government fiscal plans" and "Ambitious reforms" scenarios assume full implementation of the fiscal rule. The scenario "Spending growing above the limits established by the fiscal rule" assumes that primary spending is 1% of GDP higher than in current government fiscal plans and that revenues remain as in current government fiscal plans. In all scenarios the evolution of the interest rate paid on new debt issued is a function of the 10 years US sovereign yield and a risk spread that depends on the ratio of debt-to-GDP. In the "Higher interest rate scenario" the interest rate is 100 basis points higher over the projection period, which leds to interest spending being 1% of GDP higher than in the other scenarios, and that primary spending and revenues remain as in current government fiscal plans. All scenarios include ageing costs.
Source: OECD calculations.

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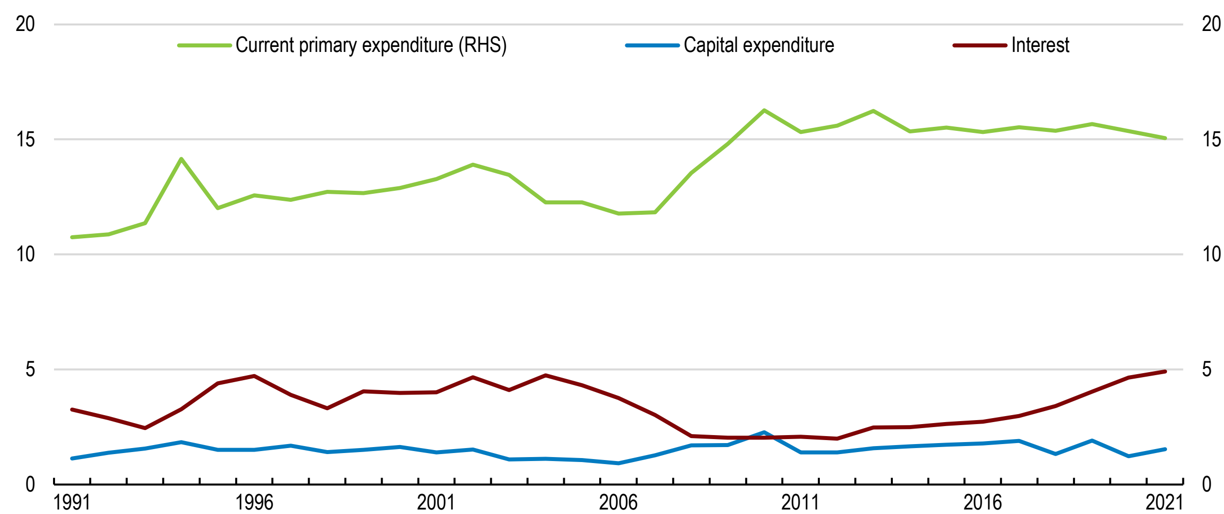
Improving the efficiency and quality of public spending

Containing spending and, at the same time, improving its efficiency and quality to better support growth and equity, is a critical challenge ahead. The surge in spending that led to Costa Rica's critical fiscal situation in 2008-19 almost exclusively involved extra current primary spending (Figure 1.17), neglecting key investments in capital expenditure that typically underpin medium-term growth prospects. This spending increase saw no improvement in the quality of spending nor any stronger contribution to economic growth and equity (OECD, 2018[5]). A paradigmatic case is education spending. Despite the increase in education spending, which accounts for a larger share of total spending than in OECD countries (Figure 1.18), education outcomes have worsened (see Chapter 2). Overall, Costa Ricans have become increasingly dissatisfied with the quality of the delivery of public services (Estado de la Nación, 2017[6]). Looking ahead, as the need to contain spending will endure, Costa Rica should continue to switch from a focus on the volume of spending to a focus on how to improve its quality and efficiency. This would require stronger accountability mechanisms, transparency and impact evaluation. This is even more necessary given that population ageing will put further pressure on some categories of social spending. The 2018 fiscal reform removed part of the revenue-earmarking provisions introduced over the years. The Finance Ministry became able to reallocate spending away from legally mandated destinations when public debt exceeds 50% of GDP. Continuing to reduce earmarking and to increase the ability to reallocate spending will be key to boost public spending efficiency. Spending reviews can inform the process to decide on the necessary expenditures prioritisation and reallocation in a transparent way and would foster accountability across the public sector.

Figure 1.17. Capital expenditure has been largely neglected

Governement expenditure, % of GDP, 1991-2021



Source: Ministerio de Hacienda; IMF World Economic Outlook; OECD System of National Accounts database.

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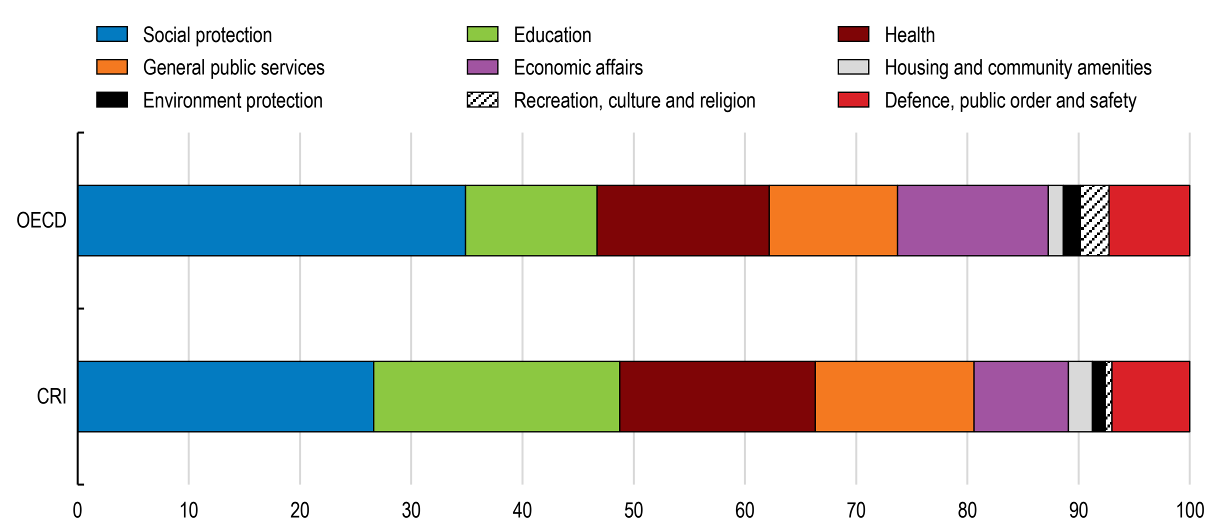
Figure 1.18. Education accounts for a larger share of public spending than in OECD countries

General government expenditure by function, % of total, 2020



Note: Data for Chile and Costa Rica are for the year 2019. OECD average excludes Mexico for which no data are available.
Source: IMF Government Finance Statistics database; and OECD Statistics on National Accounts.

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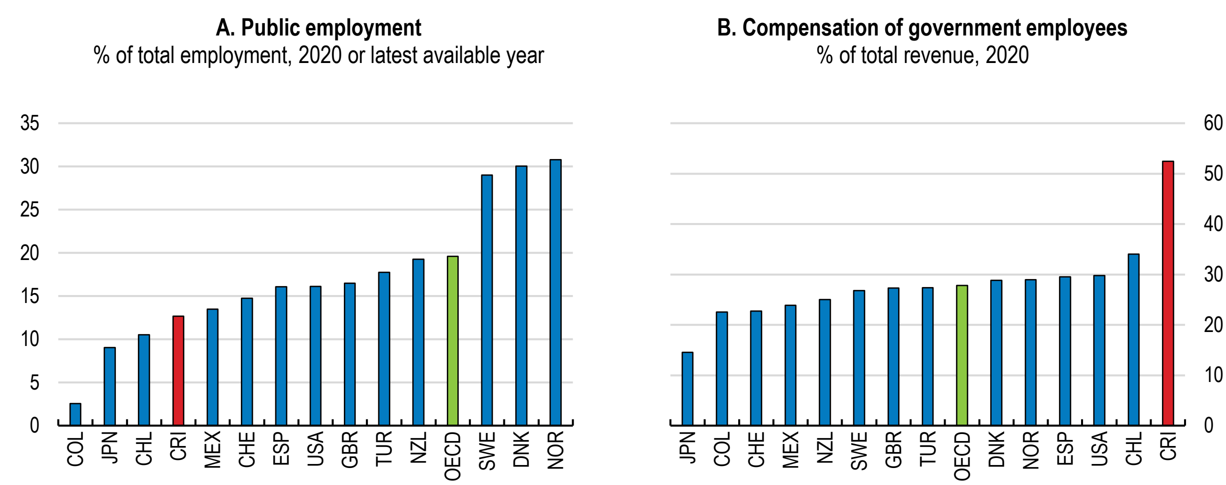
Fostering capital investment would boost the contribution of fiscal policy to growth. A first step would be to improve the ability to execute capital investment projects, as only 30% of the capital spending that is budgeted is executed. Ongoing reforms to foster the stewardship of the Ministry of Public Works and to reduce fragmentation in public investment processes can foster the ability to deliver capital investment projects in a more effective and efficient manner. Creating more space for capital spending is also needed (Figure 1.17). Focusing the needed fiscal containment efforts on current spending would facilitate deploying capital spending to close some of Costa Rica's numerous infrastructure gaps (see infrastructure section below), boosting medium-term growth prospects. Despite being in the most stringent scenario of the fiscal rule, the design of the fiscal rule allows for such possibility. It remains at the discretion of authorities to focus the fiscal effort on current spending and allow capital spending to strengthen, as long as the sum of current and capital spending remains below the limit established by the rule for total spending. Basing the selection of capital investment projects on sound cost-benefit analysis would help to reduce infrastructure gaps in a cost-effective manner.

Containing the public employment wage bill will be key to comply with the fiscal rule and improve public sector efficiency. Compensation of government employees accounts for more than half of total government revenues (Figure 1.19), 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[7]). Measures to contain the public wage bill affect more the higher-income households (Figure 1.20), with a lower propensity to consume, meaning that the impact on growth would be moderate. Limits to public wages included in the 2018 fiscal reform contributed to the reduction in the deficit in 2021. However, additional measures are necessary to make remuneration more transparent and performance based. The public employment framework law, introducing a new single and unified salary framework with equal pay scales for equivalent functions across the public sector and rationalized bonuses, a long-standing OECD recommendation, was finally approved in March 2022 (Table 1.4 and Box 1.3). Applying the law maintaining consistency between the job families and salary scales in the central government and other institutions, and ensuring a link between performance and remuneration are key challenges to reap the full benefits of the law and improve public sector efficiency.

Figure 1.19. The public employment bill accounts for a large share of government revenues



Source: ILOSTAT; IMF Global Finance Statistics.

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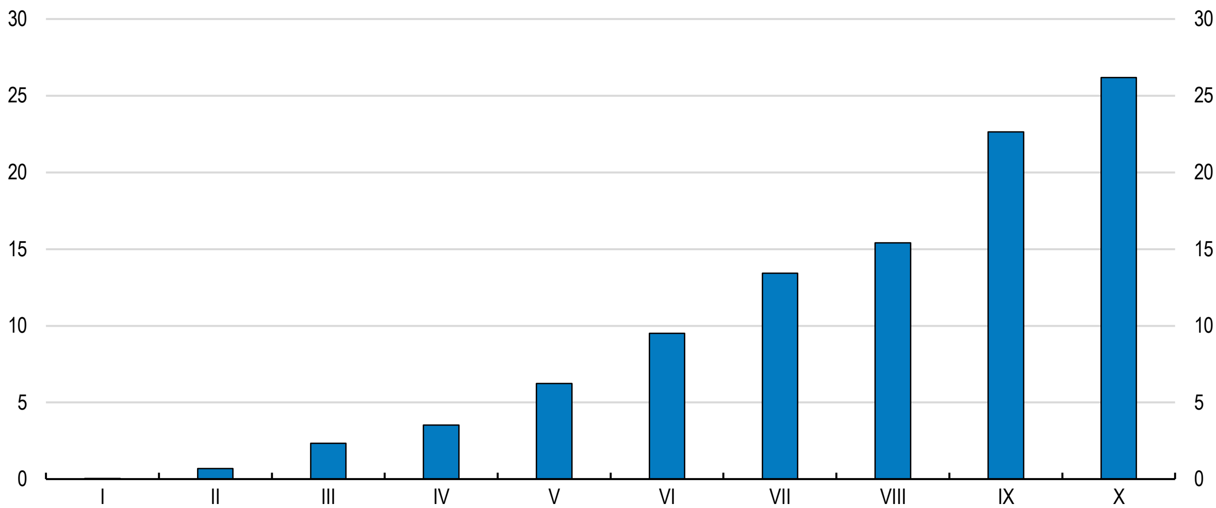
Figure 1.20. Public employment reforms in Costa Rica impact high-income households more

Percentage of Costa Rican households with at least one public worker by income decile



Source: OECD calculations based on ENAHO.

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Table 1.4. Past OECD recommendations to improve macroeconomic policies

Past OECD recommendations	Actions taken since the 2020 survey
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. Establish clear guidelines for the implementation of the fiscal rule. Allow that all spending categories can be adjusted when public debt exceeds 50% of GDP. Eliminate tax exemptions benefiting more affluent taxpayers.	"Bono Proteger", a temporary cash transfers targeted, was made available to individuals affected by the pandemic. Implemented a temporary hospital specialized in treating COVID patients. The fiscal rule underpinned the fiscal improvement in 2021. The latest two budgets contained significant spending reallocation and spending containment measures. Proposals for reducing some exemptions were submitted to Congress but were not approved.
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 Central Bank lowered the interest rate, which reached a historical low level of 0.75%. The Central Bank provided banks with temporary medium-term credit, conditional on providing finance to medium-term solvent individuals. Prudential regulations were adjusted to facilitate debt re-profiling.
Bring all purchases by all public entities to the central procurement system and limit the use of exceptions for direct contracting.	A new law establishes that all the public sector must carry their purchases through the central procurement system.
Adopt a single salary scale, streamline incentives schemes and make them performance based.	The public employment framework law, introducing a new single and unified salary framework was approved in March 2022, with implementation starting in March 2023.
Create a public debt management agency. Target attracting foreign investors to instruments issued in local currency.	Measures to facilitate the purchasing of local debt in local currency by foreign investors have been put in place.
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.	Legal changes to start publishing stress tests results bank by bank have been finalized. No actions taken.
Adopt a more diversified investment strategy, reducing the share of government securities.	Pension funds have increased investment in external assets denominated in dollars.

Box 1.3. The public employment framework law

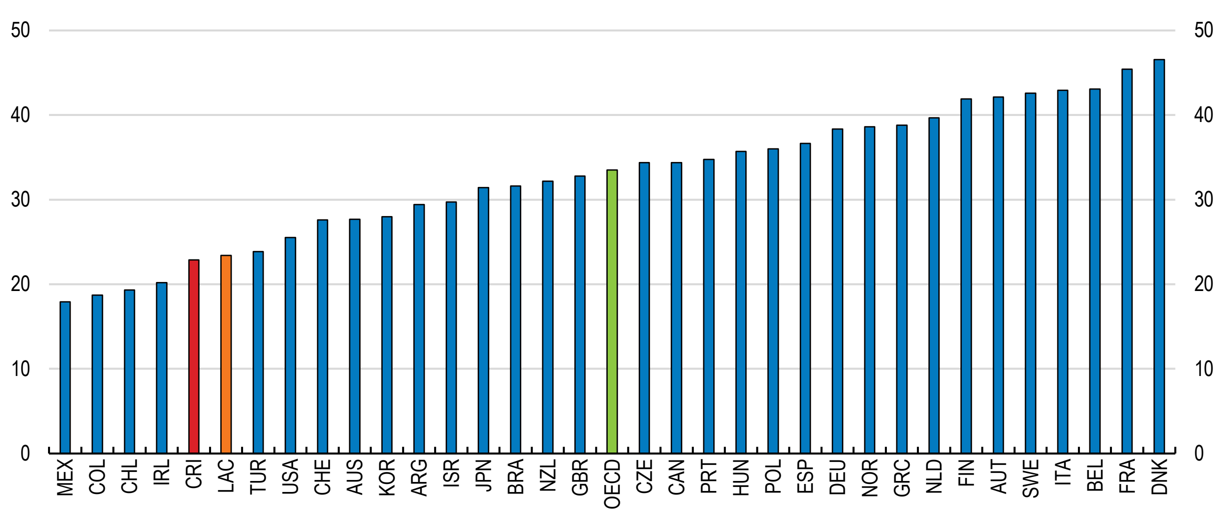
The public employment framework law, approved in March 2022, introduces a new single and unified salary framework for the public sector (excluding non-state public entities, state companies in competition and the Meritorious Fire Brigade). The framework includes equal pay scales for equivalent functions, rationalizes bonuses and makes them more performance based. Public institutions with autonomy or independence will define the job families and salary scales for exclusive and exclusionary functions assigned to them by the Constitution. Exclusive and exclusionary functions refer to strategic roles within independent institutions, determined to avoid possible infringement of power independence among government branches. The Ministry of National Planning and Economic Policy (MIDEPLAN), with the General Directorate of Civil Service, will define them for the rest of the functions of the public sector. According to estimates by the Inter American Development Bank annual savings would range between 0.5% and 0.8% of GDP for the whole public sector, and between 0.4% and 0.6% for the central government, depending on the new reference salaries.

Raising more revenue and enhancing the redistributive power of tax policy

Tax revenues are in line with regional peers but lower than in most OECD countries (Figure 1.21). High tax evasion, narrow tax bases and various tax expenditures mean that there is room to increase revenues in a way that supports growth and reduces inequality. Costa Rica's tax mix differs markedly from either the OECD or regional averages (Figure 1.22). The tax system is overly reliant on social security contributions, which account for more than one-third of total revenues, compared with the OECD average of 26% or less than 15% in peer Latin American countries. High social security contributions generate labour market distortions and favour informality (see also the informality section). This erodes the tax base and generates inequalities.

Figure 1.21. Tax revenues are low compared to OECD peers

% of GDP, 2020 or latest year



Note: LAC refers to Chile, Colombia, Mexico, Argentina and Brazil. All averages are unweighted.
Source: OECD Revenue Statistics database.

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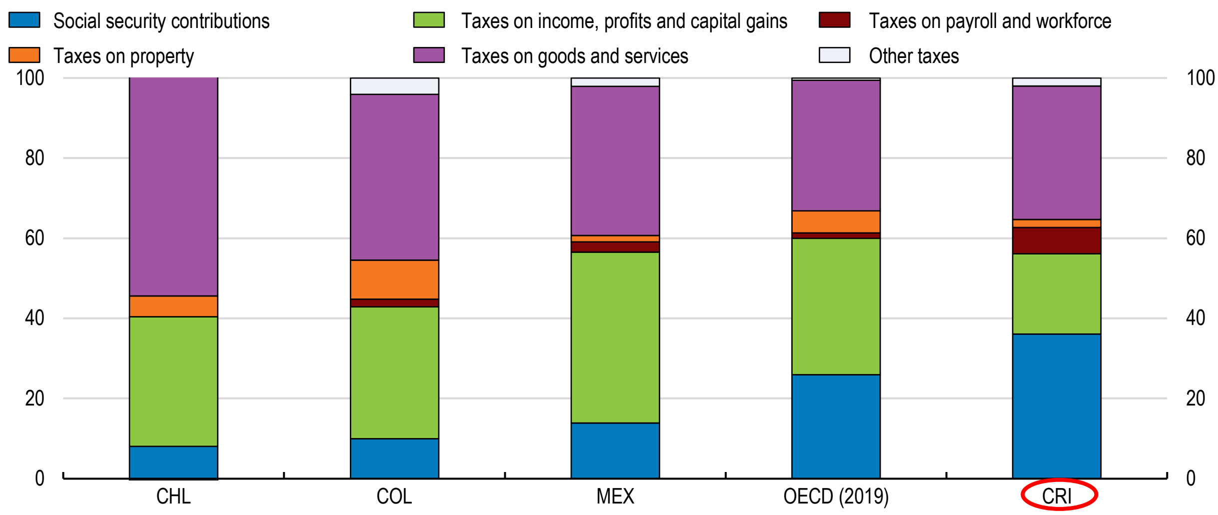
Figure 1.22. Costa Rica's tax structure relies on social security contributions

% of total taxation



Source: OECD Global Revenue Statistics.

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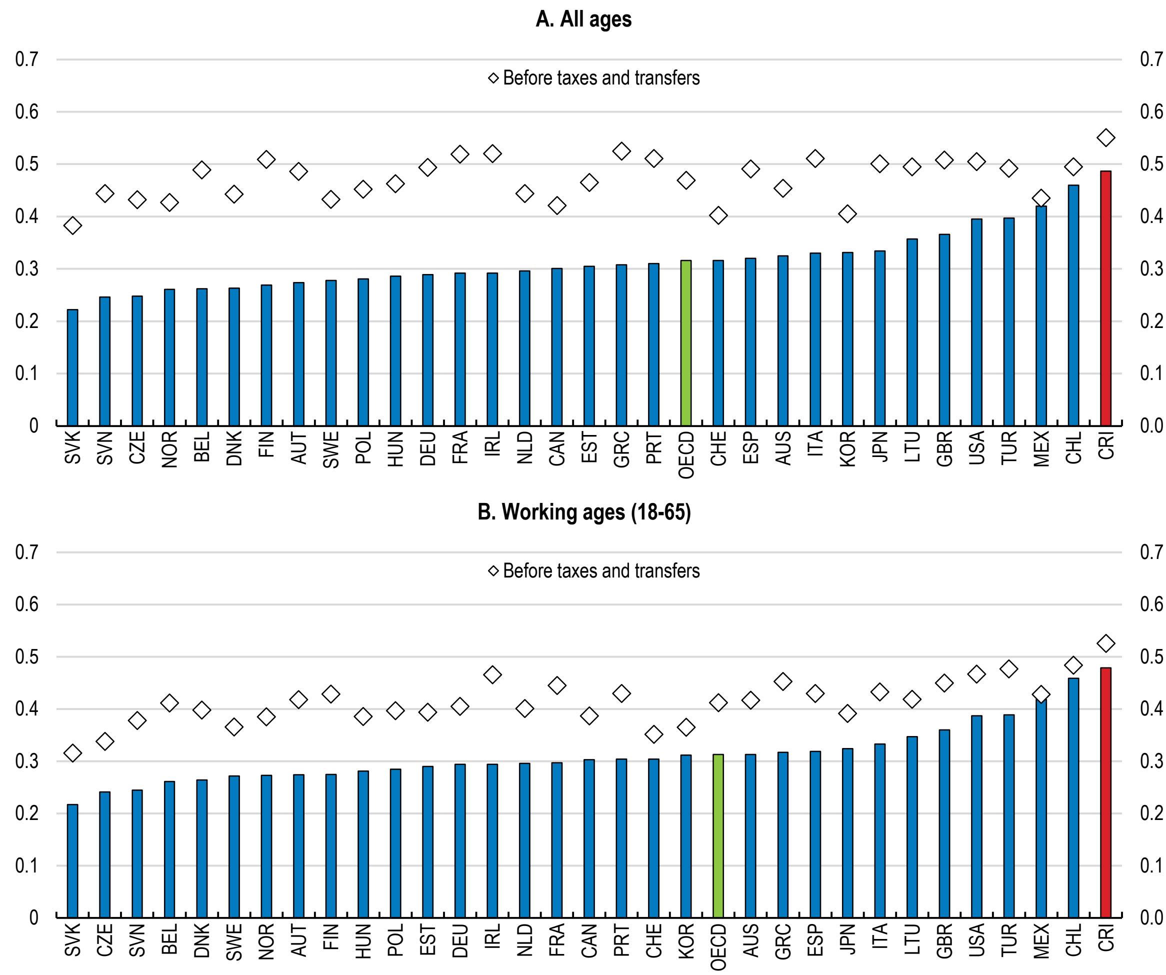
To raise additional revenue, the authorities are currently assessing new tax measures. With public debt still high and a tax system overly reliant on social security contributions and with a very weak redistributive power (Figure 1.23), Costa Rica should consider tax measures that improve the tax mix, make the tax system more progressive and raise additional revenue. In this regard, the authorities have announced plans to reform the personal income tax system and move to a system where all personal income sources are consolidated. At the moment, each personal income source is taxed separately. This change could increase revenues and the progressivity of the tax system.

Broadening tax bases also holds the promise of increasing revenues without increasing rates, and could also make the tax system more progressive. Tax expenditures are large, amounting to 4% of GDP in 2021. Tax exemptions granted to free trade zones, which amount to 1% of GDP, have brought economic advantages to the country, such as an increasingly diversified export basket. This suggests that the free trade zone tax scheme should be retained subject to regular and in-depth evaluations of its costs and benefits, focused on the additional investment, employment and productivity it generates. On the other hand, phasing out the exceptions that particularly benefit more affluent taxpayers should be prioritised, which includes the tax exemption on the additional monthly salary for most public employees *(Salario escolar)*. Starting to tax the income of cooperatives, which remain exempt despite some of them being large corporations, enjoying trade protection and monopolistic conditions in key markets, should also be considered. There remains also room to optimise reduced VAT rates. Taxing the spending on private education and health at reduced VAT rates is particularly regressive, as it disproportionately benefits high-income households.

Additional revenue collection could also come from taxes on immovable property, which account for around 6% of total revenues in the OECD and peer regional countries but less than 2% in Costa Rica. The central government is responsible for building and maintaining the cadastre while the local governments are responsible for the valuation of property. Valuation rules across local governments are very heterogeneous. Providing support to local governments to ensure that the same valuation rules are applied across municipalities would prevent unfair competition and increase revenues (OECD, 2017[8]). Exempting low value properties and establishing different tax rates depending on the property value could be useful to ensure progressivity, as exemplified by some OECD countries, such as Ireland.

Figure 1.23. The tax and transfer system could be more efficient in reducing inequality

Gini coefficient before and after taxes and transfers, 2021 or latest year



Note: Data for Costa Rica refer to 2021. OECD refers to an unweighted average of all member countries with available data. The diamonds for Mexico, Hungary and Turkey show the Gini coefficient after taxes and before transfers.
Source: OECD Income Distribution Database.

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Tax administration and collection reforms are critical. The authorities have already taken important steps, such as the roll out of electronic invoicing. Further reforms to strengthen tax administration and collection could include integrating the tax and social security contribution administrations or further modernising the tax administration through computerisation and risk-based compliance (OECD, 2017[8]). Measures to simplify the tax system could also help improve tax compliance. Numerous public agencies are involved in the collection of taxes. Beyond the Finance Ministry, municipalities, the Social Security Institute, the National Insurance Institute, the Central Bank, pensions and insurance operators, several SOEs and professional associations, all are involved in tax collection. More than 60% of the taxes are collected outside the Finance Ministry. Municipalities collect by themselves 21 taxes (CGR, 2021[9]). As a result, for the 99 taxes that remain active, there are 93 different IT platforms used in 143 public institutions. Moving towards a more centralised, digital and less fragmented tax payment and collection system could offer significant efficiency gains and savings that could reach 1% of GDP (CGR, 2021[9]) and facilitate tax compliance. Extending the use of prefilled tax returns can also help to facilitate compliance and reduce administration costs, as exemplified in several OECD countries (Box 1.4). Ongoing technical assistance to improve tax administration and public financial management, led by the IMF and with collaboration of the EU among other partners, have also a large potential to boost significantly tax efficiency and collection.

To ensure the medium-term stability and credibility of the tax system, it is also essential that Costa Rica remains proactive in the on-going international efforts to harmonise tax standards and avoid base erosion and profit shifting. Costa Rica's free-trade-zone regime is one of the elements in its strategy to attract foreign direct investment. Continuing to update domestic tax rules in line with new international standards is the best way to remain attractive for foreign direct investment and preserve its reputation for international cooperation and transparency on tax issues. At the same time, progress towards establishing a minimum global corporate effective tax of 15% means that other elements in the strategy to attract foreign direct investment, such as the availability of highly skilled workers (see Chapter 2), will gain emphasis.

Box 1.4. Prefilling tax returns

Prefilled income tax returns represent a tax simplification initiative that can foster compliance and reduce burdens for taxpayers and tax administrations. Their use began in Denmark in the late 1980s and subsequently has spread across OECD countries. Pre-filling entails the use by tax administrations of information already held by them (e.g. taxpayer identity information, elements of taxpayer history, and third-party reports of income and expenses) to populate fields within tax returns that are made available to taxpayers for examination.

In a number of countries, for example Finland, Hungary and Norway, tax administrations generate at the end of the year a fully pre-filled personal income tax return for the majority of taxpayers required to file tax returns. Australia currently prefills around 88% of all income amounts reported by individual taxpayers. Ninety percent of these are accepted without amendment by the taxpayer. Substantial use of pre-filling to fully or partially complete tax returns for a significant share of taxpayers also takes place in many other OECD countries (OECD, 2022[10]). In recent years, the use of prefilled returns has extended beyond personal income tax. For example, the availability of electronic invoicing systems allows tax administrations to pre-fill value-added tax returns, as is the case in Portugal (OECD, 2022[10]).

Strengthening the fiscal framework

To support ongoing consolidation efforts and enhance medium-term fiscal sustainability, Costa Rica should continue modernising its fiscal framework by introducing a fully-fledged multi-year expenditure framework and an effective and independent fiscal council, as recommended in previous OECD Economic Surveys (OECD, 2020[3]) and done in many OECD countries, such as Chile recently (OECD, 2020[11]). Costa Rica's high public debt implies that reducing the debt burden will be the medium-term focus of fiscal policy for several years to come. A multi-year expenditure framework would provide certainty and transparency about the medium-term plan, helping to plan and to align spending decisions with strategic objectives. The "Medium-term fiscal and budgetary framework" (*Marco Fiscal Presupuestario de Mediano Plazo*), published every year by the Ministry of Finance, detailing baseline expenditure forecasts for the year ahead, has been gradually enhanced and now covers both the central government and the non-financial public sector. Costa Rica could build on it to establish a fully-fledged multi-year expenditure framework, where multiyear targets are established. The medium-term framework publication now contains more descriptive and qualitative information about contingent liabilities but providing a quantitative assessment is a pending challenge.

Fiscal transparency and accountability would also be enhanced by establishing an independent and adequately resourced fiscal council. By providing non-partisan fiscal analysis, fiscal councils can enrich the fiscal policy debate and help to communicate fiscal risks and policy options. The law to establish an independent fiscal council was approved in March 2020 and its three members were nominated. However, no further action has been taken to enable the council to operate in a meaningful way. The council suffers from significant institutional weaknesses, such as a lack of clarity about the roles it has to perform or of a minimal technical support structure. Providing the three board members with independent technical support is critical. Defining explicitly at which moments in the process of preparation of the medium-term fiscal plan the council would be consulted and by when it should issue its assessment, providing sufficient time for preparing such an assessment, would allow the council to fulfil its role. Mechanisms to ensure that there is some follow-up of the council assessment and opinions are also lacking and should be established.

Improving public debt management

With interest payments at about 5% of GDP, and accounting for an increasing share of the central government budget, improving debt management remains increasingly important. Both domestic and global interest rates are expected to put additional pressure on the interest bill. In a scenario of increasing funding costs, the debt-to-GDP ratio would remain higher for longer (Figure 1.16, blue line). Planned access to additional international loans and issuance of instruments in foreign currency could reduce financing costs and provide some savings, relative to placing the debt in local markets to local investors. Costa Rica is expecting to access significant multilateral funding in 2023, including through the IMF Extended Arrangement under the Extended Fund Facility. In total multilaterals are expected to provide about 4% of GDP, out of the 10% of GDP of financing needs expected in 2023. Accessing some of these financing lines and issuing instruments in foreign currency requires approval by the parliament.

Issuing debt in foreign currency can provide savings relative to placing debt in local markets but also brings foreign currency risks, which should be carefully considered. Establishing a debt management agency, a long-standing OECD recommendation, would help to manage those risks. 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[5]). Debt management practices have recently improved but improving the institutional set-up would further buttress debt management. With a debt management office in place, Costa Rica could consider relaxing the requirement of approval by the parliament to issue debt in foreign currency. This would allow for putting in place multi-year debt management plans based on sound guidelines and principles, helping to take better advantage of market opportunities. Costa Rica would also benefit from continuing efforts to attract foreign investors to local-currency denominated debt, as recommended in previous OECD Economic Surveys.

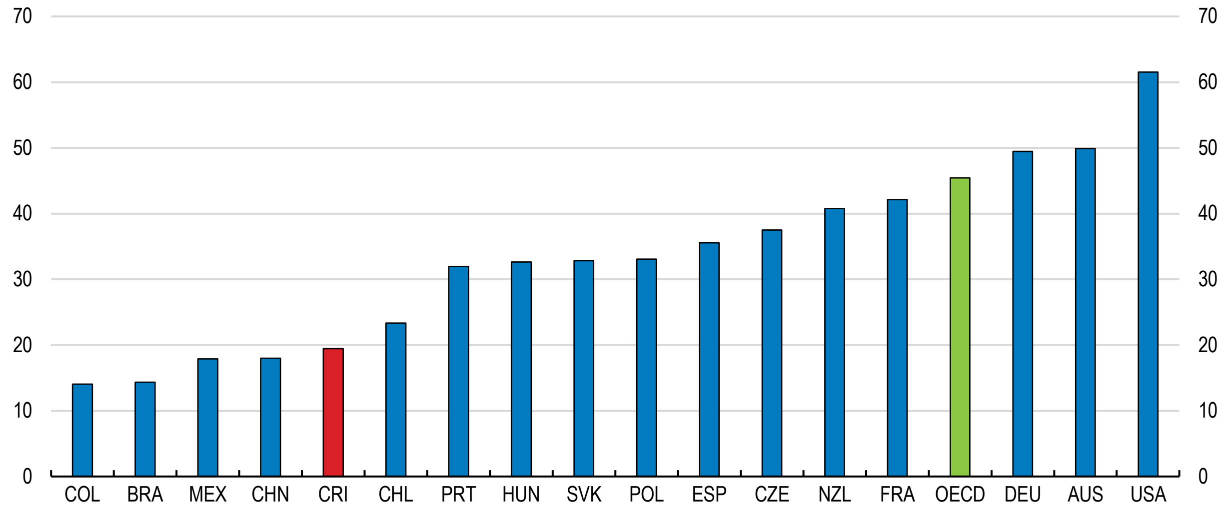
Strengthening productivity growth

Over the past 15 years, potential growth has declined markedly (Figure 1.1), from more than 5% per year in 2007, to around 2.3% now, according to OECD estimates. Falling employment rates and a shrinking working-age population have contributed to the decline. Boosting female labour market participation and further increasing employment rates hold the promise of improving growth prospects significantly. Still, population ageing will dampen aggregate growth substantially. Boosting productivity is therefore critical to uphold growth in GDP and living standards in Costa Rica.

The level of productivity is relatively low in international comparison (Figure 1.24). It remains at similar levels as in Latin American peers but below other emerging economies, such as those in Eastern Europe or Asia. One key factor helping to explain this is that Costa Rica remains a dual economy, combining a small number of large and relatively productive firms, largely focused on external markets, with another sector, mainly composed of local SMEs exclusively focused on domestic markets and unable to benefit from the opportunities provided by the integration into the global economy. 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, remains a key challenge. Boosting the productivity of local firms would also facilitate their participation in global value chains.

Figure 1.24. Labour productivity is relatively low

1000s of PPP-adjusted USD per capita, 2021



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

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Boosting productivity through more competition

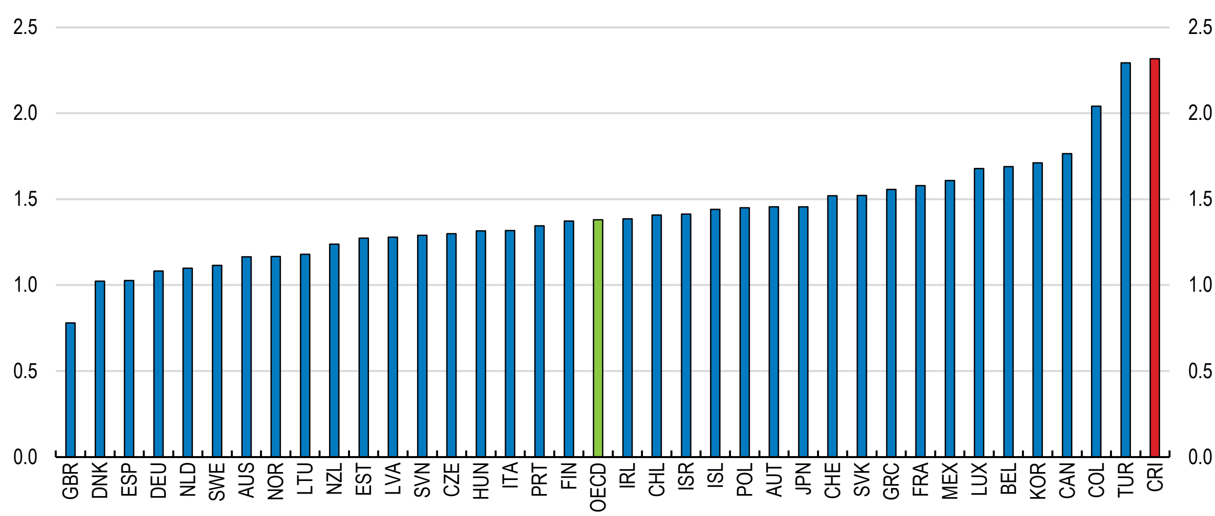
Weak competition tends to translate into relatively high prices of goods for consumers and of inputs for firms. Both features can be found in Costa Rica (OECD, 2020[3]), which has led to a general categorization of Costa Rica as an expensive country, where a basic basket of goods and services costs significantly more than in neighbouring countries (Angulo, 2014[12]). Private firms report that rising costs is the main barrier to their operations (UCCAEP, 2019[13]), particularly in agriculture and manufacturing. The elimination of the minimum price of rice is an important and welcome step to reduce the cost of the basic goods basket in Costa Rica. Likewise, the planned elimination of minimum prices in 11 professional services will foster competition in key sectors, such as healthcare and construction.

A fully independent and resourced competition authority is a key pillar of a solid competition framework. Many of the weaknesses in the competition framework, such as the lack of independence and resources of the national competition authority, were meant to be addressed by the new competition law approved in December 2019. However, in 2022, the national competition authority (COPROCOM) received less than one third of the budget granted by law. This severely hampers the authority's ability to perform its duties, as it remains understaffed and unable to buy equipment. Despite these constraints, two competition studies have been completed (professional associations and liner shipping). Providing the national competition authority with adequate financial resources, as established by law, is a necessary condition for boosting competition, which would translate into lower prices for goods and services, enhancing households' purchasing power and firms' competitiveness. Effective competition authorities, by promoting stronger economic growth, can also support tax revenues and have a positive fiscal impact. A well-resourced and fully operational national competition authority would be particularly beneficial at the current juncture when authorities are taking bold and valuable measures to improve regulations, open up key sectors of the economy and remove obstacles to competition (e.g. in the rice sector). Introducing a filing fee for merger control notifications could make available some additional resources. However, granting the budget established in the law would still remain critical. Making sure that the national competition authority receives a direct budget allocation would help secure the necessary resources. For the time being, the national competition authority is a deconcentrated institution under the umbrella of the Ministry of Economy. This means that its budget is counted as part of the budget of the Ministry of Economy, which can create difficulties when establishing spending ceilings per Ministry to comply with the fiscal rule. Spending reviews can also support the necessary spending reallocation process that the Finance Ministry needs to undertake to grant the necessary resources to the national competition authority. It remains also important to continue granting adequate resources to the sectoral competition authority (SUTEL), which is in charge of protecting and promoting competition in the telecommunication sector.

Keeping a competition-friendly regulatory framework is another key building block to foster competition. Regulations of product markets serve legitimate objectives but, when ill designed, can impose unnecessary restrictions on competition. The OECD's Product Market Regulation indicator for Costa Rica shows that there is ample room to improve regulations (Figure 1.25), with high barriers to entry and state involvement. A key strategy to ensure pro-competition regulations, used by many OECD countries and lacking in Costa Rica, is to conduct regulatory impact assessments to inform the development of new laws or regulations. In many countries, there is also a requirement to include explicitly the assessment of the impact (i.e. costs and benefits) on competition in the laws or regulations. Adopting such a requirement can ensure that competition aspects are more systematically taken into consideration across the public sector.

Figure 1.25. Costa Rica has more stringent regulations than any other OECD country

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



Source: OECD Product Market Regulation database.

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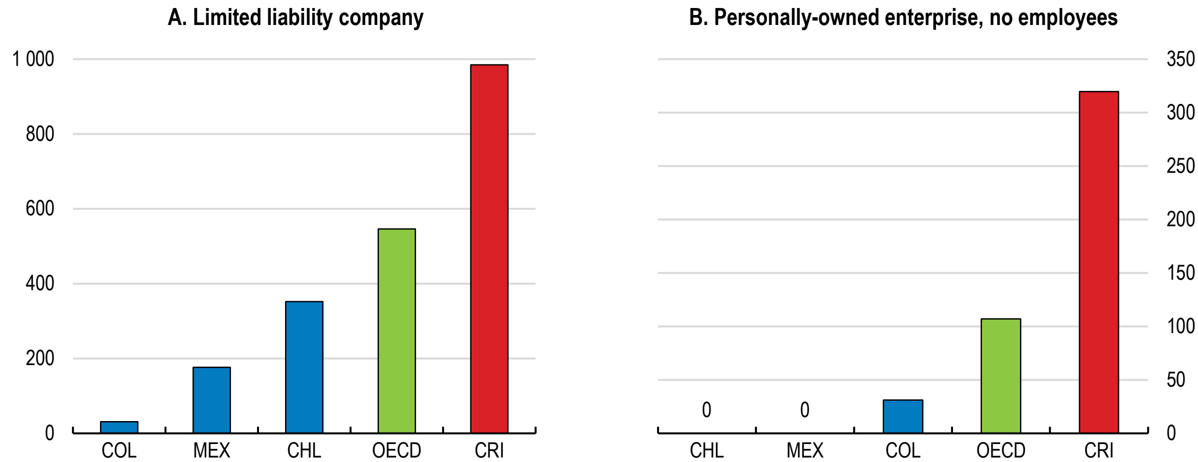
OECD countries have been boosting competition in their goods and services markets by facilitating entry. Costa Rica has ample room to follow suit. Among barriers hampering entry, administrative burdens and the license and permits system are the most problematic. Establishing a company is significantly more costly (Figure 1.26) and burdensome than in other OECD countries and in peer Latin American countries. Many OECD countries have reduced 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, which should also help to facilitate the creation of formal firms. Pending challenges are that existing one-stop shops allow for solving all administrative requirements in one place and that they do so via online facilities.

Figure 1.26. Establishing a company is costly

PPP-adjusted USD



Note: The figures display the typical total monetary cost to complete all mandatory procedures to start a limited liability company and a personally owned enterprise with no employees.
Source: OECD Product Market Regulation database.

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There is also a need to deal with the stock of regulations, many of which penalize firms and competitiveness, with a view to streamline, eliminate duplications and those no longer needed and harmonise regulations across different public agencies. International experiences show that dealing successfully with the legacy of measures requires intensified public-private dialogue, in which the private sector can flag problems and contribute to the solution, and a strong technical team (Cadot, Malouche and Sáez, 2012[14]). In this spirit, the Ministry of Economy is compiling in cooperation with the private sector a list of regulations and procedures that can be phased out, including also specific deadlines for their elimination.

Embracing e-government can be a powerful means to facilitate firms' compliance with administrative procedures at a minimal cost. Costa Rica has been lagging in the use of digital tools to interact with citizens and firms. The pandemic triggered more digital interactions, which should be further pursued. A key obstacle for increasing the use of digital tools by government, citizens and firms is the digital signature mechanism, which is perceived to be too cumbersome. Those attempting to use it also face difficulties to get the same validity as with a handwritten signature by public institutions. The Central Bank is currently working towards a solution that would enable the use of the digital signature via mobile phones (Table 1.5). Some OECD countries (see Box 1.5) exemplify 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.

A significant number of economic sectors in Costa Rica remain state monopolies or are dominated by state-owned enterprises. This includes key sectors, such as electricity, transport, banking, insurance and petroleum products. SOEs governance has been gradually improved but important challenges lie ahead, such as the full implementation of international accounting standards, establishing and monitoring performance indicators for SOEs, strengthening the functioning of boards and reviewing boards remuneration and developing recommendations to support incentives that are aligned with good board practices (OECD, 2022[15]). To promote continuing progress in addressing these challenges, it will be important to maintain strong coordination and analytical capacity in the Presidency's advisory unit for state-owned enterprises.

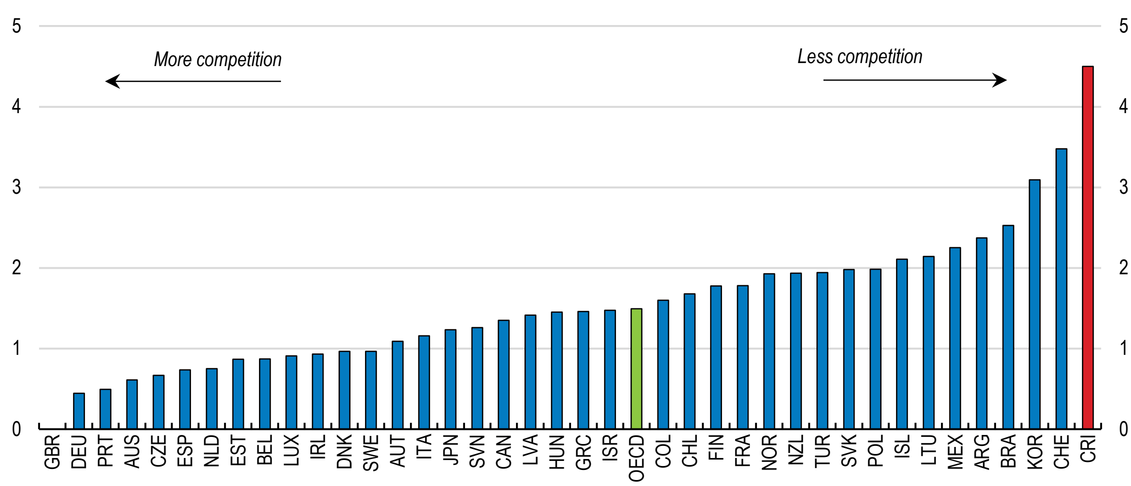
Box 1.5. The digital signature in Estonia

The Digital Signature Act in 2000 recognised digital signatures in Estonia as being equivalent to hand-written signatures, both in commercial transactions and in transactions with the public sector. The digital signature can be used directly through the national identification 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, or through 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 digital signature, created an environment that stimulated the development of compatible public services as well as their take-up by the general population (OECD, 2015[16]). All digital public services can be accessed using the digital signature, 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[17]).

As a whole, the SOE sector does not currently present a significant drain on the budget but some SOEs play a dominant role in critical sectors and their performance has critical economy-wide implications. A paradigmatic case is the electricity company, ICE, which dominates the electricity sector. It provides all transmission services in the country and is responsible for 44% of electricity distribution. One of its subsidiaries distributes around 32% of generated electricity. The share of allowed private-sector electricity generation is limited to 30%. Private-sector generators compete for the market rather than in the market, because to enter the market they must first win ICE tendering contracts. 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. This regulatory framework implies high barriers to competition (Figure 1.27).

Figure 1.27. Regulatory barriers on electricity are high

Product-market regulation index for electricity



Note: This indicator is composed of information on how entry and conduct in the electricity sector is regulated, and on the level of public ownership.
Source: OECD, 2018 PMR database.

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ICE's operating performance is mediocre when benchmarked with peer institutions (World Bank, 2015[18]) and electricity prices have been higher than in regional peer countries. 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 of innovation and lower prices (IEA, 2019[19]). Costa Rica should also consider relaxing existing restrictions and caps on private sector participation, including those related to foreign ownership, as a way to spur innovation and competitiveness and meet the upcoming challenges for the electricity sector, such as the planned electrification of transport, a central pillar of Costa Rica's decarbonisation plan.

Boosting competition in the banking sector also remains an important challenge. The banking sector remains highly concentrated, with three public banks controlling around 60% of total assets, and the rest controlled by nine foreign private banks and two domestic private banks. A number of distortions and regulatory asymmetries fragment the market and hamper competition. Key asymmetries are the legal obligation for non-bank public institutions to deposit their cash in public banks or the requirement for public banks to pay contributions to a number of state funds. Phasing out those asymmetric regulations would boost competition and have an economy-wide positive impact by facilitating access by firms and households to financial services at lower cost. In line with OECD recommendations, the law to establish a deposit insurance scheme, covering both private and public banks, was approved in February 2020. Public banks still enjoy a full blanket State guarantee, covering all financial instruments, with the exception of subordinated debt. As state banks have large exposures to the sovereign debt market, systemic risk of doom loops remains high. Phasing out the blanket guarantee is a long-standing recommendation in OECD Economic Surveys.

Reducing informality: a win-win for productivity and inclusiveness

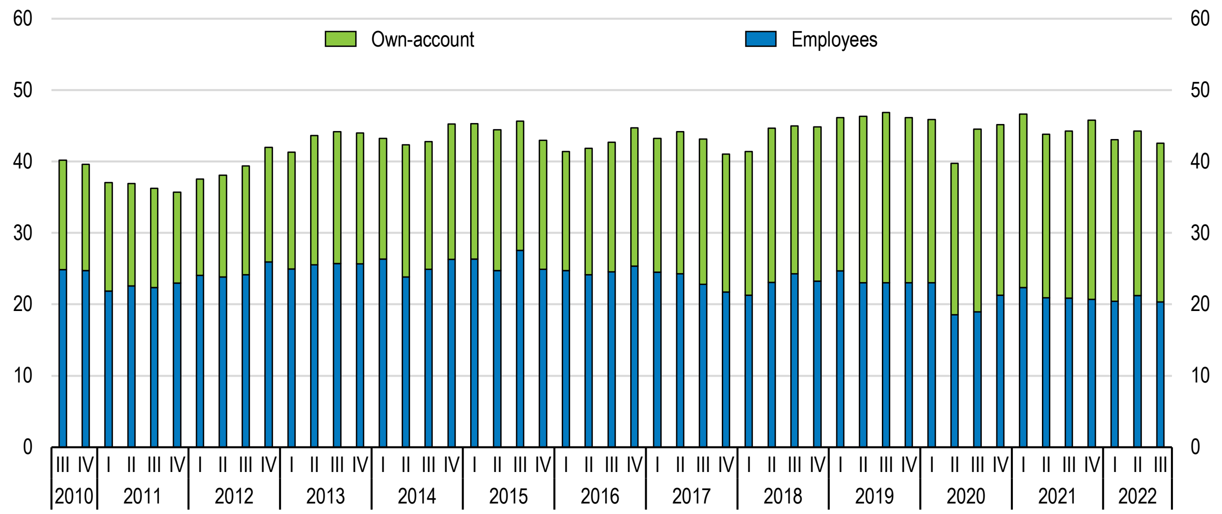
Informality, at around 45% of total employment, remains high (Figure 1.28) and is both a cause and a consequence of low productivity. A comprehensive strategy is required, with actions needed in several policy areas, such as reducing non-wage labour costs, facilitating the creation of formal firms, including by reducing the bureaucratic and economic cost of establishing a formal firm (as discussed above), helping that more Costa Rican acquire the skills needed to access formal jobs (as discussed in chapter 2), simplifying taxes and enhancing enforcement mechanisms.

Employer payroll charges are high in comparison with the OECD average (Figure 1.29), which hampers formalisation. Experience in some OECD countries, such as Colombia, indicates that reducing non-wage costs, by cutting employers payroll charges, can help to reduce informality. Available impact evaluations suggest that the reform led to a 2 to 4 percentage-point reduction in the informality rate in Colombia (OECD, 2022[20]). Costa Rica's relatively high pay-roll contributions indicates that there is ample room to move in this direction. At the end of 2019, authorities introduced lower employer and employee payroll charges for informal companies that become formal. The reduction was temporary (four years) and targeted at small firms (one to five workers). However, the scheme had little impact and it was taken-up by very few firms. A number of roundtables with the social partners have been held to discuss how to boost formalisation but such efforts have not translated into any significant policy initiative.

Payroll charges account for 37% of the wage bill with employers paying 72% of them. However, not all the payroll charges are allocated to finance the social security system (i.e. health and contributory pensions). Around 35% of the payroll charges go to finance other institutions, more notably the fund in charge of social protection programs (FODESAF), the vocational training unit (INA) or a stated-owned bank. This is a very regressive and inefficient way to finance these institutions, as it hampers the creation of formal jobs, eroding tax bases. Instead, those institutions could be financed in the medium-term fully through the general budget. This would facilitate formalisation without compromising the financing of the social security system. This change would even be positive for the social security system, as more workers would become formal workers and contributors. The institutions currently financed via the payroll charges are already receiving part of their financing from the general budget, which suggests that all institutional arrangements to facilitate the change are in place.

Figure 1.28. Informality is high

% of total employed population



Note: Informality is defined as the percentage of workers in employment meeting one of these conditions 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 Contiínua de Empleo.

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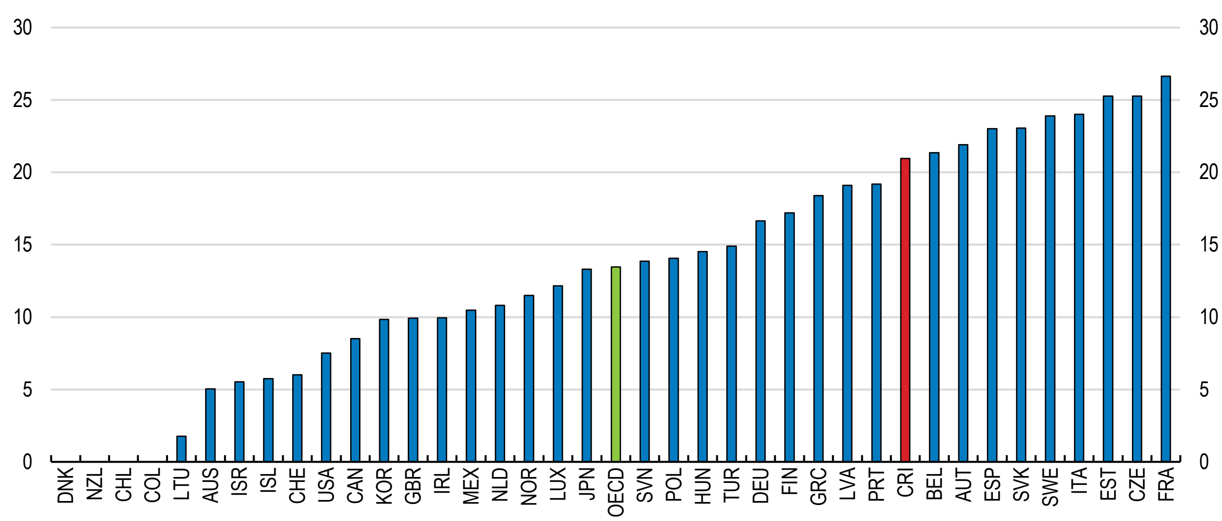
Figure 1.29. Employer payroll charges are high in international comparison

Employer contributions, % of labour costs, 2021



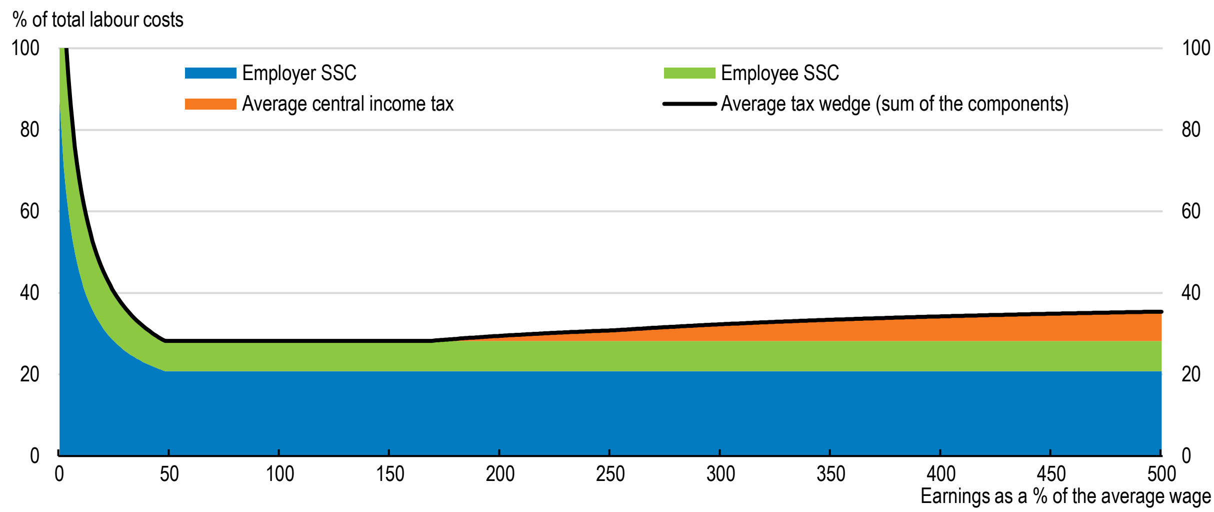
Source: OECD Taxing wages database.

StatLink https://stat.link/wealyv

A high tax wedge can help to explain the incidence of informality. In Costa Rica the tax wedge is highly regressive at the bottom of the income distribution (Figure 1.30) This results from social security contributions that are levied at flat rates but with a minimum base contribution. Removing the minimum base, so that both workers and employers would contribute according to their reported earnings, would reduce non-wage costs particularly for low-income workers. The Costa Rican Social Security Fund (CCSS) is planning to gradually introduce a lower minimum base contribution for low-wage and temporary workers, to facilitate their formalisation. This will apply to workers under 35 years old as of 2023, workers between 35 and 50 years as of 2024, and to all ages as of 2025. Another alternative to make social security contributions more progressive is to reduce or eliminate them for low-income workers. The associated loss of revenue could be compensated by other measures to increase revenues, as detailed in Table 1.7. Better enforcement should also be part of the formalisation strategy, and the reductions in employers' payroll charges could be implemented hand in hand with reinforced auditing, to strengthen the enforcement of labour regulations.

Figure 1.30. Low-income workers face a large tax wedge

Average tax wedge across earnings levels, % of total labour costs



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

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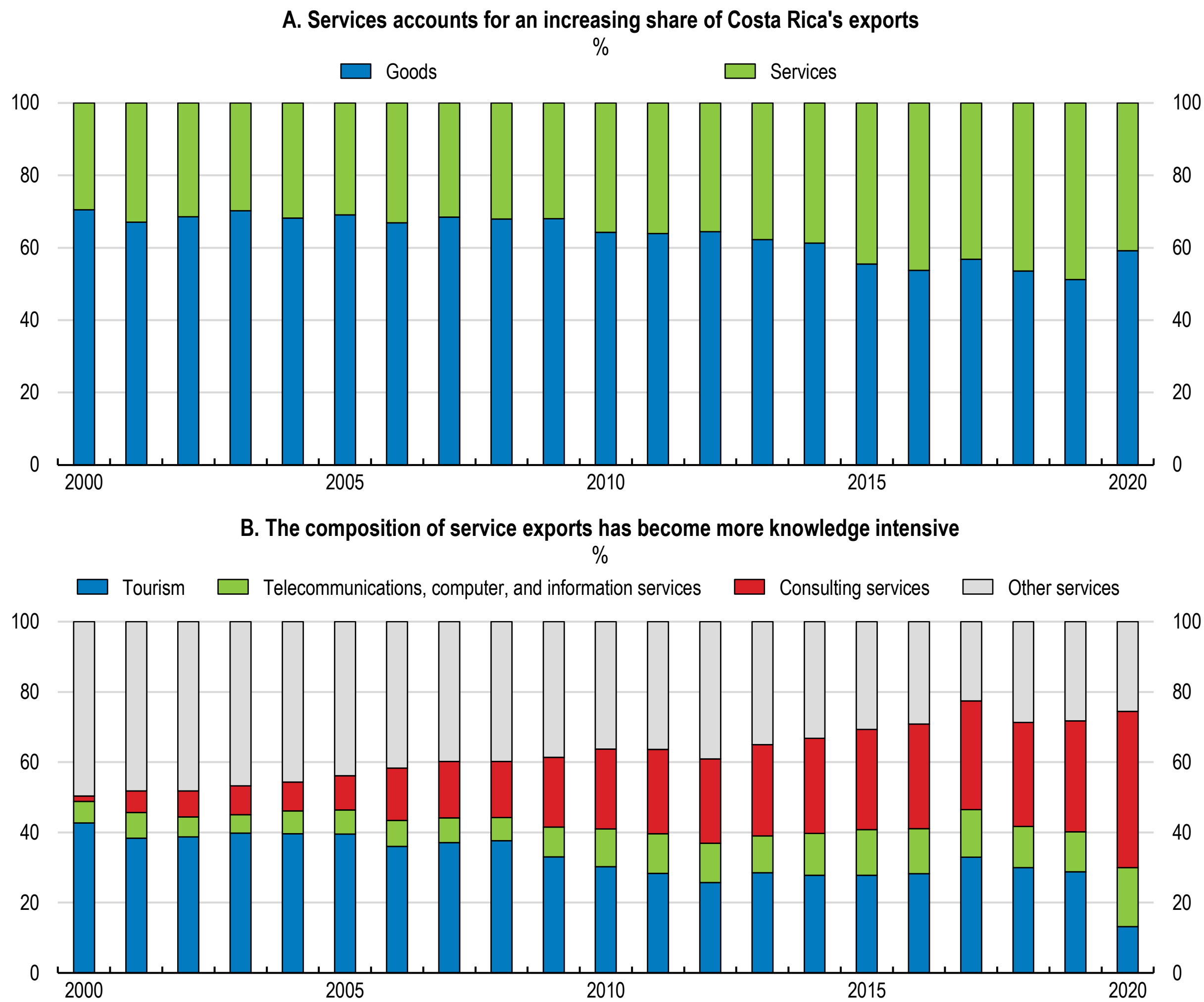
Table 1.5. Past OECD recommendations to boost productivity

Past OECD recommendations	Actions taken since the 2020 survey
Finance public research based on competitive and performance-based criteria and establish independent evaluation mechanisms.	No actions taken.
Enact a law or legal provision related specifically to protect reporting or prevent retaliation against whistle-blowers in the public sector.	No actions taken.
Introduce online one-stop mechanisms and ensure physical ones cover all licenses and permits and are present in all major cities. Eliminate the requirement for using a notary to register a company.	One-stop shops are being gradually rolled out, but they do not cover all permits. No actions taken.
Make the electronic signature mechanism more user-friendly.	The Central Bank is in the process of improving the digital signature mechanism.
Widen the scope of silent is consent rules and remove the need to require administratively their application.	The application of silent is consent rules has been simplified by means of sworn declarations.

Further spreading the benefits of trade integration

Costa Rica has greatly benefited from its open trade and foreign investment policies. The United States and the European Union are the main trading partners. As exemplified during the pandemic recession, Costa Rica's well diversified export basket, with an increasing share of high value-added goods, such as medical equipment (Figure 1.4, above), and services, such as business services (Figure 1.31), is a source of resilience during negative economic shocks. Exports of optical, surgical and medical equipment to the European Union have recently surpassed the exports of fruits. A stable pipeline of foreign direct investment flows, particularly in the manufacturing sector and from the United States (Figure 1.32), has underpinned this shift towards higher value-added exports.

Figure 1.31. High value-added services account for an increasing share of the exports basket



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

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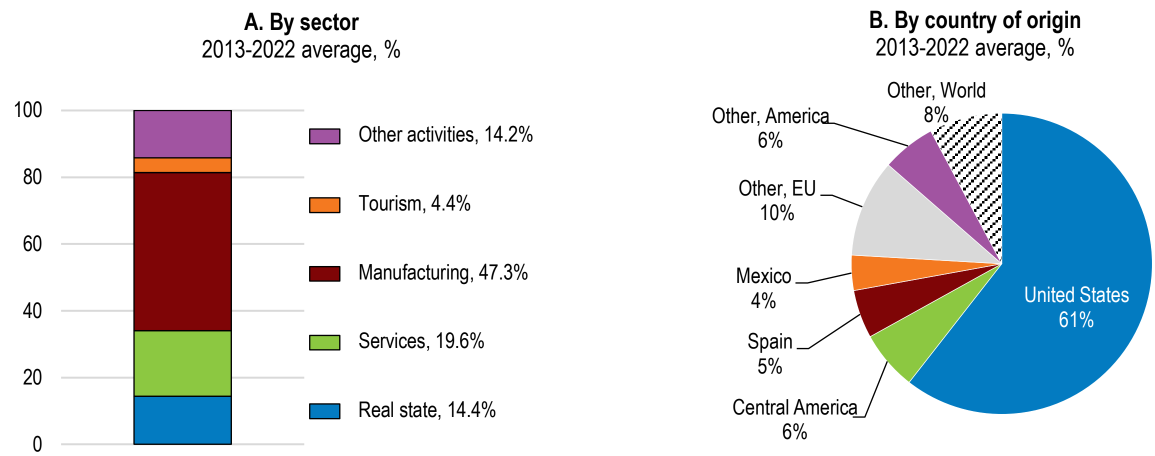
Figure 1.32. FDI inflows are larger in manufacturing and services



Note: Data for 2022 are estimates.
Source: Inter-institutional Foreign Direct Investment Group (Central Bank of Costa Rica, Costa Rican Investment Promotion Agency, Foreign Trade Promotion Enterprise, Ministry of Foreign Trade & Costa Rica Tourism Board).

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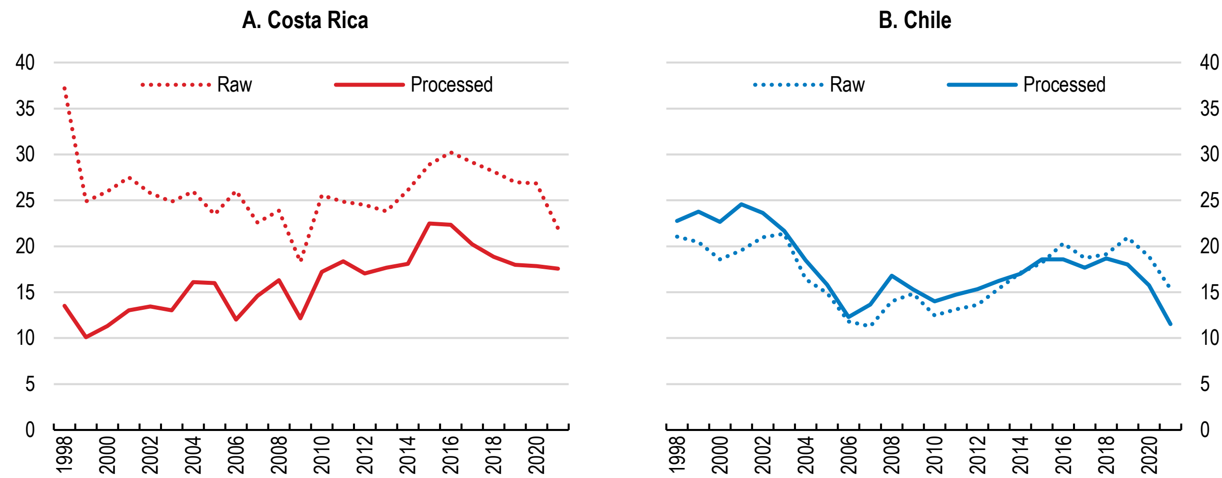
Nearshoring trends provide additional opportunities and efforts to increase trade integration have recently regained considerable impetus. Costa Rica's clean electricity matrix and its ambitious decarbonisation plan also provide the opportunity to become a global leader in carbon-free or low-carbon exports. The United States are Costa Rica's main exports destination, accounting for around 45% of total exports. There is room to further diversify export destinations and to boost trade relationships with other countries. To that end, the authorities have initiated negotiations to become a member of the Pacific Alliance, a trade bloc comprising Chile, Colombia, Mexico and Peru, where so far Costa Rica only has a status of candidate/observer. The Alliance accounts for 60% of Latin America's imports. If Costa Rica became a member, it would benefit from its geographical location in between the Pacific Alliance members, enhancing access to a large market and improving its prospects to attract further direct investment. It would also strengthen value chains in the region and offer a valuable platform to increase trade integration with Asia, given Costa Rica's bilateral free-trade agreements (FTAs) with China, Singapore and South Korea. SMEs could greatly benefit, using Latin American markets as a first step and trial ground before accessing more complex markets, such as the United States. Further integration in the Pacific Alliance would imply lowering tariffs in the agriculture sector, where tariffs are still higher in Costa Rica than on average in the OECD, particularly in sectors such as sugar. Model-based simulations about the impact of the tariff reductions associated with an integration in the Pacific Alliance suggest that further integration in the Pacific Alliance would have a direct positive impact on Costa Rican growth of 0.3% (CEPAL, 2021). Employment would increase in 15 out of 20 sectors, with more positive effects in dairy, meat, and processed food. Even if reallocation effects seem small, some sectors, such as forestry and timber would nonetheless be negatively impacted, and would need targeted retraining programmes to provide workers with new skills to move to new jobs. Costa Rica has also started negotiations with Ecuador to establish a free trade agreement and a roadmap to join the Comprehensive and Progressive Agreement for Trans-Pacific Partnership.

Both manufacturing and services have greatly benefited from trade openness. The agriculture sector also contributed to good export performance. However, there is significant untapped potential in the agriculture sector. Costa Rica is one of the world's largest exporters of pineapples and an important supplier of banana and coffee. Even so, progress to move up in the value chain in other sectors, such as processed food products, has been uneven. The share of processed agriculture products in global trade has been increasing, which offers additional opportunities. So far, the share of processed agriculture exports in Costa

Rica remains lower than that of raw products (Figure 1.33). Organic production is another market segment where Costa Rica could capitalise on its strong reputation for both quality and sustainability. However, Costa Rica's share of organic production is below the world average, and lower than in many other countries in the region, despite its good export potential (OECD, 2017[21]).

Figure 1.33. Processed agriculture exports have not picked up

Share of raw and processed agriculture and food exports over total exports, %



Source: OECD calculations based on UN Comtrade database.

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Taking advantage of these opportunities will require boosting productivity in the agriculture sector, which would be facilitated by a better delivery of public policies in this area. This could be achieved by streamlining the complex institutional structure governing the sector, consisting of eleven institutions under the Ministry of Agriculture and Livestock. These institutions enjoy varying degrees of autonomy, and some have mandates that are established by legislation, posing challenges for the Ministry to achieve an effective coordination and risks of fragmenting responsibility, slowing decisions and duplicating functions. Effective governance is also impeded by the fact that the agricultural sector and its institutional structure are regulated by several hundred laws and ministerial decrees (OECD, 2017[21]).

Experience in OECD countries also suggests that non-distorting support provided either directly to producers or to the sector as a whole has a more positive influence on both GVC participation and domestic value added than market intervention mechanisms, such as minimum prices (OECD, 2022[22]). In this vein, phasing out minimum prices in the rice sector, as recommended in previous OECD Economic Surveys, is a very positive step, which would also facilitate access to basic goods at lower prices, benefiting low-income households in particular. Recent changes to facilitate more foreign direct investment in rural areas, such as strengthening the investment single window in municipalities, fostering vocational training and new regulations to prioritise access to digital services outside the San Jose Metropolitan Area, can be a more effective way to support productivity and job creation in rural areas.

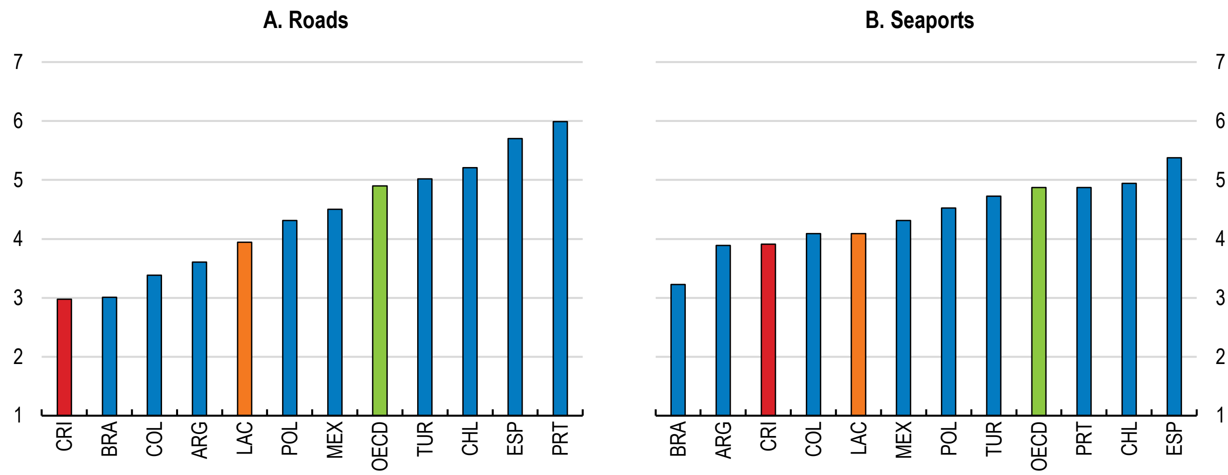
Closing infrastructure gaps

Infrastructure bottlenecks are large, particularly in road transportation (Figure 1.34). This not only hinders regional development but also has a detrimental impact on competitiveness, productivity and the environment. The road network is extensive, but the quality is poor, suffering from years of underspending due to weak governance, planning and execution. Reducing these infrastructure gaps would particularly help the agriculture sector, whose productivity has been constrained by the poor quality of rural roads.

Poor quality increases transport costs and production losses and limits the competitiveness of both large and small-scale producers, preventing them from accessing wider markets. Reducing these infrastructures gaps, would also help to spread the benefits of trade integration and foreign direct investment throughout Costa Rica. So far, San Jose Metropolitan Area has concentrated most of the benefits of the successful strategy to attract and retain foreign direct investment.

Figure 1.34. Costa Rica's infrastructure lags behind

Indices of the quality of roads and of the efficiency of seaport services, 1 to 7 (best), 2019



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

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Previous OECD Economic Surveys recommended institutional reforms to favour sounder planning and clearer accountability. The public works sector has a complex institutional structure. Beyond the Ministry of Public Works, there are eight independent agencies with specific responsibilities. This structure contributes to duplications, excessive policy fragmentation, lengthy project preparation and delays in project execution. Recently announced plans to simplify the institutional framework of the sector and eliminate some public agencies hold the promise of recovering the ministry's stewardship and facilitating better planning and management. Project preparation and selection could also improve with a more extensive use of careful cost-benefit analysis.

The fiscal situation will continue to limit public investment for some time and well-designed PPPs could help to reduce infrastructure gaps. Public spending on infrastructure, at 1% of GDP is far below the latest Ministry of Public Works' National Transport Plan, that calls for gradual increases in infrastructure spending, to 4% of GDP by 2035, with two-thirds financed by the private sector. The PPP framework has recently improved thanks to a stable PPP agency and an independent project development fund financed by the Inter-American Development Bank. However, further improvements are needed, including increasing transparency and accountability by publishing more project information and evaluations online, and improving the capacity of the PPP agency to conduct evaluations (EUI, 2019[23]). This should be complemented with proper fiscal accounting of PPPs, including recording them as contingent liabilities in the budget.

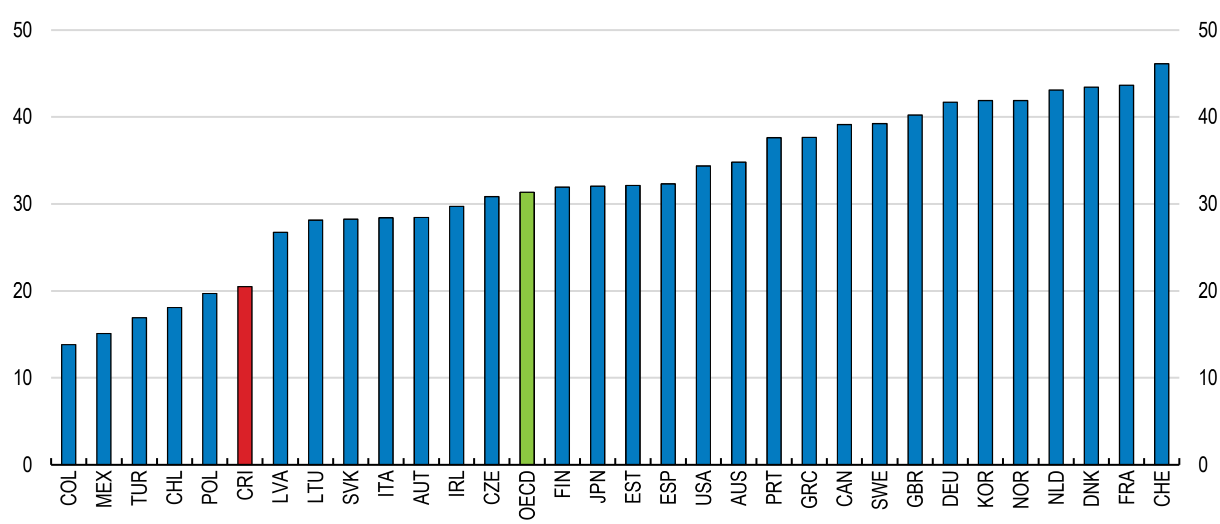
Making the most of digitalisation

Reliable and quality connectivity is essential to make the most of digital transformation. Costa Rica has greatly advanced in internet connectivity through mobile lines but lags in fixed broadband penetration (Figure 1.35). Around 34% of fixed broadband subscriptions allow for high-speed connections. Fostering competition, investment, and innovation in broadband development is therefore a fundamental priority. This will hinge on maintaining a regulatory framework that is flexible and facilitates the entry of new operators, contributing to further broadband deployment. According to the OECD Product Market Regulations index, regulatory barriers on e-communications are relatively high in Costa Rica (Figure 1.36). Excessive and sometimes inconsistent regulations across public institutions also hinders infrastructure deployment. Heterogeneous regulations at municipal level are a particular concern. Streamlining and harmonising regulations and setting common guidelines would facilitate infrastructure deployment and lower entry barriers for new operators. To advance in these objectives, the authorities have recently published a law to promote regulatory consistency throughout the country, to promote and facilitate the deployment of infrastructure. A law has also been approved to enable the use of public spaces to install telecommunications infrastructure and to ensure that all technical aspects for the development of telecommunication infrastructure are properly taken into account when designing and planning national roads.

Costa Rica's experience with the opening of the monopoly in mobile services in 2011 illustrates how competition can spur access and lower prices. Currently, Costa Rica displays prices of mobile services that are significantly lower than in regional peers and at par with the OECD average in terms of affordability (Figure 1.37, Panel B). Conversely, fixed broadband services prices remain significantly above those seen in OECD and regional peers (Figure 1.37, Panel A). At the same time, the fixed broadband market shows a high degree of concentration (Figure 1.37, Panel C). Opening to competition the fixed broadband market, by facilitating entry of new operators, can facilitate more affordable prices, which in turn will help to boost access and close divides.

Figure 1.35. Expanding access to fixed broadband is a challenge

Fixed broadband subscriptions per 100 inhabitants



Note: Data for Costa Rica refers to the year 2021.
Source: OECD Broadband Portal (database) ; SUTEL, Dirección General de Mercados.

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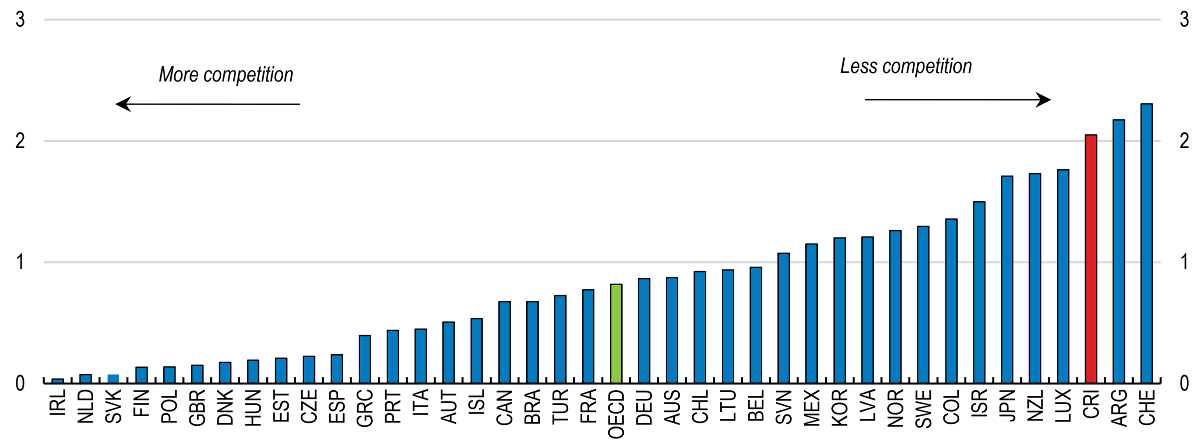
Figure 1.36. Regulatory barriers on e-communications are high

Product-market regulation index for e-communications



Note: E-communications include both voice services and data services.
Source: OECD, 2018 PMR database.

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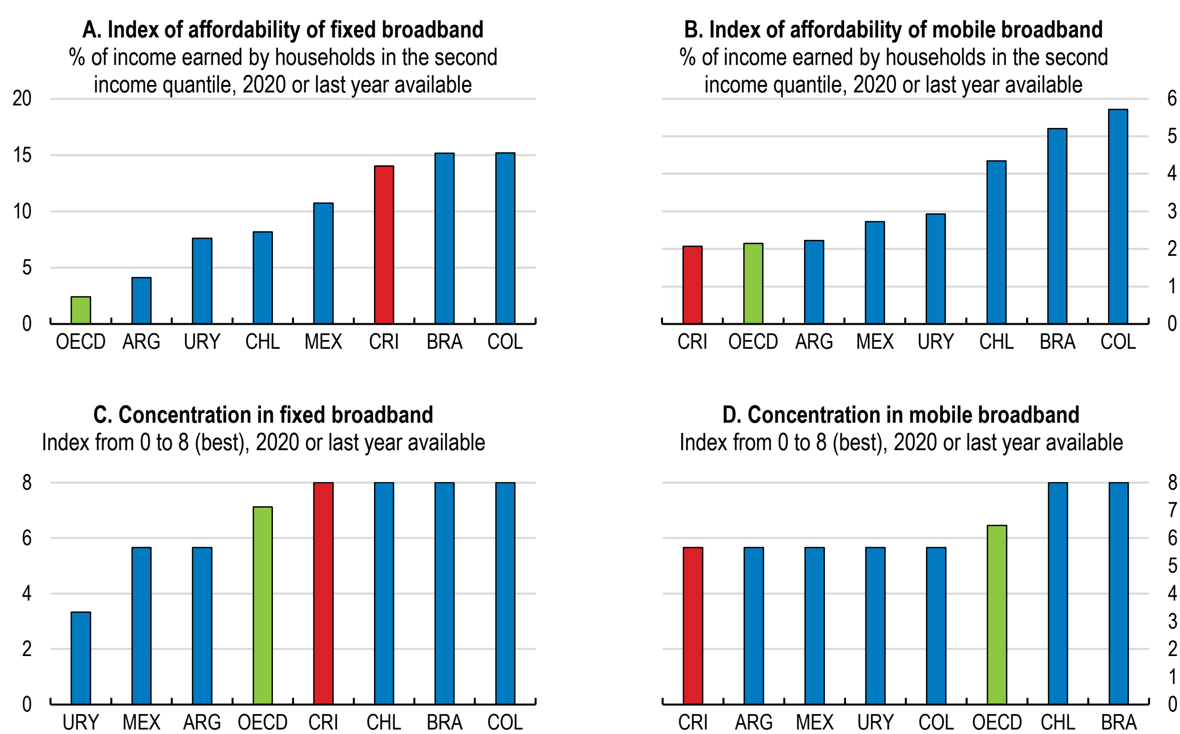
Figure 1.37. Fixed broadband subscriptions are expensive



Note: Panel A and B; The index of affordability of fixed broadband services is the monthly cost of a subscription to a fixed broadband service of 2 Mbps of speed as a share of the average income of a household in the second quantile of the income distribution. The index of affordability of mobile broadband services is the monthly cost of a subscription to a mobile broadband service of 1 GB of data as a share of the average income of a household in the second quantile of the income distribution.
Source: Interamerican Development Bank DigiLAC Indicators.

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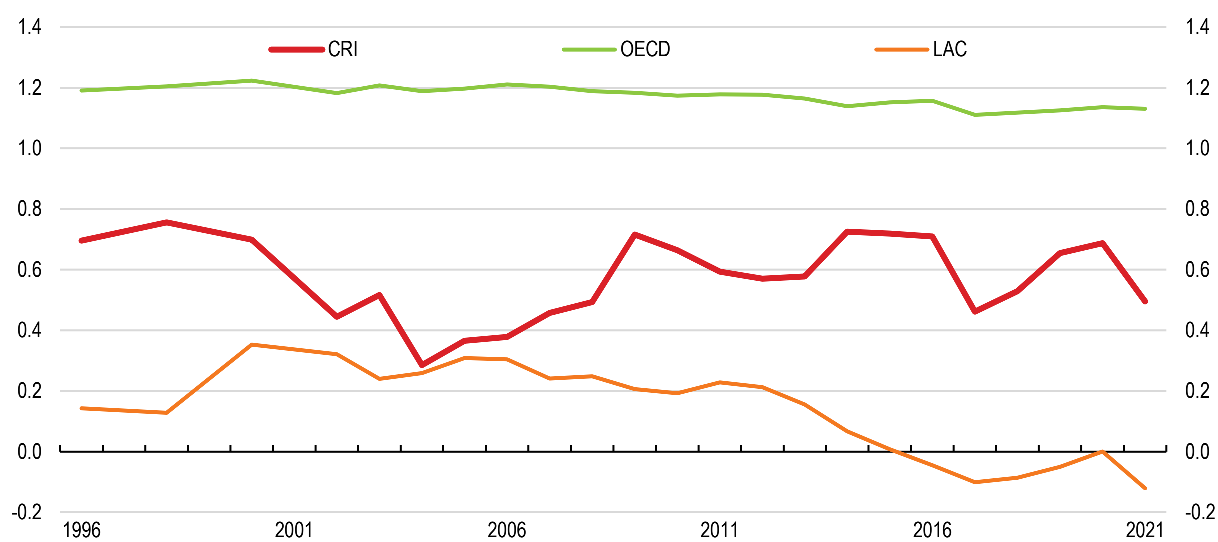
5G can act as a 'leapfrog' technology, allowing to fast-track digital development in rural areas. This would require more infrastructure and fibre deployment and new last mile connectivity solutions. Costa Rica lags behind other Latin American countries. There are already 22 5G networks deployed in Latin America, most notably in Brazil. Costa Rica should accelerate the release of the 5G spectrum. According to estimates by the regulator, the cost of delays in the release of the 5G spectrum would range between 8% and 12 % of GDP. The authorities have recently requested the release of 5G frequencies that the Institute of Electricity (ICE) has retained and remain unused. This would allow for licensing the spectrum, facilitating entry of providers. The deployment of 5G services would still take at least three years. Setting a transparent and robust concession process will be critical for an effective deployment and a competitive market.

Continuing to improve governance and reduce corruption

Corruption continues to be one of the top concerns for Costa Ricans. Costa Rica has made progress to foster integrity and combat corruption in the public sector. It ranks third in Latin America in terms of capacity to fight corruption, just behind Uruguay and Chile (AS/COA, 2021[24]). However, public perceptions about corruption remain higher than in OECD countries (Figure 1.38). The country has been regularly shaken by corruption scandals in recent decades. Policy efforts to reduce and prevent corruption are therefore warranted. The national strategy of integrity and prevention of corruption, presented in 2021, provides a useful framework for such efforts, as it defines priority areas for the next decade in matters of integrity, corruption, transparency, and probity.

Figure 1.38. Perceptions about corruption remain higher than in OECD countries

Evolution of "Control of Corruption", scale: -2.5 (higher corruption) to 2.5 (lower corruption)



Note: Control of Corruption captures perceptions of the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as "capture" of the state by elites and private interests. LAC is a simple average of Chile, Colombia, and Mexico.
Source: World Bank, Worldwide Governance Indicators.

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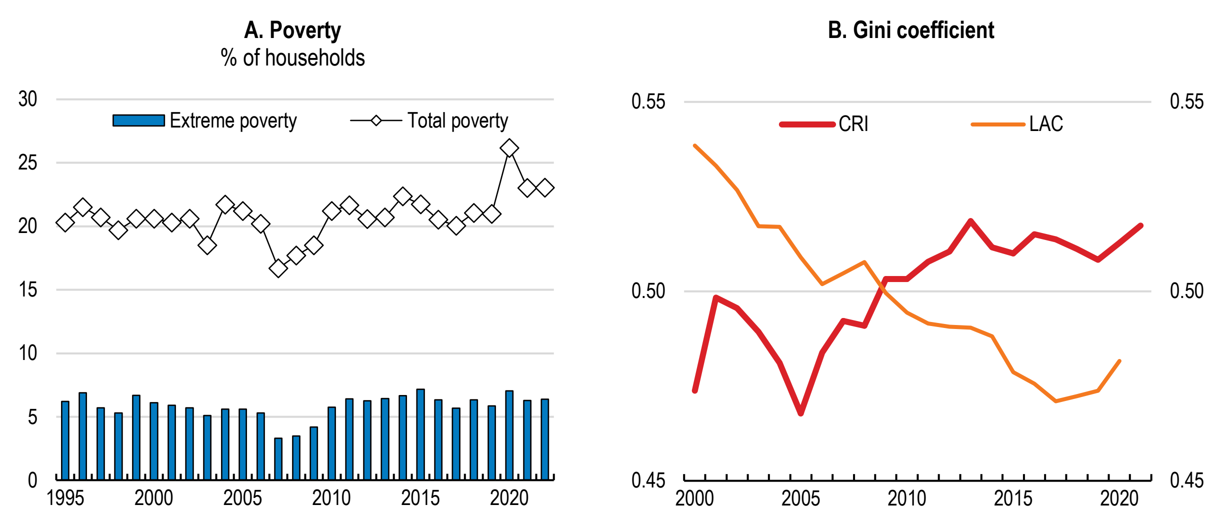
Whistle-blower protection is an important tool to promote accountability. Costa Rica has a number of protection mechanisms for whistle blowers, victims and witnesses of acts of corruption that apply at the criminal and administrative levels. However, there is currently no dedicated law that would provide protection of employees in the public or private sectors from discriminatory or disciplinary action once they have disclosed wrongdoing (OECD, 2017[25]) (OECD, 2020[26]). This discourages public servants from sharing valuable information about corruption cases with competent authorities. Costa Rica is currently working a bill to provide whistle-blowers with clear and comprehensive protection from retaliation, covering both the public and private sectors. Enacting a whistle-blower protection law or legal provision related specifically to protected reporting or prevention of retaliation against whistle-blowers, as recommended in the previous Economic Survey (OECD, 2020[3]), would be an effective step to boost corruption prevention.

The biggest corruption scandals have been linked to public procurement (UNCAC, 2021[27]). A significant part of procurement has been carried out through direct contracting, which is, according to the law, an extraordinary procedure that is faster and has fewer controls. The Integrated Public Procurement System (SICOP) brought together 20 virtual public procurement platforms and its use was made mandatory for the entire public administration in 2016. However, it has not yet been incorporated into all public entities. Until 2019, 30% of institutions were missing, and even those that have implemented SICOP do not use it for all stages of the contracting procedure, nor for all purchases. A recently adopted law intends to prevent the coexistence of multiple procurement regimes, to reduce the cases of exceptions to circumvent ordinary procedures and to introduce requirements for the application of direct contracting. Full implementation of the law would reduce the scope for corruption and at the same time boost public sector efficiency.

Redoubling efforts to improve equality of opportunities

Virtually universal health care and primary education and one of the highest pension coverage in the region have led to remarkable social outcomes, such as relatively long-life expectancy (above 80 years) and low infant mortality. However, Costa Rica faces substantial social challenges. Poverty, measured as reference to a poverty line, has remained largely unchanged at around 20% over the last 25 years and inequality has trended up (Figure 1.39). With unemployment at two-digit rates, informality affecting nearly half of the labour force and significant demographic changes ahead, efforts across different policy areas are needed to improve equality of opportunities. Improving education and training policies is a critical challenge (see Chapter 2) but there is also urgent need to upgrade social protection programmes, reduce gender inequalities and buttress the pension system.

Figure 1.39. Poverty has remained unchanged and inequality has trended up



Note: Panel A: Poverty measures are based on poverty lines. Panel B: The Gini coefficient is based on disposable households income. The indicator for Costa Rica was rescaled back before 2010. LAC is a simple average of Chile, Colombia, and Mexico.
Source : INEC Encuesta Nacional de Hogares (ENAHO) and Encuesta de Hogares de Propósitos Múltiples (EHPM); World Bank Poverty and Equity database.

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Upgrading social protection

Social policies are in the process of being enhanced, thanks to SINIRUBE, a common database putting together all registries from social programmes. It helps to eliminate overlaps and increase coverage by enabling identification of potential eligible beneficiaries not yet covered by the programmes. The tool has been used to assess the targeting of some social programmes (such as scholarships and non-contributory pensions). The authorities are planning to further increase the coverage of SINIRUBE and to incorporate into the database those individuals in remote locations or without access who are not yet included. SINIRUBE should become the building block of social policies and be the central tool to select beneficiaries for all social programmes. This would help to improve the targeting and evaluation of social policies. In some social programmes, more than 40% of beneficiaries are middle and high-income households (Table 1.6), while according to the law the programmes are targeted to those in poverty.

Table 1.6. There is room to improve the targeting of social protection programmes

Percentage of beneficiaries in each income quintile (2021)

Programme	Income quintiles					
	I	II	III	IV	V	
Scholarships for secondary education (*Avancemos*)	49	33	15	3	0	100
Scholarships for primary education (*Avancemos*)	53	32	13	2	0	100
Non-contributory pensions (*RNC*)	46	30	16	7	2	100
Insured on the account of the state (*Asegurados por cuenta del estado*)	55	25	14	5	1	100
Housing subsidy (*Bono familiar vivienda*)	31	26	23	16	5	100
Childcare services (*Red de cuido*)	56	25	17	3	0	100
School meals	39	29	20	9	4	100

Source: OECD calculations based on ENAHO.

There also remains room to reduce fragmentation in the social protection sector, which would help to increase coverage. Social protection is financed through a fund (FODESAF) that allocates resources to 21 institutions that are in charge of delivering more than 35 schemes. Better targeting and reducing fragmentation would facilitate reinforcing social protection in key areas, which would reduce inequality. The authorities are planning to move in this direction and aim at reducing the number of social programmes to 25. Reinforcing the social protection of children is a key priority, as poverty affects 40% of children and only 30% of poor children between 0 and 17 years old are in families receiving monetary benefits (Pacheco et al., forthcoming[28]). Experience in other OECD countries, such as Austria, Sweden, or Finland, show that targeted unconditional cash transfers can reduce children poverty significantly (Förster and Verbist, 2012[29]). Setting a universal cash transfer for poor children in Costa Rica would cost 0.21% of annual GDP (Table 1.7), and could be partly financed by improving the targeting of existing programmes. This in particular concerns the housing subsidy (*Bono familiar vivienda*), as 45% of its beneficiaries are middle or high-income households.

Table 1.7. Illustrative fiscal impact of some OECD recommendations

Measure	Change in annual fiscal balance (percentage points of GDP)
Spending side	
Universal pension for poor seniors	- 0.1
Universal cash transfer for poor children	- 0.2
Improved e-procurement and centralized purchasing	1.5
Total spending side	*1.2*
Revenue side	
Making social security contributions more progressive	- 0.6
Remove tax exemptions on additional salary for most public employees	0.3
Remove cooperatives tax exemption	0.1
Improving property tax collection	1
More centralised and less fragmented tax collection	1
Implementation of public employment bill	0.8
Total revenue side	*2.7*

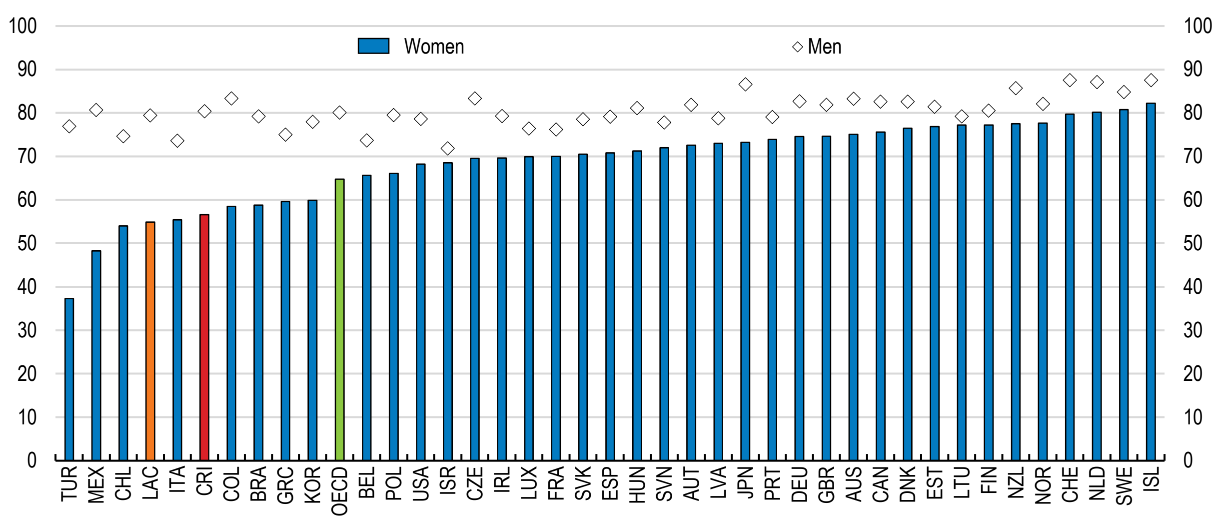
Note: The fiscal impact of introducing universal pensions and cash transfers for poor children, and of making social contributions more progressive are based on (Pacheco et al., forthcoming[28]). Savings from centralizing procurement and tax collections are based on General Comptroller reports (CGR, 2019[30]), (CGR, 2021[9]). The impact of the public employment bill is based on Inter American Development Bank estimates. It is assumed that Costa Rica gets to collect via the property tax as the average Latin American peers (Chile, Colombia, Mexico, Argentina and Brazil). The impact of removing tax exemptions is based on World Bank public finance review ((World Bank, 2019[7]).
Source: OECD calculations based on (World Bank, 2019[7]), (CGR, 2019[30]), (CGR, 2021[9]) and (Pacheco et al., forthcoming[28]).

Reducing gender inequalities

Female labour force participation continues to lag the OECD average (Figure 1.40). Participation is particularly low in low-income households, with more than 90% of women in poor households out of the labour force. In particular, women taking on family care responsibilities face difficulties to complete education or continue to be in the labour force. This affects women at all income levels but particularly those in low-income households (Figure 1.41).

Figure 1.40. Female labour market participation is low

Working-age (15-64) labour force participation rate, %, 2021



Note: LAC is a simple average of Brazil, Chile, Colombia and Mexico.
Source: OECD Labour Force statistics.

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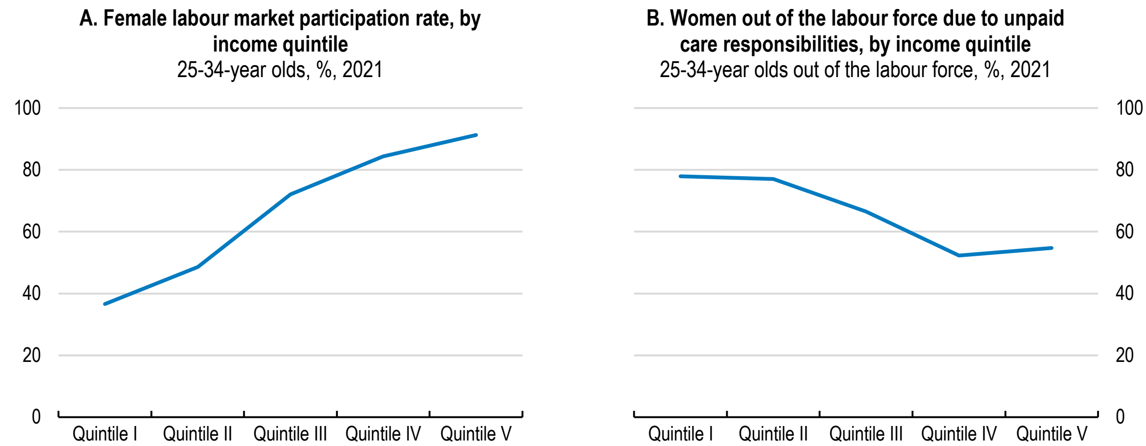
Figure 1.41. Care responsibilities hinder women's labour market participation



Source: INEC Encuesta Nacional de Hogares 2021.

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Expanding access to good quality affordable early childhood education and care should be a priority as both facilitates women's participation in the labour market and raises outcomes and equity in education (see also Chapter 2). The coverage of early childhood education and care for five-year-old children has recently increased but access to early childhood education should also be expanded for children under the age of four. Recent efforts to foster early childhood education include the elaboration of quality standards and preparations for the launch of a means-tested co-payment mechanism (Table 1.8). Prioritising access to early education by low-income workers and establishing co-payment mechanisms for higher-income households are an effective way to expand coverage in a difficult fiscal environment. Gradually expanding elderly care services, including both home-based and community-based care, would also contribute to higher female labour market participation among low-income households.

Table 1.8. Past OECD recommendations on social policies

Past OECD recommendations	Actions taken since the 2020 survey
Improve targeting and focus social spending program on low-income individuals.	Bono Proteger mitigated the impact of the pandemic on low-income workers. SINIRUBE, the registry of beneficiaries of social programmes, is being further enhanced.
Continue to increase the supply of affordable childcare. Introduce a paid leave entitlement reserved to fathers.	A co-payment mechanism to improve access and supply of childcare is in preparation. Starting 3 June 2022, all workers in the private sector can benefit from a special permit allowing two days off from work per week, during the first month after birth. During these days, workers shall receive their full salary, which is financed in equal parts by the employer and by the CCSS, the social security provider of the country. Public sector workers have also become entitled to a month of paid paternity leave.
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.	No actions taken.
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.	No actions taken. There are plans to run teacher evaluations but there has not been progress in improving training nor recruitment.
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.	No actions taken. A reform to the pension system was approved in 2021. Benefits are now computed using the highest 300 monthly contributions. Early retirement is no longer allowed for men while women can retire early at 63 instead of 60. No actions taken.

Costa Rica has recently introduced paid leave entitlements reserved to fathers. In the private sector workers have become entitled to two days of leave per week, during the first month after birth. During those days, workers would receive their full salary, which is financed in equal parts by the employer and by the social security system. For public employees, the Public Employment Bill that enters into force in March 2023 grants workers a month of paid paternity leave. These are positive initial steps to promote a better sharing of paid and unpaid work between men and women. Promoting the take-up of these new paternity leave entitlements and gradually lengthening them, following the recent trend of many OECD countries, including France and Spain, can be additional steps to facilitate a higher female labour market participation.

Adapting the pension system to ageing

Costa Rica has been reaping the benefits of a significant demographic dividend, but trends are shifting. 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. This demographic transition challenges the sustainability of the contributory pillar of the pension system, whose financing is heavily dependent on employment-linked contributions and is also hampered by informality. The statutory retirement age is 65, but women can opt for early retirement at the age of 60 if they have contributed for at least 37.5 years and men at the age 62 if they have contributed for at least 38.5 years. Individuals who have had volatile careers and long periods in informality usually do not qualify for a contributory pension and can get a minimum pension through the non-contributory regime, which is financed from the government budget. The total contribution period required for full pension entitlement is 25 years and 300 monthly contributions. Authorities have recently approved a package of changes to the contributory pillar, including using the highest 300 salary payments to compute the pension benefit, instead of the average salary of the last 12 years. Men will be excluded from the possibility of early retirement, while women could still retire at the age of 63 if they have contributed for 33.75 years. These changes will become effective in January 2024 and are expected to keep the financing of pensions sustainable until 2050. Policies aimed at promoting formal labour and female labour force participation would also help to finance pensions. Looking forward, linking the statutory retirement age to increases in life expectancy, as done in some OECD countries, would strengthen the link between contributions and pensions and improve the sustainability of the system. Automatic adjustment mechanisms, in which pension parameters are automatically adjusted to changes in indicators such as life expectancy, have become part of a standard toolset in pension policies among OECD countries (OECD, 2021[31]). Improving lifelong learning opportunities would also support longer career opportunities. Targeted career advice and guidance, together with efforts to align the training offer with the needs of the labour market (see Chapter 2), can facilitate participation of adults in training activities. More flexible approaches to learning, such as modular or online training, can facilitate combining work schedules with training participation.

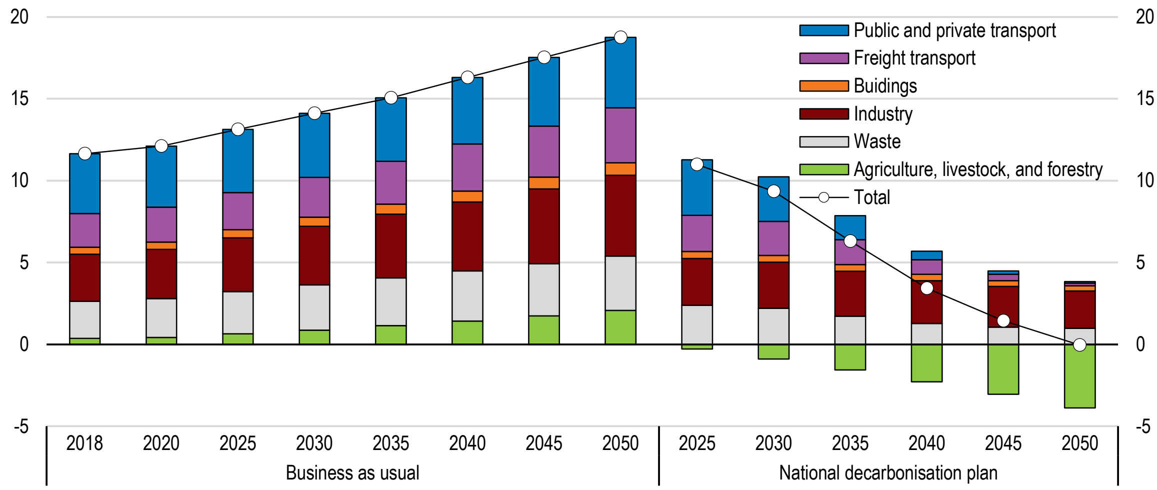
Beyond continuing to improve pension sustainability, increasing pension coverage is another fundamental challenge. Pension coverage is higher than in most countries in the region, but still around 30% of individuals older than 65 have no pension. Introducing a universal pension covering all poor individuals currently without income protection, and with the poverty line as defined benefit, would cost 0.13% of GDP (Pacheco et al., forthcoming[28]). A universal pension benefit, covering all individuals currently not receiving pensions, would cost 1% of GDP.

Transitioning towards net carbon neutrality

Costa Rica is a forerunner in efforts to reduce greenhouse gas emissions, a pioneer in the sustainable tourism sector, with 60% of its territory covered by forest, and it is the first tropical country to have reversed deforestation (Box 1.4). Almost 100% of the country's electricity stems from renewable sources (mainly hydropower). Its level of emissions is low by international standards, but emissions are increasing. Costa Rica aims at achieving the goal of net-zero emissions by 2050, which would require reducing emissions, particularly in the transport sector, and increasing emission sinks (Figure 1.42).

Figure 1.42. Costa Rica aims at being carbon neutral by 2050

Emissions, Mt CO_2e



Source: Ministerio de Ambiente y Energía.

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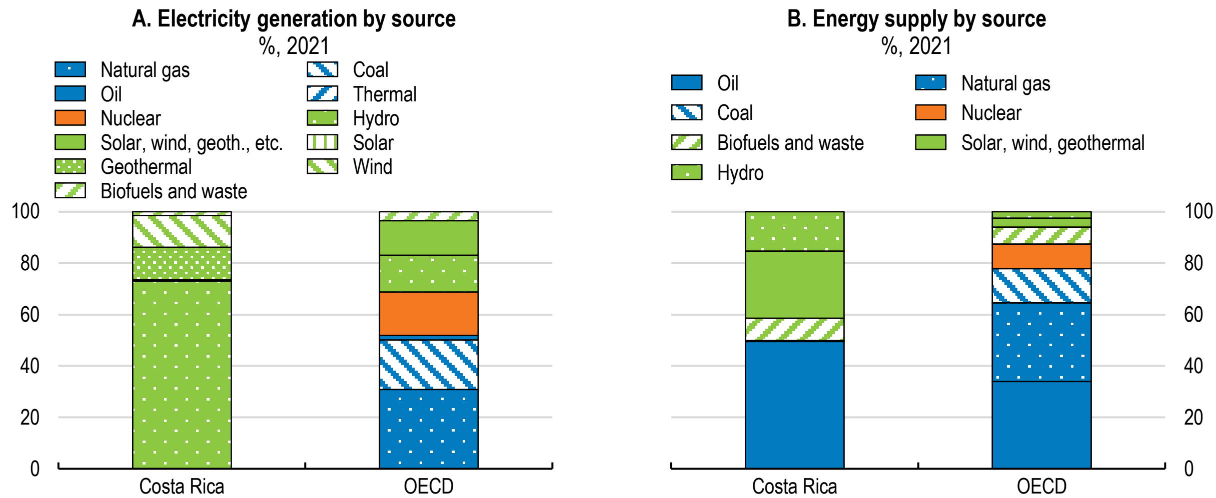
Reducing emissions in the transport sector is a key element of the government's strategy to transition towards net zero. In 2021, the sector accounted for 42% of carbon emissions and 79% of hydrocarbon consumption, largely explaining why oil remains a significant source of energy supply in Costa Rica while having an almost fully renewables-based electricity matrix (Figure 1.43). Emissions by the transport sector are increasing and driving up the total level of emissions in the country. The large increase in the vehicle fleet, especially private vehicles, is largely responsible for these increases. The lack of an efficient public transport network has encouraged widespread and increasing use of private transport to meet mobility needs, which has led to congestion, whose costs in the greater metropolitan area are estimated at 3.8% of GDP. About half the monitoring stations in key urban areas showed nitrogen oxide concentrations exceeding World Health Organization limits in 2019.

Transitioning towards clean massive urban and interurban transport will be critical to reduce emissions by the transport sector. This has been reflected in the national decarbonisation plan, where putting in place reliable, efficient and green public transportation is a key pillar. Some progress has been achieved in this area, such as starting some pilot exercises with electric buses. Improving the public transportation network in the great metropolitan area of San Jose is a critical pending challenge. Authorities are currently undertaking feasibility studies for an electric train line (*Tren Rápido de Pasajeros*) joining San Jose and the eastern part of the great metropolitan area. Costa Rica aims at having 30% of the public transport fleet electric by 2035, with the goal of 85% electrification by 2050. Upgrading the electricity grid would be key to cope with the significant increase of electricity generation and distribution that this transition implies. Digitalising and fully automating the grid would increase efficiency, reliability and facilitate incorporating distributed energy resources and storage.

There is also room to enhance regulations and tax design to facilitate the planned move towards a less-carbon dependent economy. Costa Rica, one of the pioneers in establishing a carbon tax, has room to improve the design of the fuel tax. At the moment diesel is taxed at a rate that is 60% lower than gasoline, despite its higher polluting nature. The tax on bunker fuel is also 10% lower than on regular gasoline. Gradually aligning the rates on diesel and bunker fuel with the gasoline rate would be a first step to reduce emissions by the transport sector. Going further and increasing the overall carbon tax would induce further emission cuts. Increasing the carbon price implies significant political economy challenges, especially at the current moment when global energy prices are high. Phasing in the increase gradually, once energy prices decline, and using part of the additional revenues to offset the effects of higher energy prices on low-income households, could facilitate buy-in.

Figure 1.43. Electricity is fully renewables-based and oil remains significant in the energy supply



Note: The data for the OECD refer to the year 2020. Panel A: In Costa Rica, about 0.2% of electricity is generated from a thermal source.
Source: Secretaría de Planificación Subsector Energía in Costa Rica and IEA.

StatLink https://stat.link/fuzp0w

There is also room to better design the vehicle tax to take into account environmental performance and incentivise the use of more energy-efficient vehicles (Table 1.9). Currently the rate is the same for all vehicles, regardless of their fuel consumption capacity or emissions. Toll fees have been frozen since 2002. Updating them, so that they reflect the cost of road use, and introducing congestion charges can facilitate the move towards cleaner and massive transport means. Giving the current environment of high pressures on costs of living, preparatory work for these changes could start and implementation take place once inflationary pressures abate.

The transition towards more energy-efficient vehicles would also imply a gradual reduction in tax revenues, which have been partly used to finance the Payment for Environmental Services (PES) scheme, key to halt deforestation in Costa Rica (Box 1.6). Following the decrease in fuel consumption during the pandemic, the funding available for the programme has already decreased. Looking ahead, broadening the financing sources of the programme would help to preserve its role in protecting forest lands and maintaining and reinforcing forests' role as valuable emission sinks.

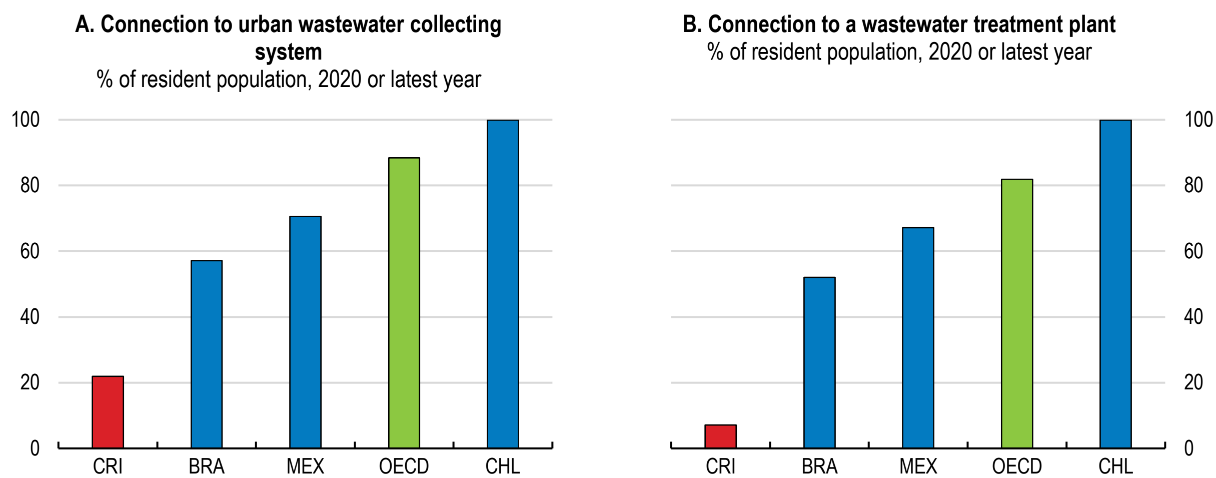
Box 1.6. Reversing deforestation in Costa Rica

The increase in forest-covered area seen in Costa Rica has been underpinned by the deployment of a Payment for Environmental Services (PES) scheme. The programme was launched in 1997 aiming at stopping the ongoing deforestation process. The programme offers compensation to landowners for providing particular eco-services. In the early stages, there were three contracts: forest conservation, which required owners to protect existing forest for 5 years; reforestation, where landowners had to plant trees in abandoned cleared lands and maintaining them for 15 years; and sustainable forest management, that required having low-intensive logging while maintaining ecosystem services for the logged forests (Robalino and Pfaff, 2013[32]). Since then, the programme has evolved to make it more effective in pursuing its objectives and to have a more inclusive participation. For example, in 2003 a new scale was created to include small-sized landowners, allowing them to combine agriculture activities and forest conservation (Sánchez and Navarrete, 2017[33]).

Table 1.9. Past OECD recommendations on green growth

Past OECD recommendations	Actions taken since the 2020 survey
Issue green bonds.	No action taken by the central government. New regulations have been put in place to foster issuance of green bonds by private companies and SOEs.
Modulate vehicle taxes according to pollution or emission performance. Introduce road use charges.	No actions taken.
Require separate waste collection by municipalities and improve wastewater treatment.	Most local governments now run selective collection but with few routes and only in main towns.

Figure 1.44. There is a need to improve wastewater collection and treatment



Note: OECD average excludes Colombia and Iceland (and the United Kingdom, Italy and New Zealand in Panel A).
Source: OECD Water Database.

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There is also a critical need to improve wastewater collection and treatment (Figure 1.44). Most residual waters from homes and industries flow into rivers without treatment. Sanitation coverage increased between 2011 and 2018 but progress has stalled since then. Septic tanks, which create seepage risks to subterranean water sources, are used by 77% of the population. Without any additional policy change, sewage will only cover 15% of the population, far from the 100% target by 2045 established in the national policy of wastewater treatment. If existing plans are executed coverage will go to 38% (Estado de la Nación, 2021[34]). Public-private partnerships can help fund the much needed additional investment to reach the 100% target.

Table 1.10. Policy recommendations from this chapter (Key recommendations in bold)

MAIN FINDINGS	CHAPTER 1 RECOMMENDATIONS
Further strengthening macroeconomic policies	
Households debt has increased significantly, including in foreign currency. The coverage of the credit registry is low.	Strengthen the credit registry office to include information for a larger share of the population and covering all entities with lending activities
Costa Rica is particularly vulnerable to climate-related risks, which could have a significant impact on the financial system.	Phase in gradually a mandatory disclosure of climate-related risks by large financial institutions.
Inflation and its expectations have picked up strongly. Inflationary pressures are broad-based.	**Maintain a restrictive monetary policy stance to ensure the return of inflation to the 3% target.**
Dollarization remains high, with both credit and deposits in dollars representing 40% of the total credit and deposits. Two thirds of dollarized private debt is unhedged. Private banks face difficulties to collect local currency deposits and are forced to lend and borrow in dollars.	Preserve exchange rate flexibility and limit interventions to those necessary to avoid abrupt changes in the exchange rate. Eliminate the requirement on public institutions to deposit in state banks.
A vacancy in the Central Bank board remains unfilled, which potentially enables the Minister of Finance to vote in the Central Bank board meetings.	Fill the current vacancy in the Central Bank board.
The fiscal situation improved in 2021, thanks to the 2018 fiscal reform, but remains challenging, requiring sustained efforts to contain spending and boost public sector efficiency. The implementation of the fiscal rule has met significant opposition from different segments of the public sector.	**Maintain a prudent fiscal policy stance, including by ensuring a full and timely implementation of the fiscal rule.** **In the medium-term undertake a review of the fiscal rule to ensure that it continues to secure a prudent fiscal stance and sustainable debt dynamics.**
Containing spending and improving its efficiency and quality to better support growth and equity remains a critical challenge. Capital spending has historically been largely neglected. Infrastructure gaps remain significant. Medium-term growth prospects are falling.	**Based on spending reviews and sound cost-benefit analysis, continue to undertake the necessary expenditures prioritisation and reallocation and create space for capital spending to strengthen.**
Compensation of government employees accounts for more than half of total revenues. The salary structure contributes to income inequality.	**Fully implement the public employment framework law across the public sector.**
Tax revenues, at 23% of GDP, are hampered by high tax evasion, narrow tax bases and a multiplicity of tax expenditures. The tax system hardly reduces income inequality.	**Broaden tax bases by phasing out regressive exemptions, such as the tax exemption on the 13th monthly salary and the one benefiting cooperatives.** Apply market-based property valuation across the country.
Numerous public agencies are involved in the collection of taxes, which increases the cost of paying taxes and contributes to tax evasion.	Integrate the tax and social security contribution administrations and move towards a less fragmented tax collection system in order to facilitate tax compliance.
The law to establish an independent fiscal council was approved and three members nominated but no further action has been taken to allow the council to operate in a meaningful way.	**Provide the fiscal council with independent technical support and define its role more explicitly.**
Boosting productivity and formal job creation	
The national competition authority remains severely under resourced. An adequately resourced and operative competition authority is critical to ensure that ongoing efforts to improve regulations and open up key markets translate into lower prices for households and lower costs for firms.	**Provide the national competition authority with the financing set in the law.**
The number of regulations is large. Same administrative requirements are replicated across different public agencies. Regulations do not take into account their impact on competition.	**Reduce the stock of regulations and conduct regulatory impact assessments.**
Establishing a company in Costa Rica is costly and burdensome. Existing one-stop shops do not cover all administrative requirements.	Introduce online one-stop mechanisms covering all licenses and permits.
Regulatory barriers on electricity remain high. The state company dominates the market and has low operating performance. Electricity prices have been higher than in regional peer countries. The planned electrification of the transport sector will increase electricity demand notably.	Introduce separation between generation, transmission and retail supply and relax restrictions and caps on private sector participation.
Regulatory asymmetries hamper the performance of both public and private banks, fragment the market and reduce competition.	Gradually reduce regulatory distortions affecting public and private banks, including the requirement for public banks to pay contributions to a number of state funds.
Informality, at around 45%, remains high. It is both a cause and a consequence of low productivity and widens inequalities.	**In the medium-term eliminate payroll charges not allocated to finance social security and finance social programmes and vocational training from the general budget.** **Reduce social security charges for low-income workers**.

There is room to deepen trade with Latin American countries and other regions, which would facilitate further integration in global and regional value chains.	**Pursue ongoing renewed efforts to increase trade integration further, including becoming a member of the Pacific Alliance.**
There is untapped potential in the agriculture sector. Boosting its productivity would help the sector to benefit more from trade integration.	Reduce red tape and the number of agencies in the agriculture public sector.
Infrastructure gaps are large, following years of underspending due to weak governance, planning and execution. The public transport infrastructure sector has a complex institutional structure that hampers planning and execution.	Streamline the institutional structure of the public works sector and eliminate ineffective agencies. Publish online project information and evaluations on large infrastructure projects and expand the use of evaluations and cost-benefit analysis.
Digital connectivity through mobile lines has improved but fixed broadband penetration lags. Costa Rica lags in the deployment of 5G services.	Facilitate entry and higher competition in the fixed broadband market. Streamline and harmonise e-communications regulations. License the 5G spectrum through a transparent concession process.
Public perceptions about corruption have worsened and the country has been regularly shaken by corruption scandals. The biggest corruption scandals have been linked to public procurement.	Maintain policy efforts to strengthen anti-corruption mechanisms. Enact a whistle-blower protection law or legal provision to protect reporting and prevent retaliation against whistle-blowers. Ensure a comprehensive use of the integrated public procurement system across the public sector.
Improving equality of opportunities	
Only 30% of poor children receive a cash transfer. In some social programmes more than 40% of beneficiaries are middle or high-income households. Numerous institutions participate in the delivery of more than 35 social programmes.	**Set up a universal cash transfer for poor children.** **Continue to improve targeting and reduce fragmentation of social programmes.**
Around 30% of seniors (65 years and over) have no pension. The demographic transition challenges the sustainability of pension and health systems.	Link the statutory retirement age to increases in life expectancy. Set up a universal pension covering all poor seniors.
Strengthening green growth	
The transport sector is the main source of emissions. Meeting the plan to be net carbon neutral by 2050 will require reducing emissions in the transport sector and strengthening carbon sinks. Diesel is taxed at a rate that is 60% lower than gasoline.	Pursue efforts to strengthen the public transport network. **Align the tax rates on diesel and bunker fuel with the gasoline rate and gradually increase the carbon tax rate once high energy prices start falling, and channel part of the revenues towards low-income households.** Align taxes on vehicles with their emissions to encourage a shift towards less polluting vehicles. Update toll fees to ensure they reflect the cost of road use and introduce congestion charges.
The planned electrification of transport will imply a significant increase in electricity generation and distribution.	Digitalise and fully automate the electricity grid.
The increase in forest-covered areas has been underpinned by the Payment for Environmental Services scheme, offering compensation to land owners for providing eco-services. So far, the scheme has been financed only with fuel tax revenues, which will fall overtime.	**Broaden the sources of financing of the Payment for Environmental Services scheme.**
There is a critical need to improve wastewater collection and treatment. Large use of septic tanks add pressures on water resources.	Deploy additional investment on wastewater collection and treatment financed via PPP schemes.

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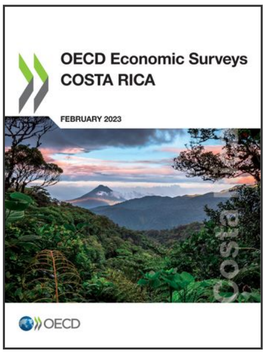

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