1 Key policy insights

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

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

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

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

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

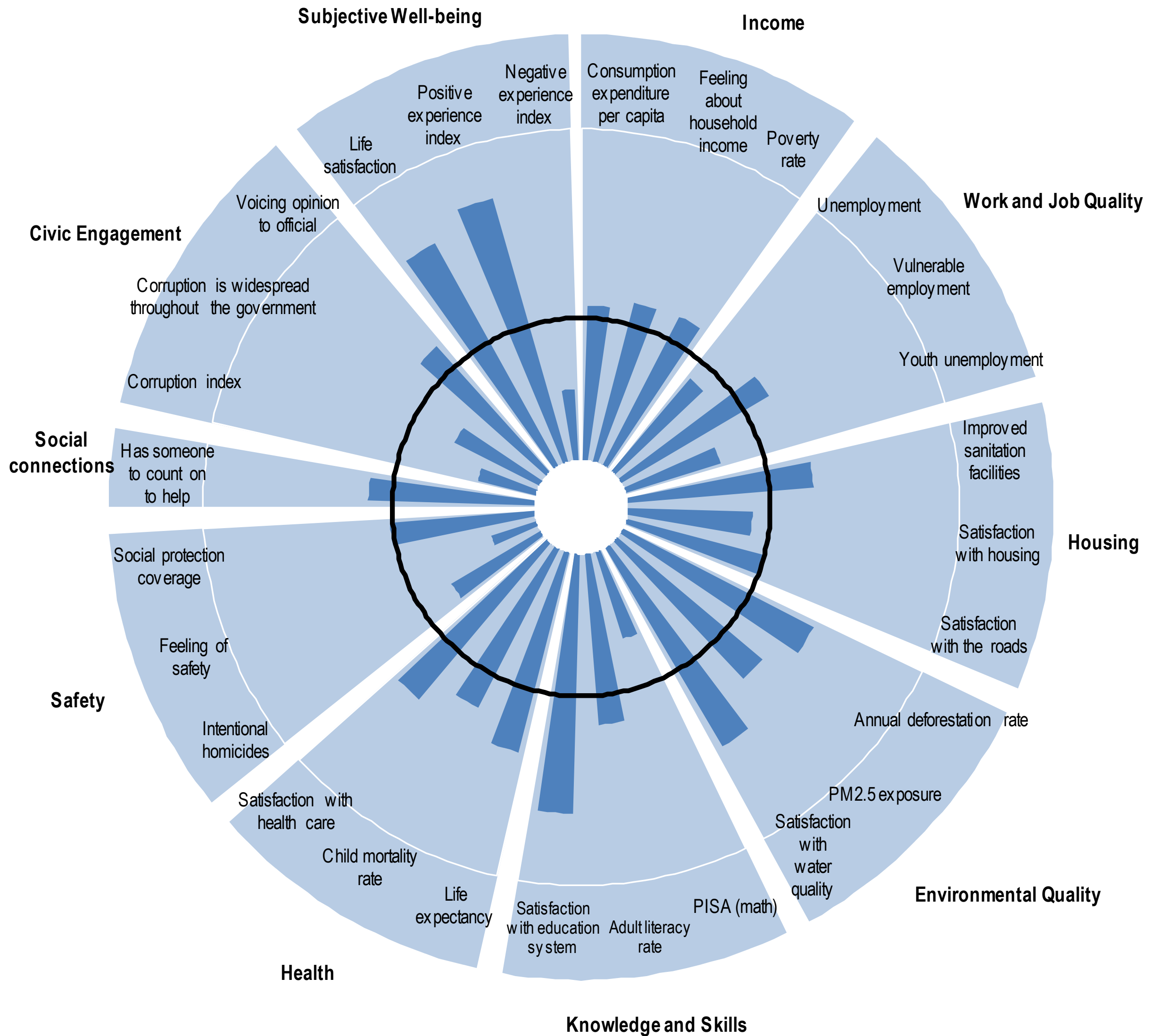
Responding successfully to these substantial challenges will hinge on buttressing the fiscal framework and implementing reforms to foster inclusive growth. Despite a complex political environment, there has been a significant cross-party consensus in Congress on the reform agenda linked to the OECD accession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

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

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

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

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



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

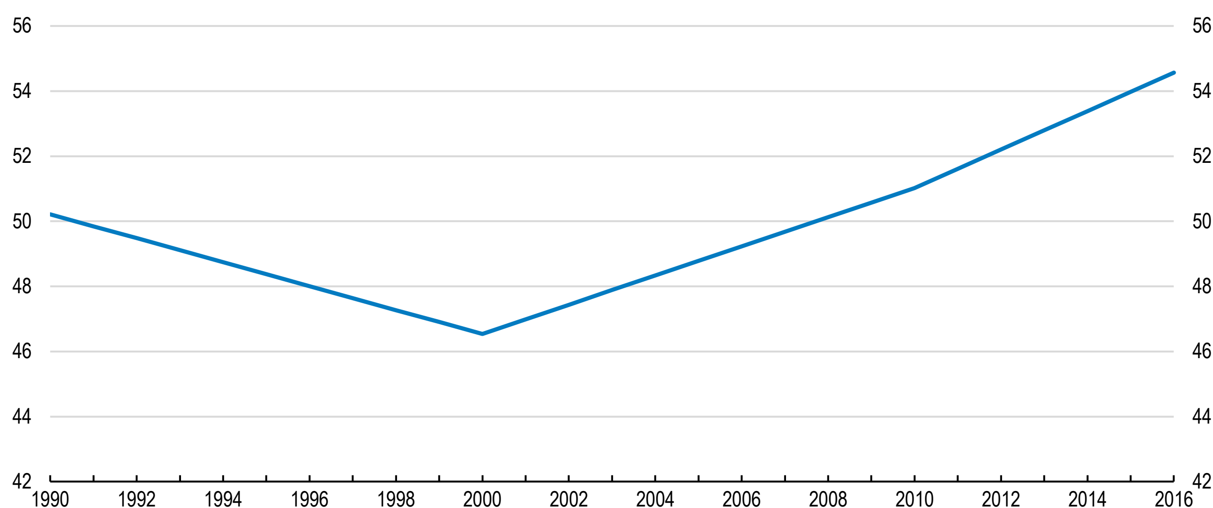
Table 1.1. Costa Rica: Selected indicators in comparison with the OECD

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

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

Figure 1.2. Forest cover has rebounded since 2000

Land covered by forest, % of total land area



Source: OECD Environment database.

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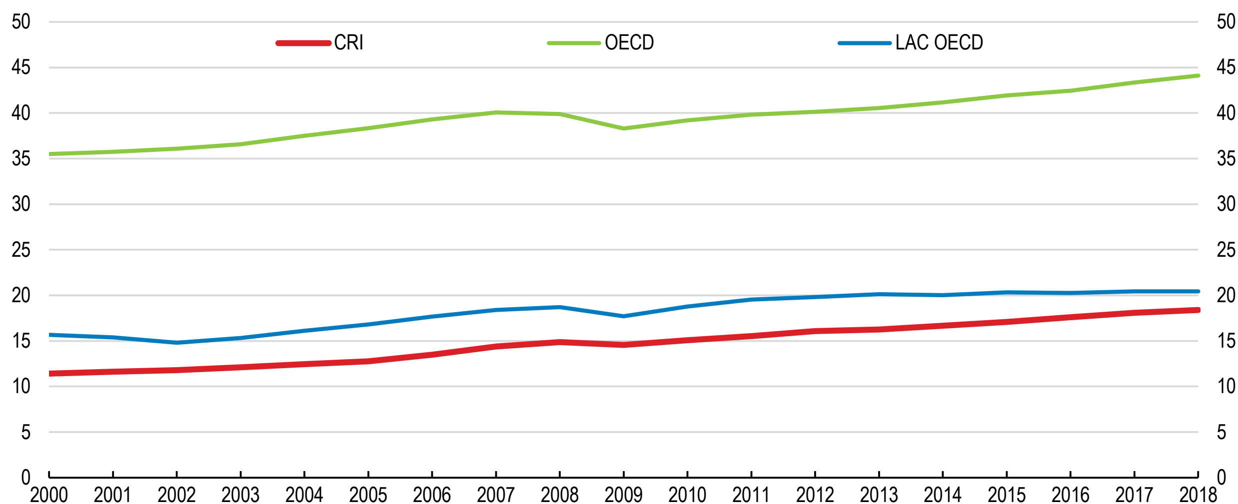
Figure 1.3. The gap with advanced economies remains large

Thousands of PPP-adjusted 2015 USD per capita



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

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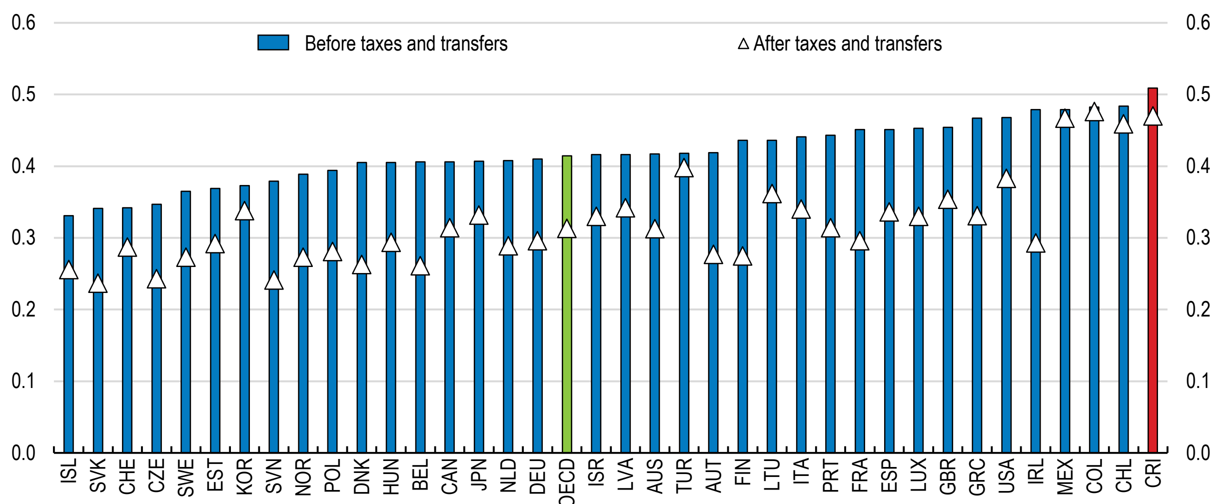
Figure 1.4. Inequality remains high

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



Source: OECD Income Distribution database.

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Box 1.1. Recent economic reforms

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

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

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

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

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

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

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

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

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

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

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

Table 1.2. Ongoing structural reforms will boost growth

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

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

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

Table 1.3. Additional reform efforts would pay off

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

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

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

Table 1.4. Reforms would also help to reduce inequality

Potential impact of selected reforms on the GINI coefficient

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

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

The economy is contracting due to the coronavirus outbreak

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

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

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

Containment measures

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

Economic measures

The following measures have been implemented:

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

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

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

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

Figure 1.5. The economy is in recession

A. Real GDP

B. High unemployment drags on consumption

C. Gross fixed capital formation

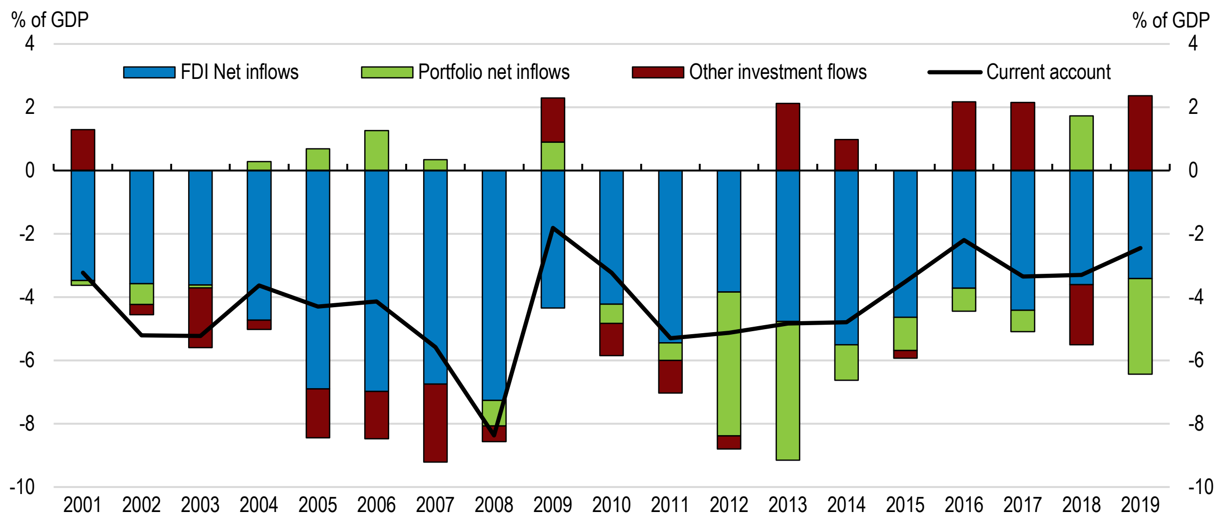
D. Credit growth by currency denomination

Note: LAC is simple average of Argentina, Brazil, Chile, Colombia and Mexico. Data for 2020 refer to the average over 2020Q1 and 2020Q2, which are forecasts. In Panel D, foreign currency refers to USD.

Source: OECD Economic Outlook database; and Banco Central de Costa Rica.

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

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



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

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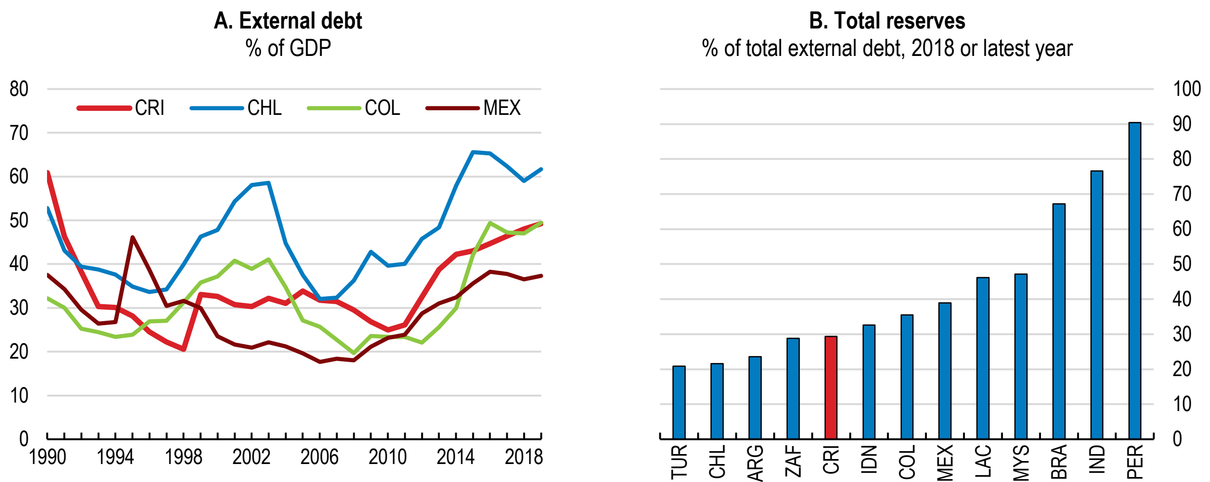
Figure 1.7. External debt has increased



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

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

Table 1.5. Macroeconomic and financial projections

A. Single-hit scenario

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

B. Double-hit scenario

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

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

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

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

Table 1.6. Possible shocks to the Costa Rican economy

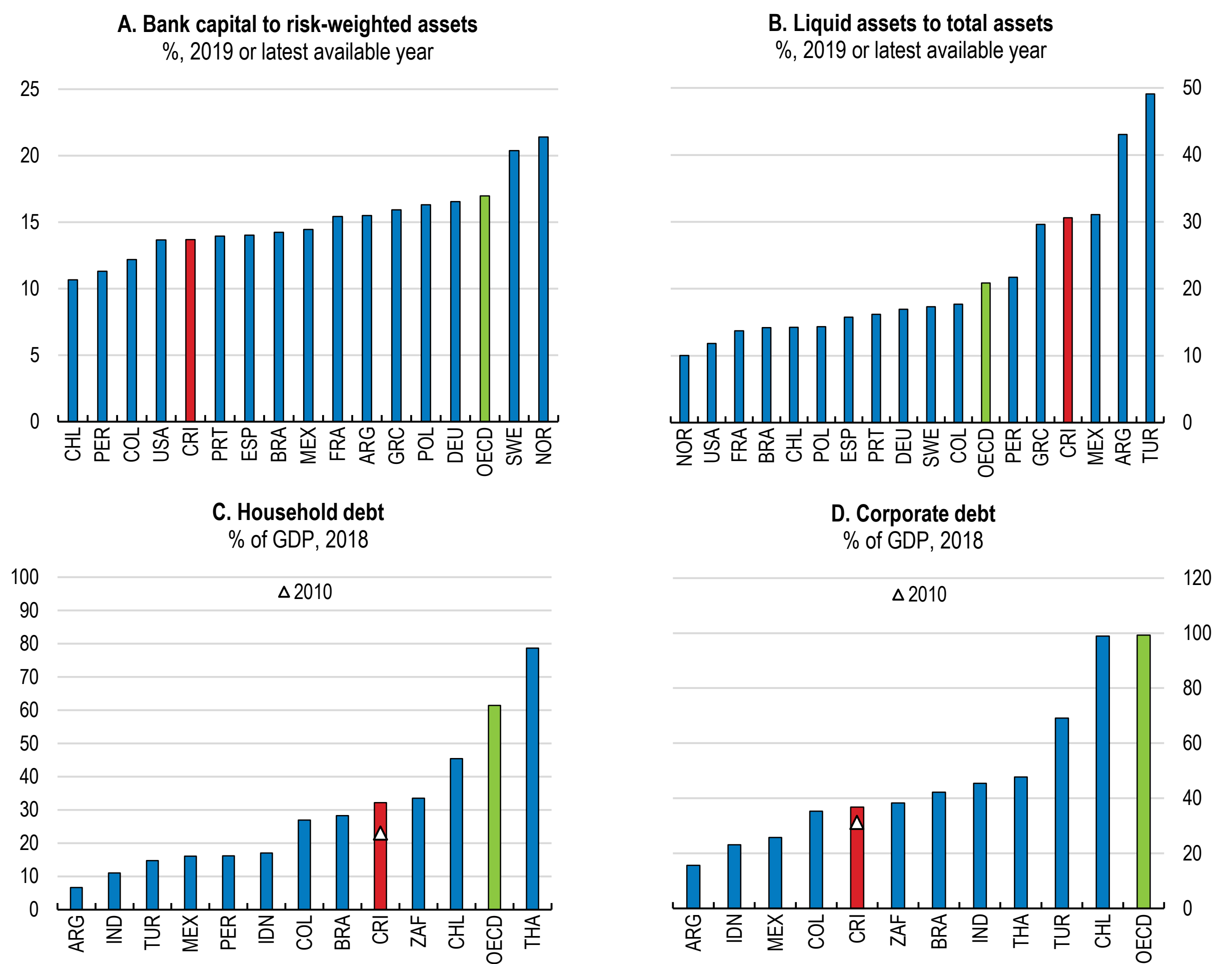
Vulnerability	Possible outcome	Possible policy action
Contagion from emerging markets financial volatility	Large exchange rate depreciation and higher costs of financing the fiscal deficit and servicing debt.	Tighten monetary policy and take additional fiscal measures to reduce the fiscal deficit.
Deepening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

Enhancing financial resilience

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

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

Figure 1.8. The authorities consider banks to be well capitalised



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

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

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

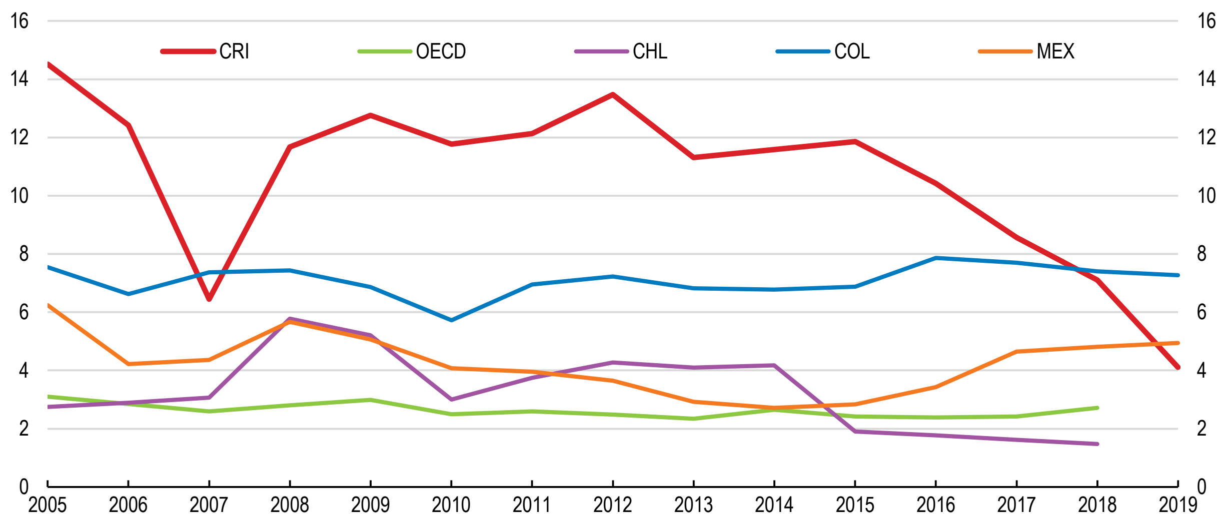
important as pooling eventually the compartments would boost risk-sharing and financial stability (Schoenmaker, 2018[8]).

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

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

Figure 1.9. Interest rate spreads are relatively high

Percentage points



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

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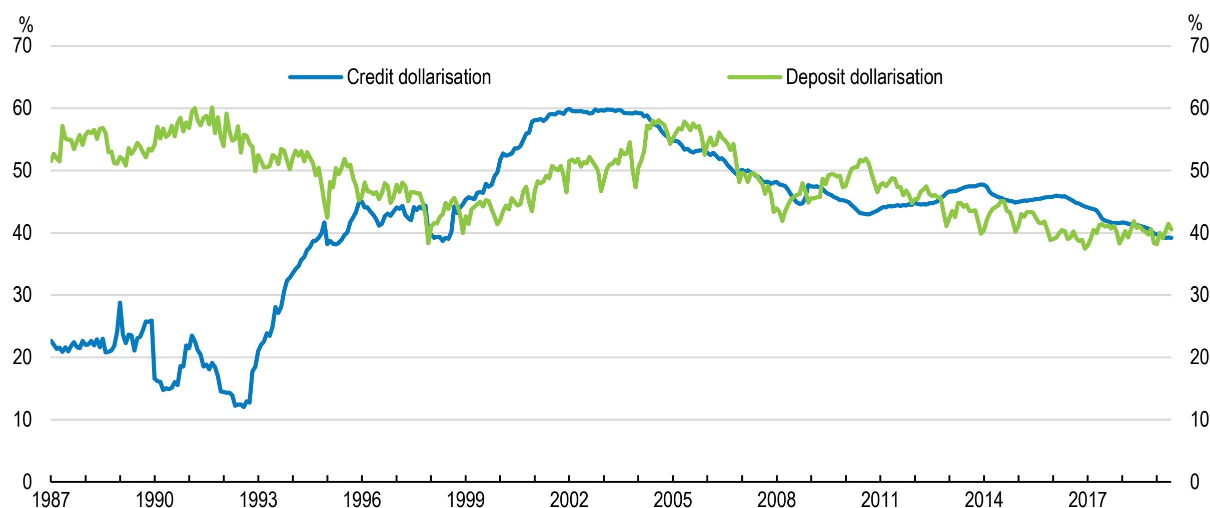
Financial dollarisation has fallen but remains high (Figure 1.10). Both credit and deposits dollarisation are around 40%. According to authorities' estimates, two-thirds of the dollarised debt in Costa Rica is unhedged. In June 2018, provisions for granting foreign exchange loans to non-dollar earners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

Figure 1.10. Financial dollarisation remains large



Source: Banco Central de Costa Rica.

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

Table 1.7. Past OECD recommendations on financial stability

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

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

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

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

Macroeconomic policies have improved but the fiscal framework should be reinforced

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

Monetary policy has improved

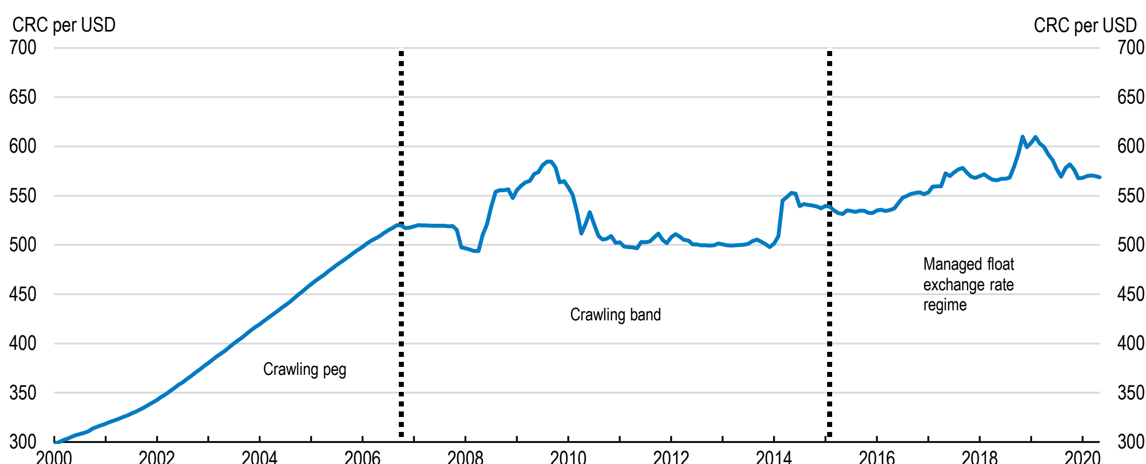
Costa Rica has improved its inflation targeting framework, in line with previous Economic Surveys recommendations (Table 1.8); OECD, (2018[7]). The Central Bank has also shown a stronger commitment towards exchange rate flexibility (IMF, 2019[6]); (Figure 1.11). Exchange rate interventions have become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

Table 1.8. Past OECD recommendations on macroeconomic policies

Past recommendations	Actions taken since the 2018 survey
Adopt the draft bill that reforms the rules for appointing the President of the Central Bank; rule out that Ministers or their representatives can vote in Board decisions.	The designation of the President of the central bank has been delinked from the political cycle and the dismissal rules have been clarified. The vote of the Minister of Finance in monetary policy decisions has been removed.
Gradually reduce interventions in the foreign exchange market.	Exchange rate interventions are limited to address episodes of large exchange rate volatility.
Implement immediate measures to reduce the budget deficit by 3 percentage points of GDP during 2018-20 to stabilise the debt-to-GDP ratio, through a comprehensive package of measures to raise revenue, curb spending, and strengthen the fiscal rule. In the medium term, take actions to reduce the debt-to-GDP ratio to prudent levels while building fiscal space to address contingencies. Reduce budget rigidities stemming from legally mandated spending and earmarking of government revenues. Streamline public sector employment to better control payroll costs.	The fiscal reform approved in December 2018 includes measures to increase revenues, introduces a fiscal rule, aiming at containing nominal current spending growth, reduces earmarking and rationalizes some remuneration incentives (Box 1.4). On 10th February 2020, the authorities announced a complementary fiscal package to further consolidate the fiscal position, including actions in four areas: i) fighting evasion and reducing tax expenditures; ii) reorganisation of public sector institutions and enactment of a public employment law, iii) improving debt management, and iv) selling of state-owned assets.
Assess contingent liabilities.	Some contingent liabilities have been assessed (debt, municipalities, pension system, PPPs or lawsuits against the state) while others (public enterprises, natural disasters, financial risks) are in process.
Create a fiscal council and introduce a multi-year expenditure framework.	The three board members of the fiscal council have been appointed. They will be working part-time and supported by the Finance Ministry.
Modernise debt management by reducing the number of benchmark securities and improving communication with the markets.	The number of benchmark securities has been reduced to 8. Since January 2019, the calendar of quarterly auctions is published. Debt management plans are now presented to markets twice per year.

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

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



Source: OECD Economic Outlook 107 database.

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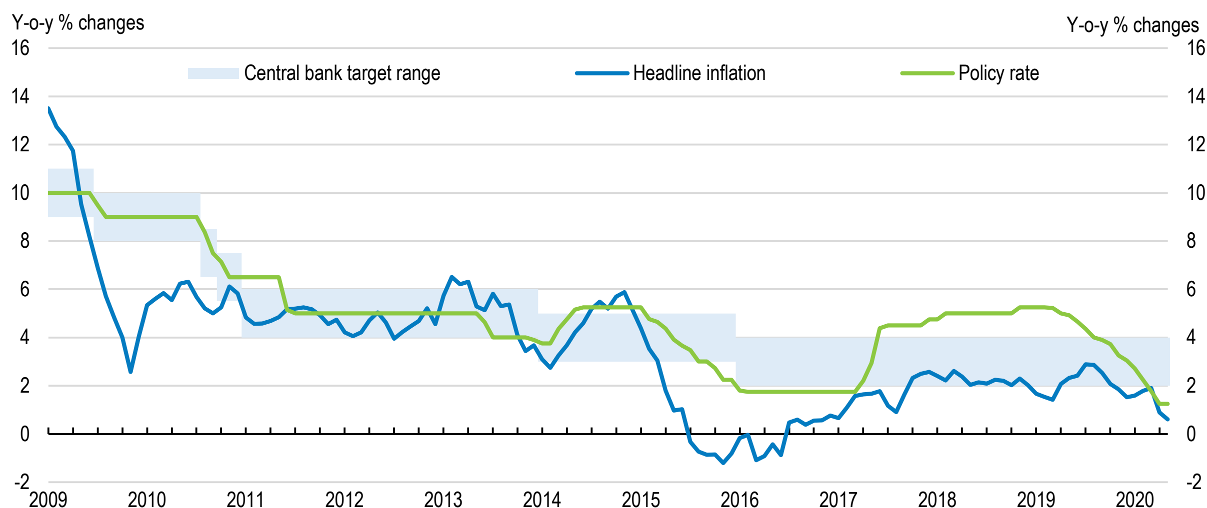
Figure 1.12. Monetary policy is appropriately accommodative



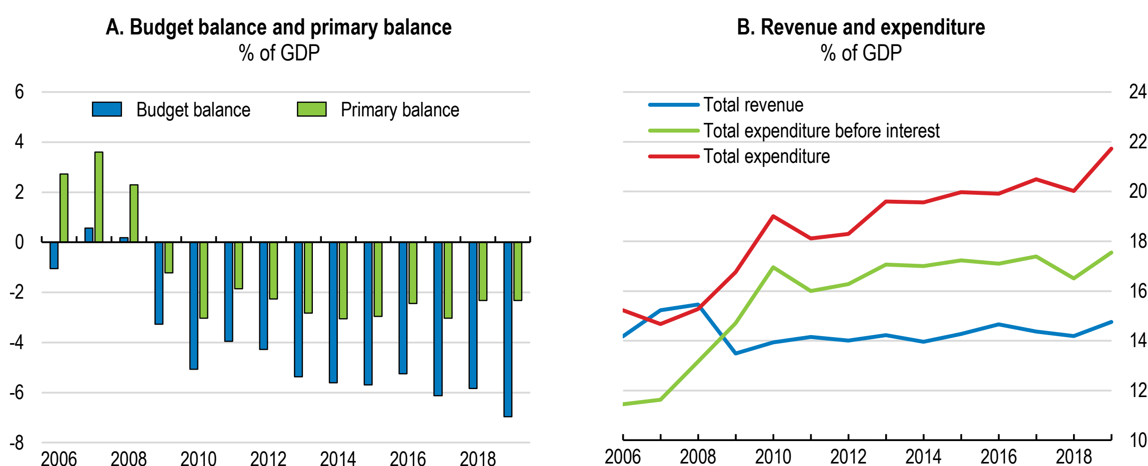
Note: Shaded area represents the central bank target. Data are based on monthly averages. Latest value refers to May 2020.
Source: Banco Central de Costa Rica.

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

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

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

Figure 1.13. Fiscal deficits remain large



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

Box 1.4. The fiscal reform

The main elements on the revenue side are:

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

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

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

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

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

- When the debt at the end of the previous fiscal year is under 30% of GDP or the current expenditure-to-GDP ratio is below 17%, the annual growth of current expenditure should not exceed the average nominal GDP growth in the past four years.
- When the debt at the end of the previous fiscal year is between 30% and 45% of GDP, the annual growth of current expenditure should not exceed 85% of the average nominal GDP growth in the past four years,
- When the debt at the end of the previous fiscal year is between 45% and 60% of GDP, the annual growth of current expenditure should not exceed 75% of the average nominal GDP growth in the past four years.
- When the debt at the end of the previous fiscal year is above 60% of GDP, the annual growth of total expenditure should not exceed 65% of the average nominal GDP growth in the past four years.

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

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

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

Table 1.9. Fiscal impact of the fiscal reform

% of GDP

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

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

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

Table 1.10. Main revenue and expenditure categories

% of GDP

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

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

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

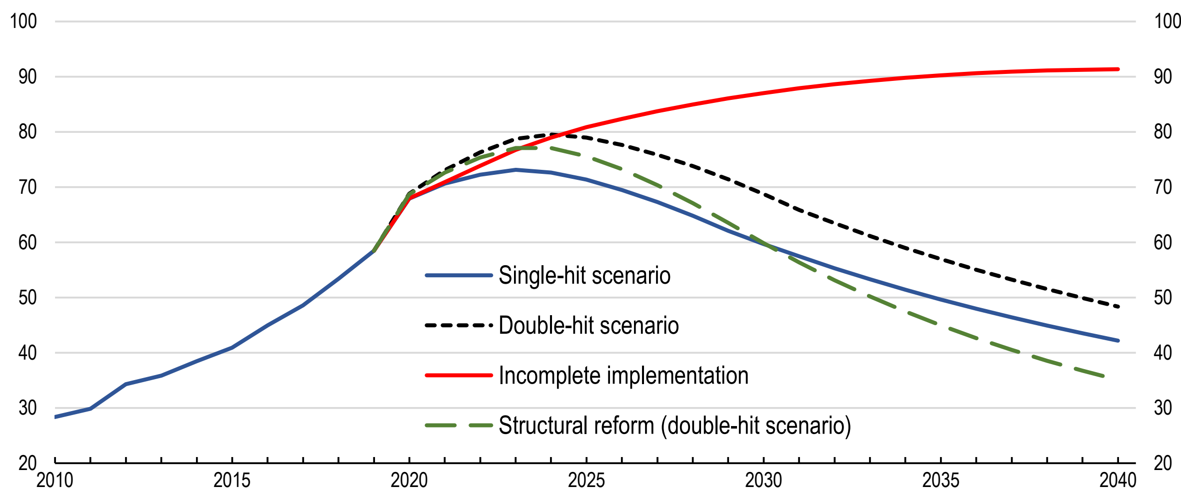
significantly as of 2021. The authorities expect that the primary deficit will get to zero in 2022. Assets sales would also contribute significantly to reduce the stock of debt up to 2023. Measures underlying the increase in revenues, the containment in spending and the reduction of public debt are subject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

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

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

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

Central government public debt, % of GDP



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

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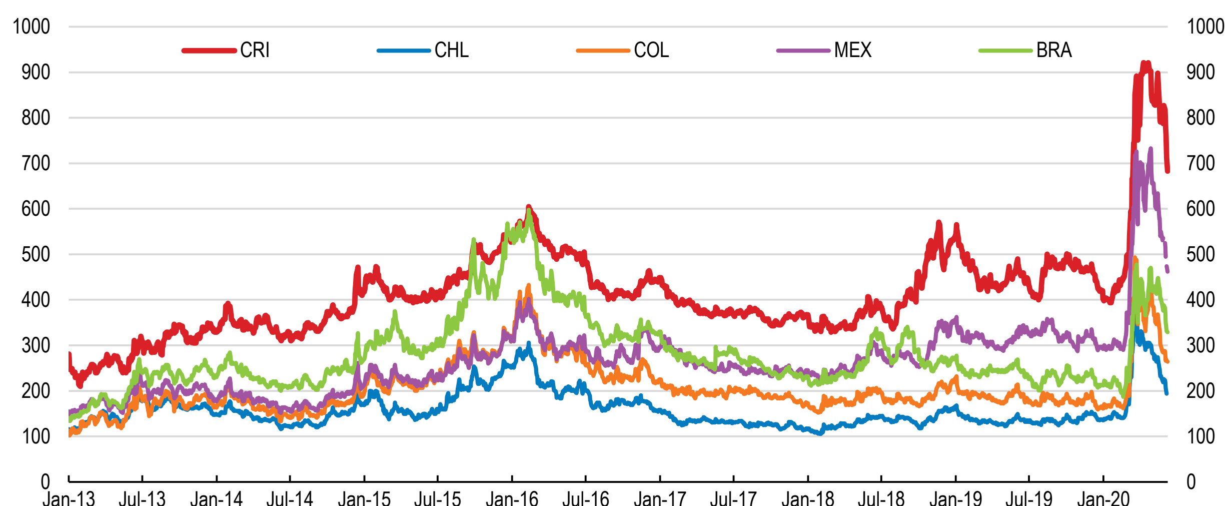
Debt simulations also highlight that full compliance with the fiscal rule, is critical. The authorities have appropriately and temporarily activated the emergency escape clause in the fiscal rule for health-related institutions. Maintaining income support payments as long as confinement measures weigh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

Figure 1.15. Sovereign risk premia remain high

Sovereign risk bond spreads, basis points



Source: Refinitiv.

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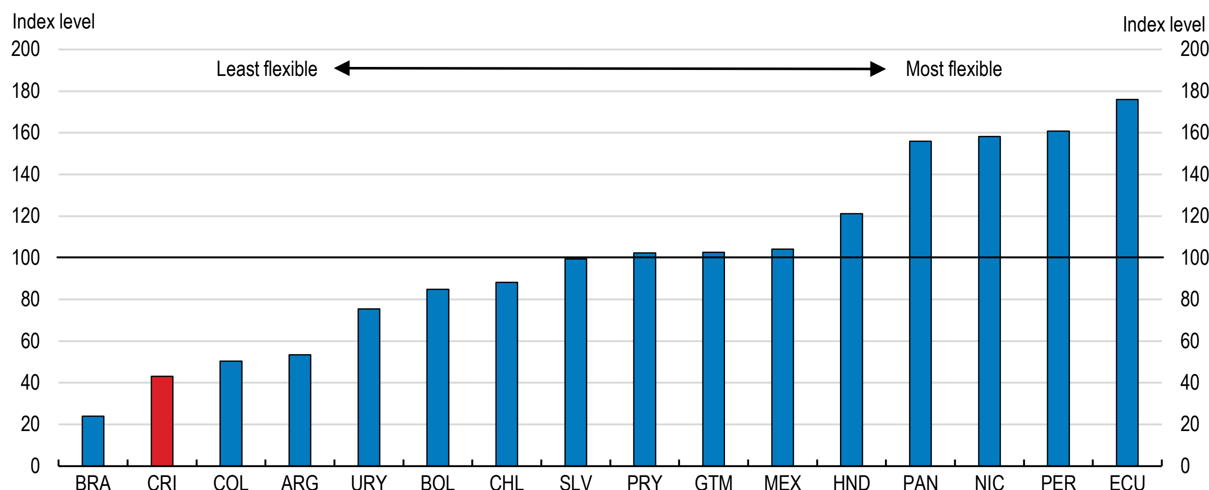
The fiscal reform has removed significant revenue-earmarking provisions introduced over the years. The Finance Ministry can now reallocate spending away from legally mandated destinations when public debt exceeds 50% of GDP, with the exception of areas mandated by the Constitution, such as public education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

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

Figure 1.16. Public spending remains inflexible

Expenditure flexibility index, 100 = LatAm average



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

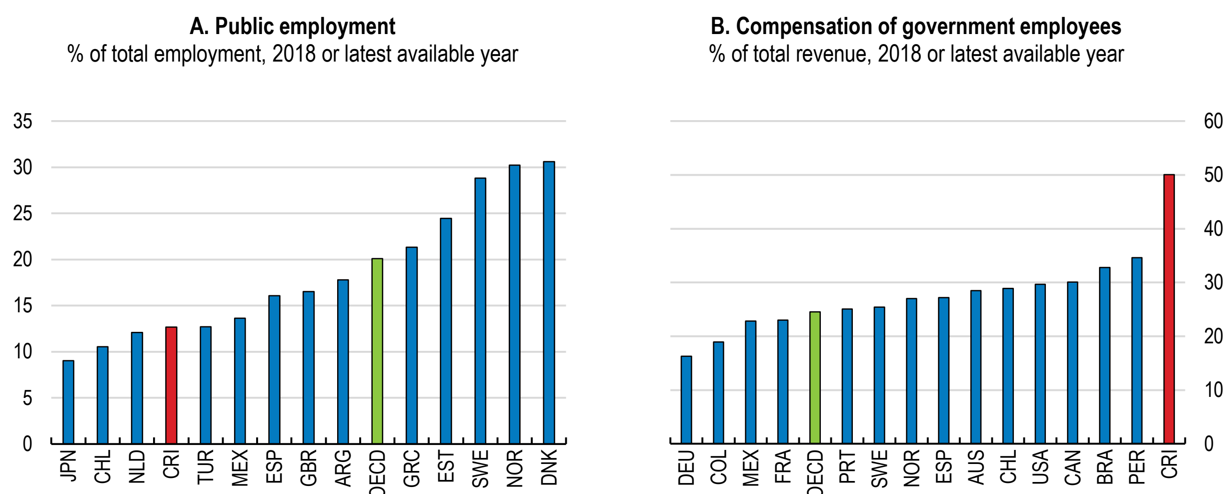
The need to meet the fiscal rule, together with the need to reduce inequality and boost growth, makes improving the efficiency of public spending a fundamental and social challenge. Public spending is on an increasing trend since 2008, but these increases have not been matched by an improvement in performance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

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

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

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

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



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

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

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

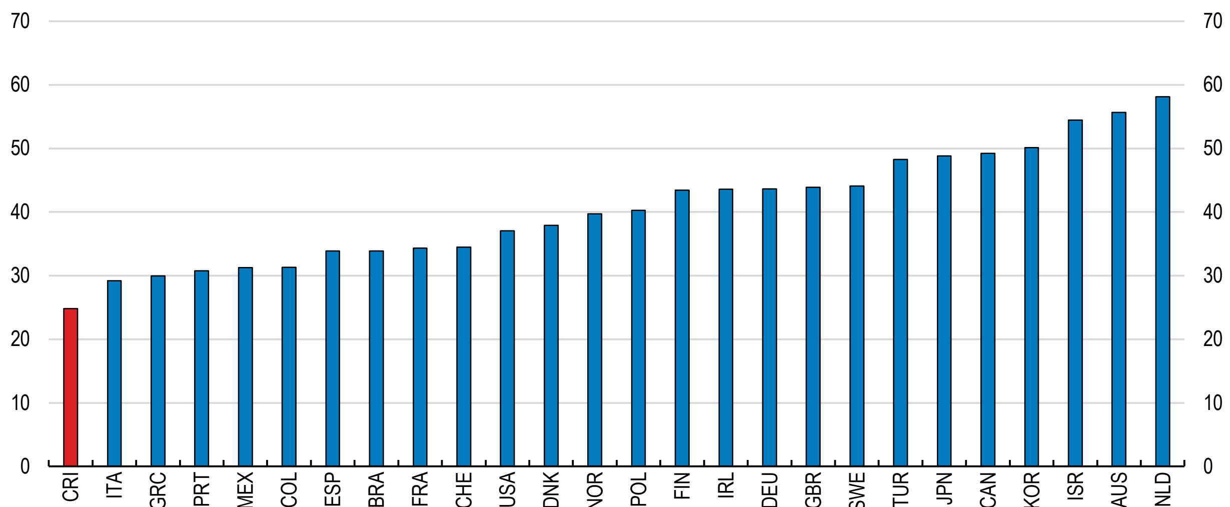
A thorough review of the public sector is needed to boost public sector efficiency and central government's ability to reallocate funds to priority areas. Previous studies already identified that a large number of public institutions are non-functional (OECD, 2018[7]). The authorities are in the process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

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

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

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

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



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

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

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

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

Broadening tax bases and improving the tax mix

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

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

Figure 1.19. There is room to improve the tax mix

% of GDP, 2018 or latest available year

A. Total tax revenue (excluding social security contributions)

MEX CRI COL CHL LAC5 ARG BRA OECD

B. Personal income tax

COL CRI CHL ARG LAC5 BRA MEX OECD

C. Property tax

MEX CRI CHL LAC5 BRA COL OECD ARG

D. Social security contributions

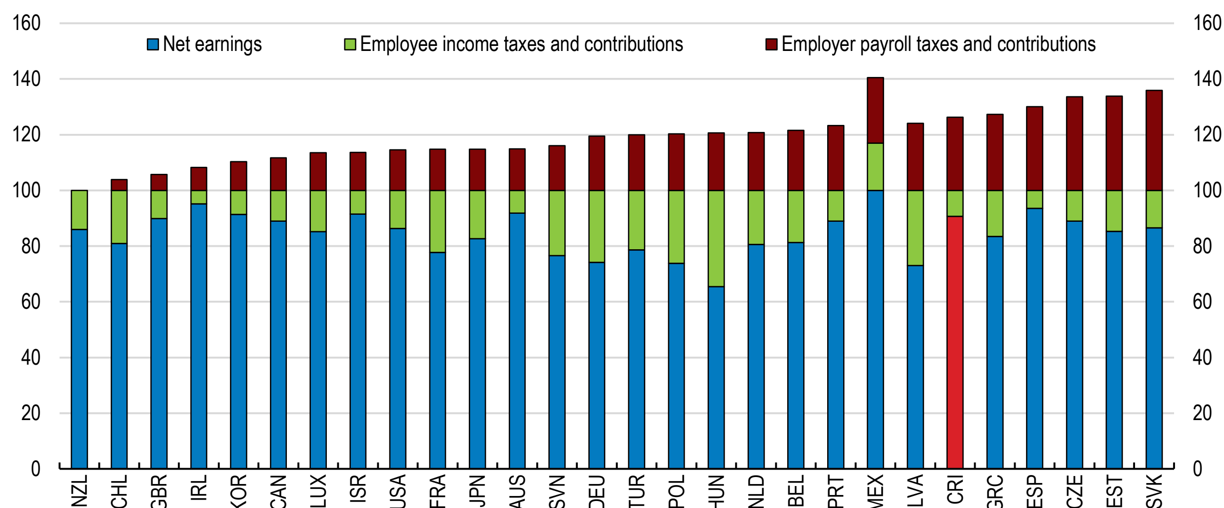
CHL COL MEX LAC5 ARG CRI BRA OECD

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

https://doi.org/10.1787/888934148562

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

% of gross earnings, 2013



Note: Tax burdens are calculated for a full-time worker in a single-person household earning a minimum wage at the standard (adult) rate. Full-time refers to usual full-time hours in each country. Employer and employee social contributions also include any mandatory payments to private insurance for health, retirement pensions, etc.
Source: OECD Reviews of Labour Market and Social Policies: Costa Rica.

Table 1.11. Fiscal quantification of some recommendations

% of GDP

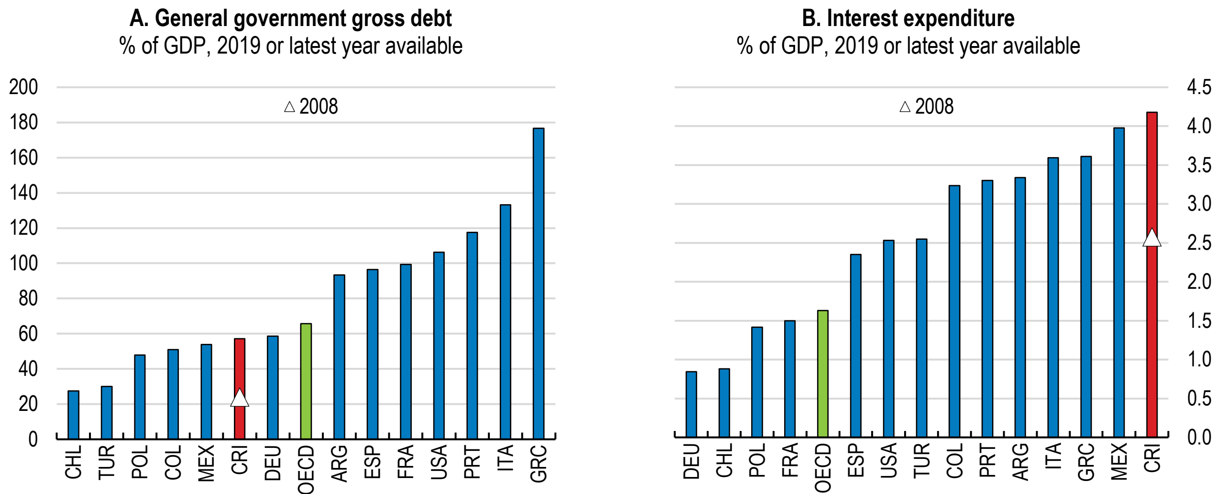
Measure	Change in fiscal balance
Removing some tax exemptions in personal tax (13th salary and school expenses)	0.35
Removing some tax exemptions in corporate tax (cooperatives)	0.15
Strengthening property tax	0.6
Increasing e-procurement and centralised purchasing	1.55

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

Improving debt management

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

Figure 1.21. Interest expenditure is high



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

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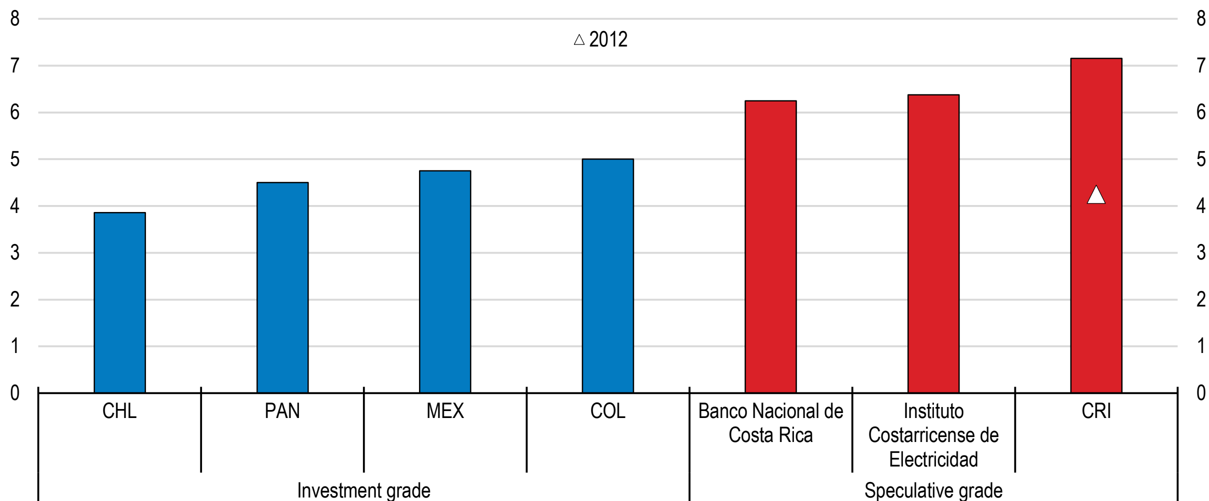
Figure 1.22. The cost of external financing is high in comparison with other countries

Coupon rates (%) of Eurobond issuances in 2019



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

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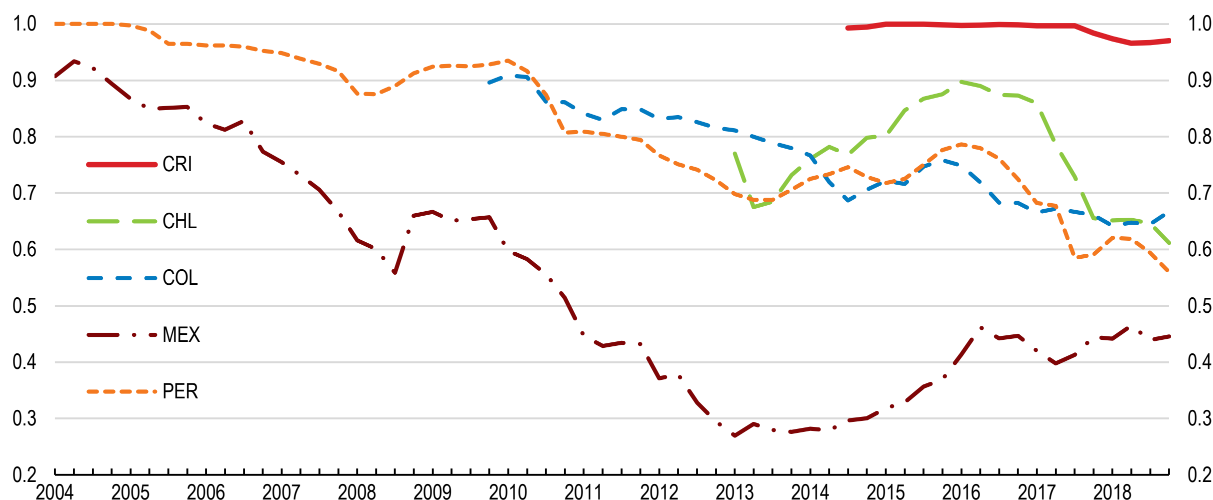
Issuing debt in foreign currency may help to reduce interest costs in the short term, but it also increases currency risks, as exemplified by Argentina. Almost all Costa Rican external government debt is already denominated in foreign currency. Other countries in Latin America have been increasingly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

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

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

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

Original Sin Index (0-1)



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

StatLink https://doi.org/10.1787/888934148638

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

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

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

Continuing to buttress the fiscal framework

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

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

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

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

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

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

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

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

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

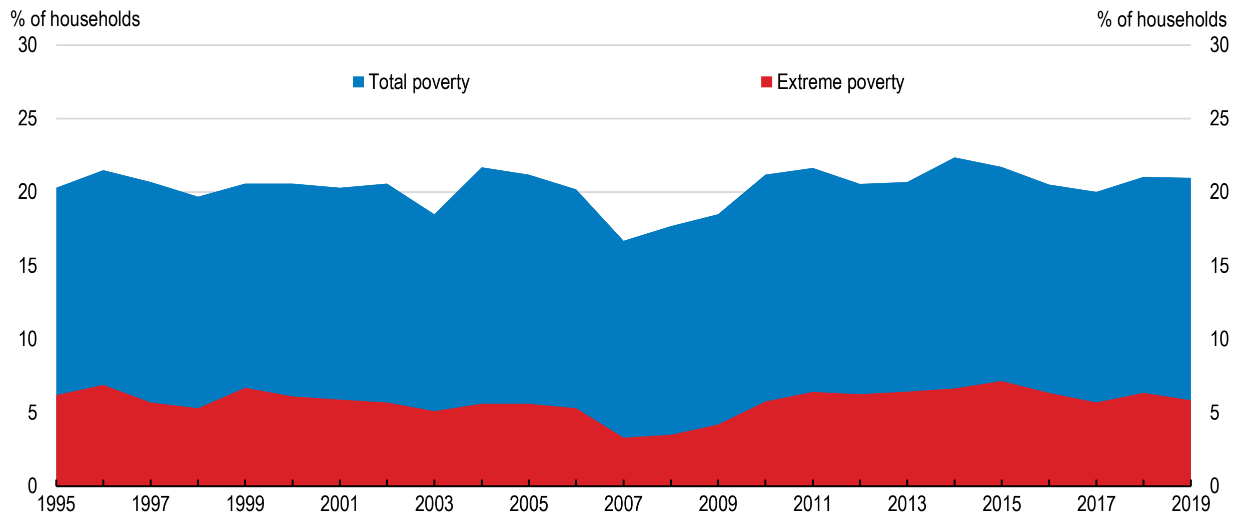
The programme is well targeted, as being economically affected by the COVID-19 is a requirement, and inclusive, as informal sector workers also can receive the transfer. Public sector workers, pensioners of any regime, citizens under 15 years old, persons deprived of liberty and families that currently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

Source: Ministry of Labour and Social Security.

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

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

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



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

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Improving the targeting of social policies

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

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

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

Table 1.12. Past OECD recommendations on making growth more inclusive

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

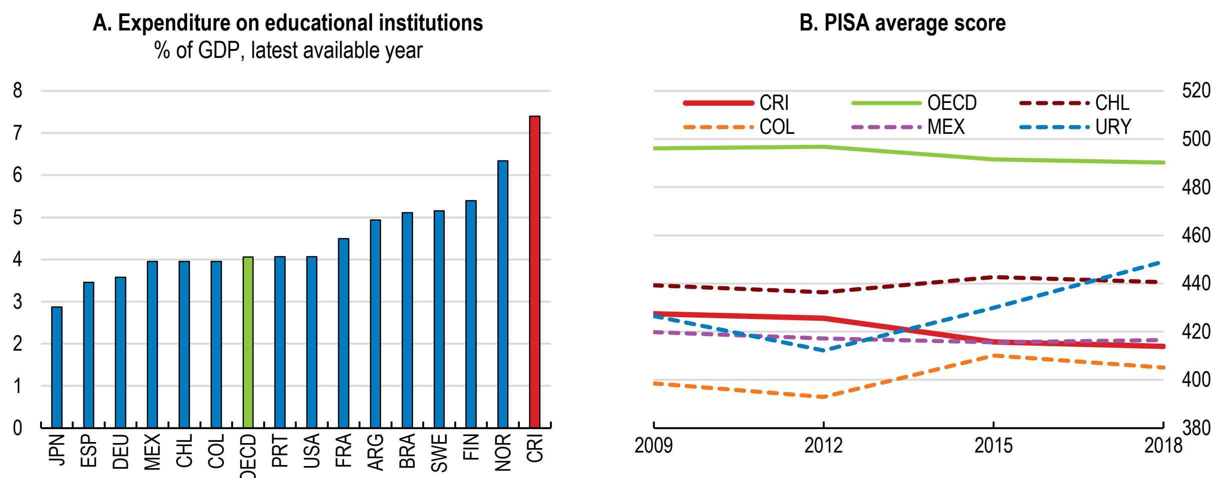
Making education policies more conducive to growth and equity

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

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

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

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



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

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

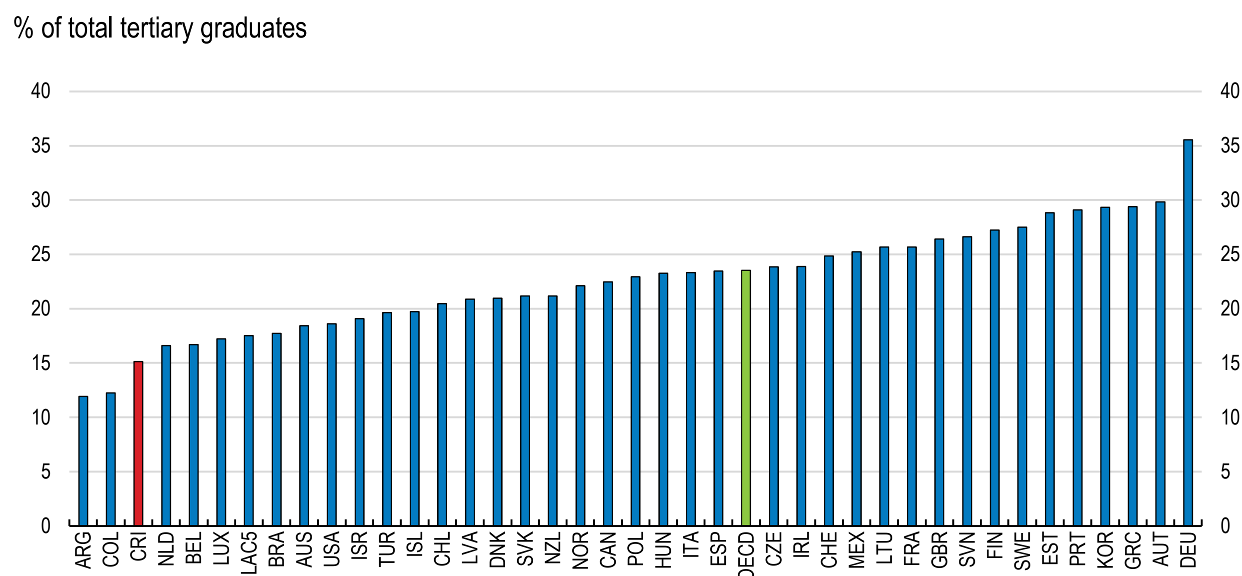
Updating curricula regularly is therefore fundamental. The Ministry of Education has made good progress in adapting and improving curricula in primary and secondary education, but there are significant delays in implementing the new curricula in classrooms (Estado de la Educación, 2019[34]). Experience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

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

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

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

% of total tertiary graduates



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

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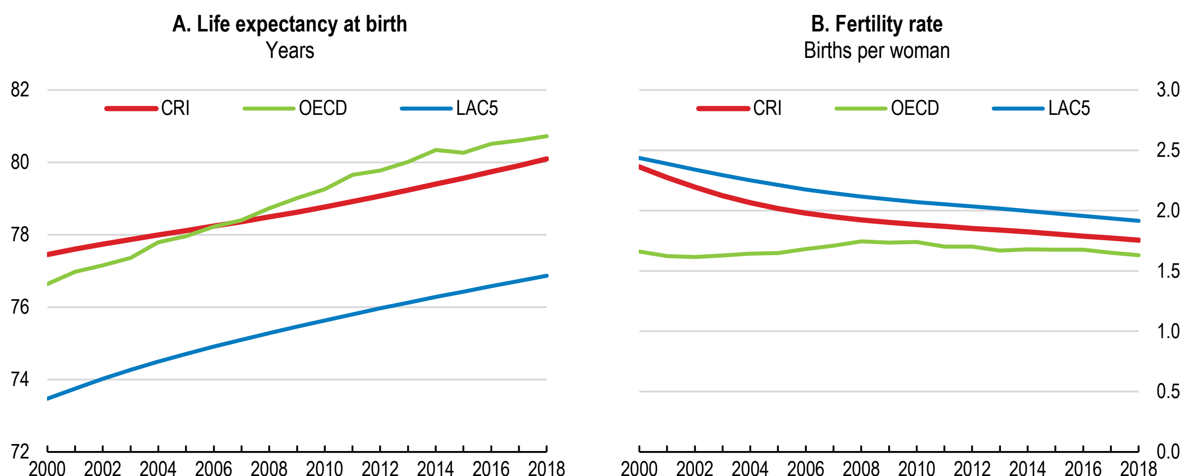
The demographic bonus is ending

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

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



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

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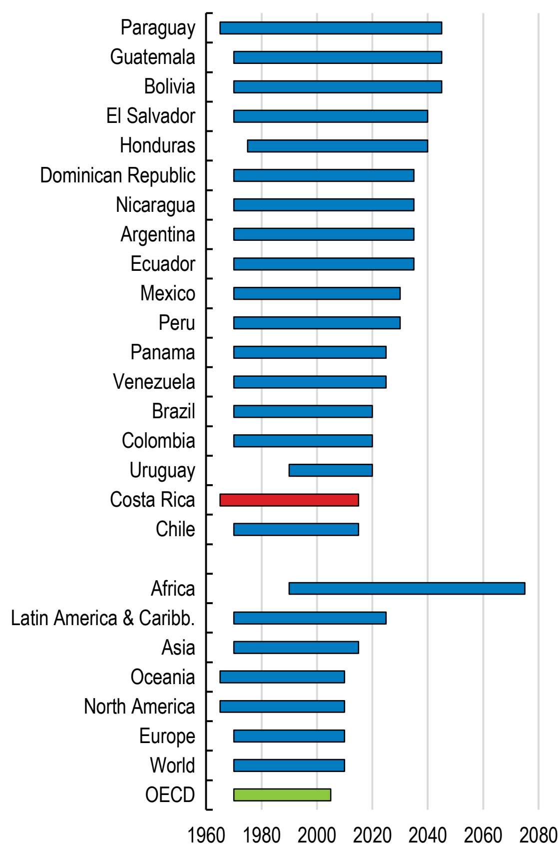
Figure 1.28. The demographic dividend is ending

Duration of demographic dividend, total dependency ratio



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

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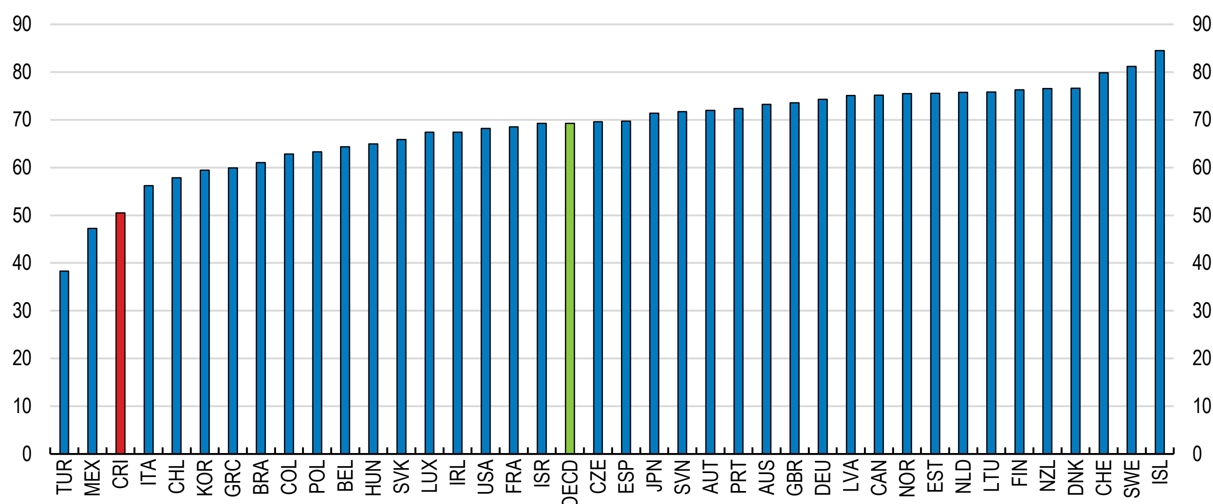
Boosting female labour market participation

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

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

Figure 1.29. Female labour market participation is low

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



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

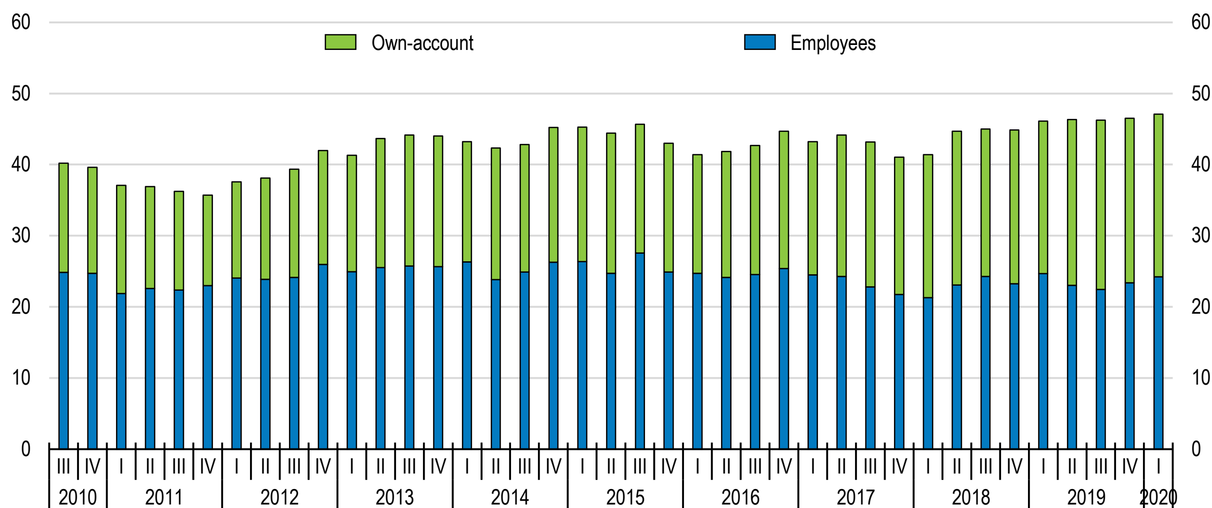
Reducing informality

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

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

Figure 1.30. Informality is high

% of total employed population



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

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

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

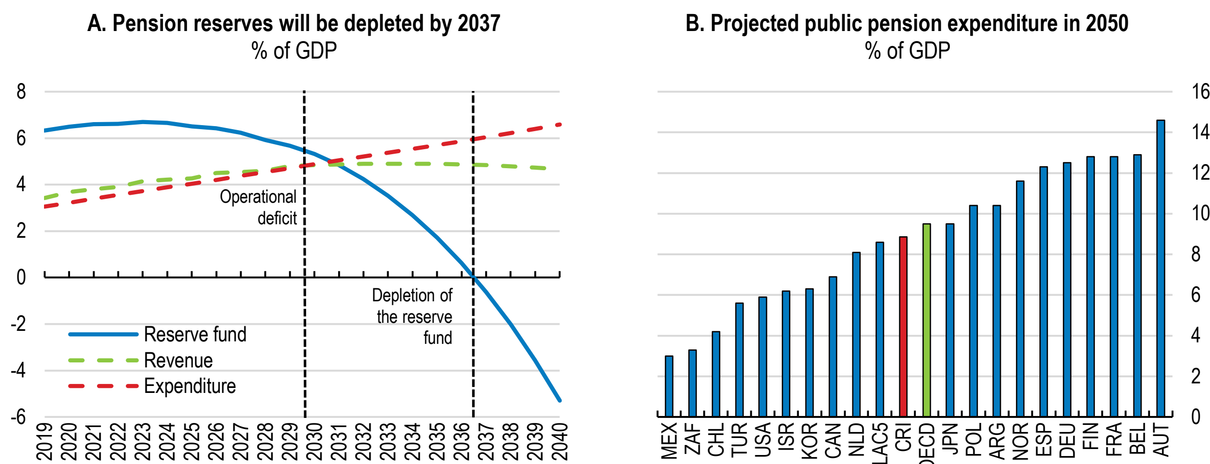
Improving the sustainability of the pension system

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

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

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

Figure 1.31. The pension system does not generate enough resources



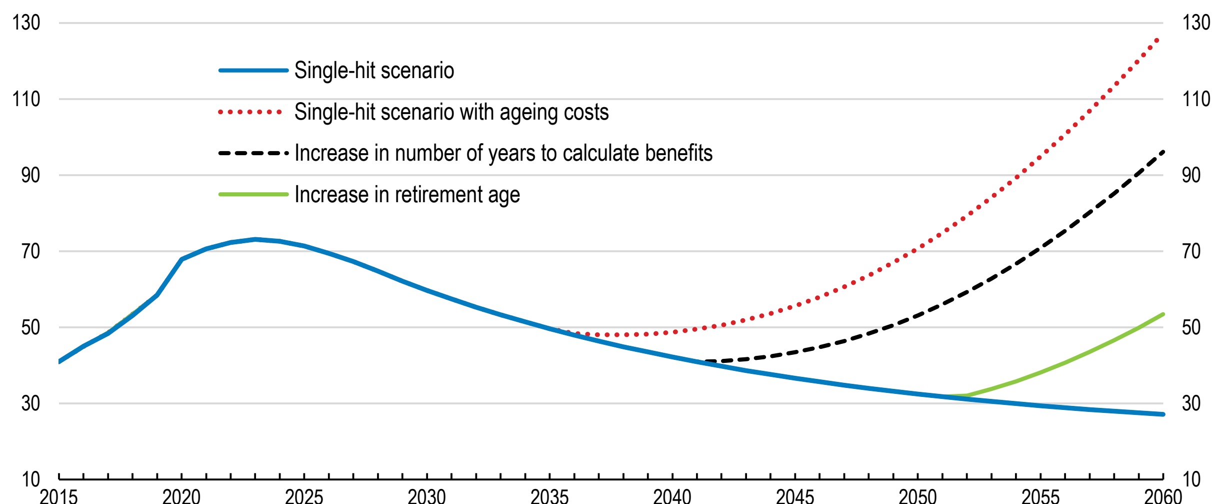
Note: Panel A reflects Caja Costarricense de Seguro Social's pension income, expenditure and reserve fund evolution scenario based on the actuarial study conducted by Carranza and Jiménez (2019[38]). This scenario assumes that pension contributions increase by two percentage points by 2029, an annual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

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

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

Figure 1.32. Financing pension deficits can hamper public debt dynamics

Central government public debt, % of GDP



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

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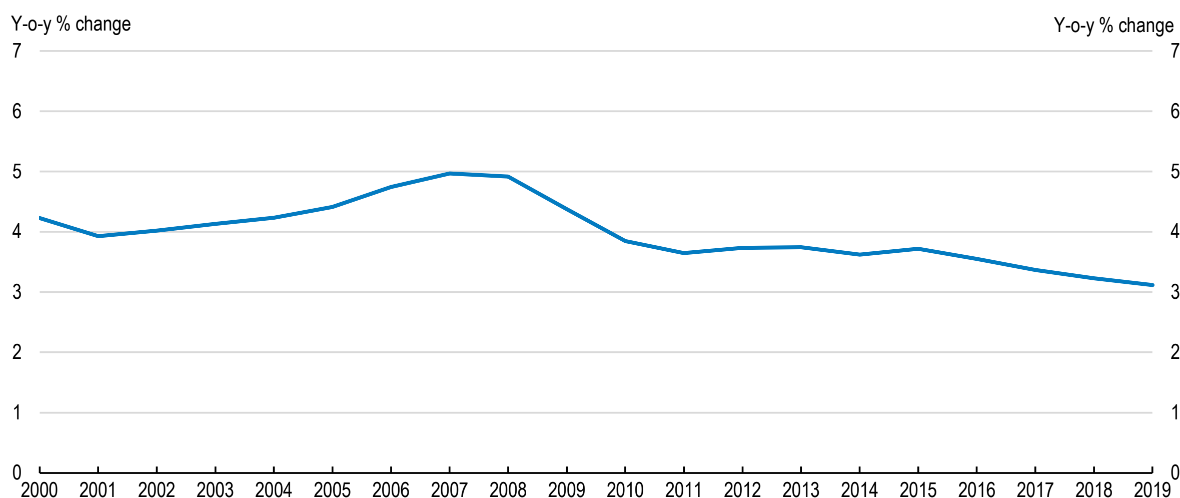
Costa Rica's pension system has a highly concentrated asset portfolio, as 95% of the contributory defined benefit pillar assets are invested in general government debt, and 87% on central government debt (SUPEN, 2019). The third pillar has a more diversified portfolio, yet general government debt represents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

Broadening growth sources and boosting productivity

Medium-term growth prospects have weakened

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

Figure 1.33. The economy's growth potential has declined



Source: OECD Economic Outlook database.

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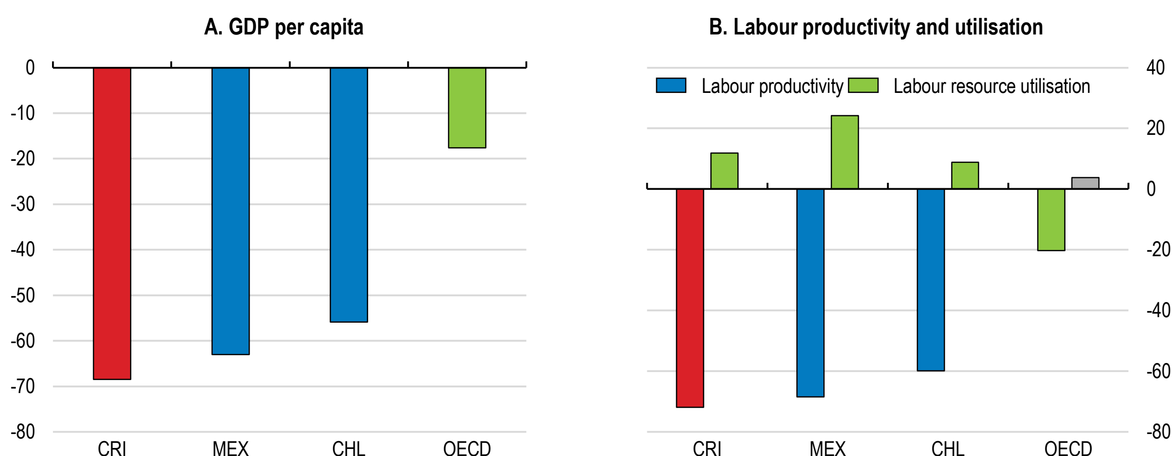
Figure 1.34. Income gaps with the OECD are large due to low productivity



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

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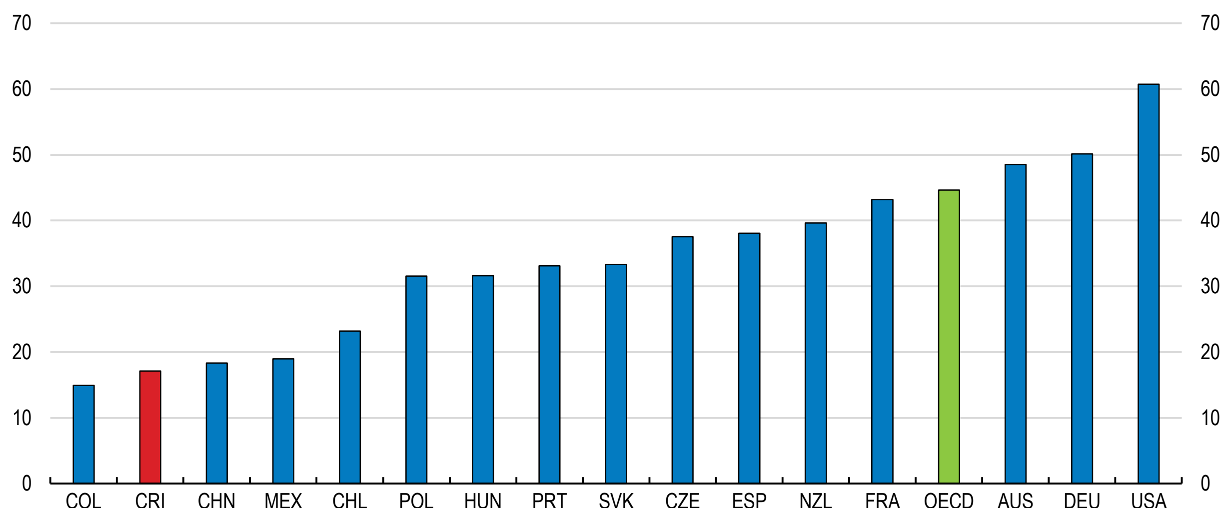
Figure 1.35. Labour productivity is relatively low

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



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

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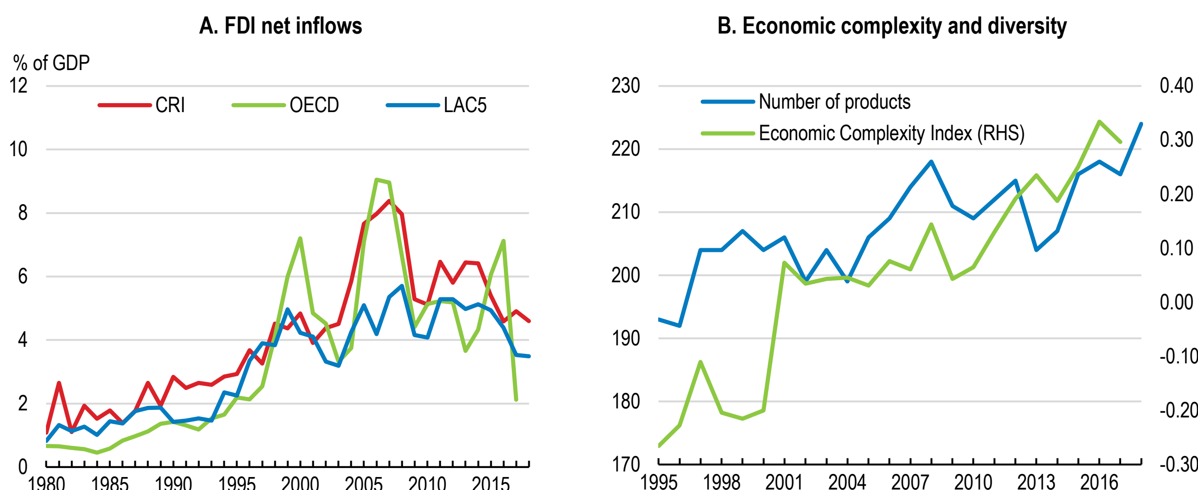
Boosting productivity of local firms

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

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

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

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



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

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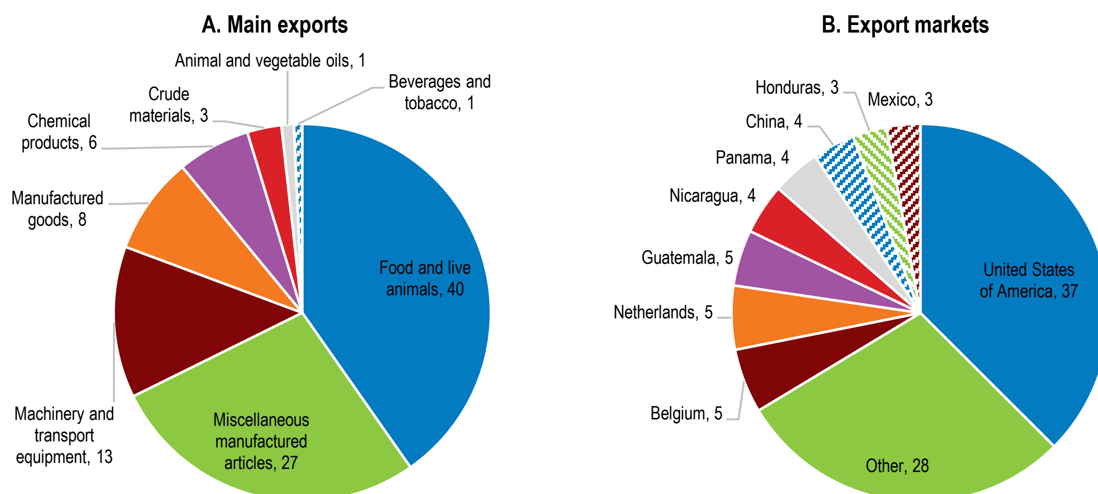
Figure 1.37. The United States is the main export market

Total goods, % of total, 2018



Source: UNCTAD.

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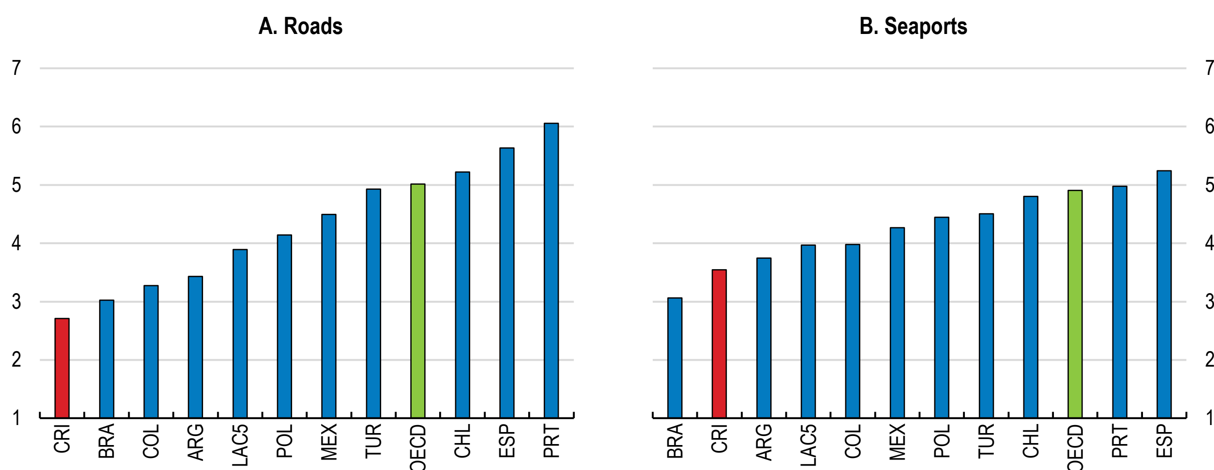
Boosting the innovation performance of SMEs would be key to closing their productivity gaps. Across OECD countries, universities play a key role to enhance SME innovation activities, as it is through close collaboration between universities and firms that the latter, especially small ones, can access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

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

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

Figure 1.38. Costa Rica's infrastructure lags behind

Index 1 to 7 (best), 2018



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

Table 1.13. Past OECD recommendations on boosting productivity

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

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

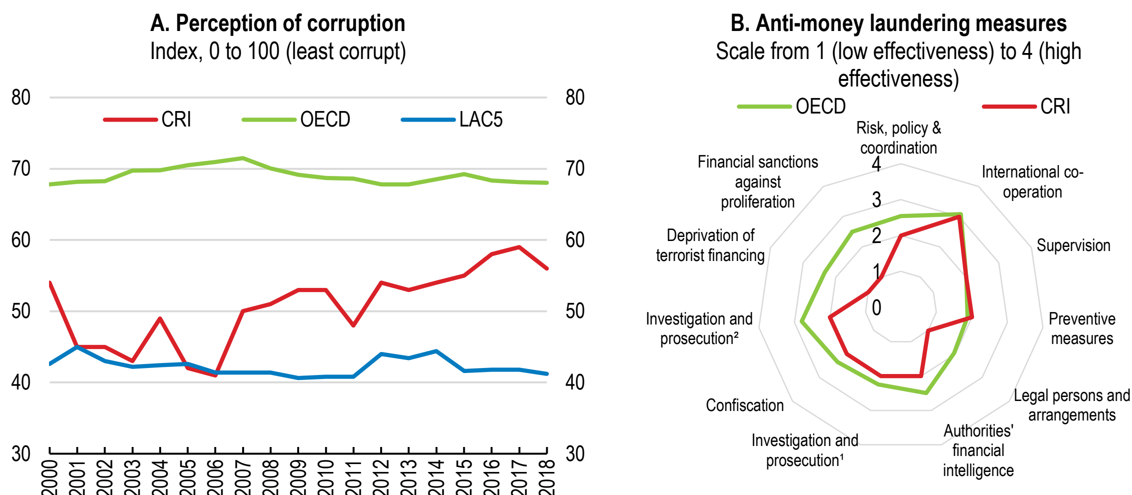
To attract private participation in financing and execution of infrastructure projects, both concessions and public-private partnerships (PPP) can be useful models. In the case of PPPs, projects should be chosen which represent good value for money. The literature and international experience suggest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

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

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

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

Figure 1.39. Corruption perceptions are relatively low



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

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

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

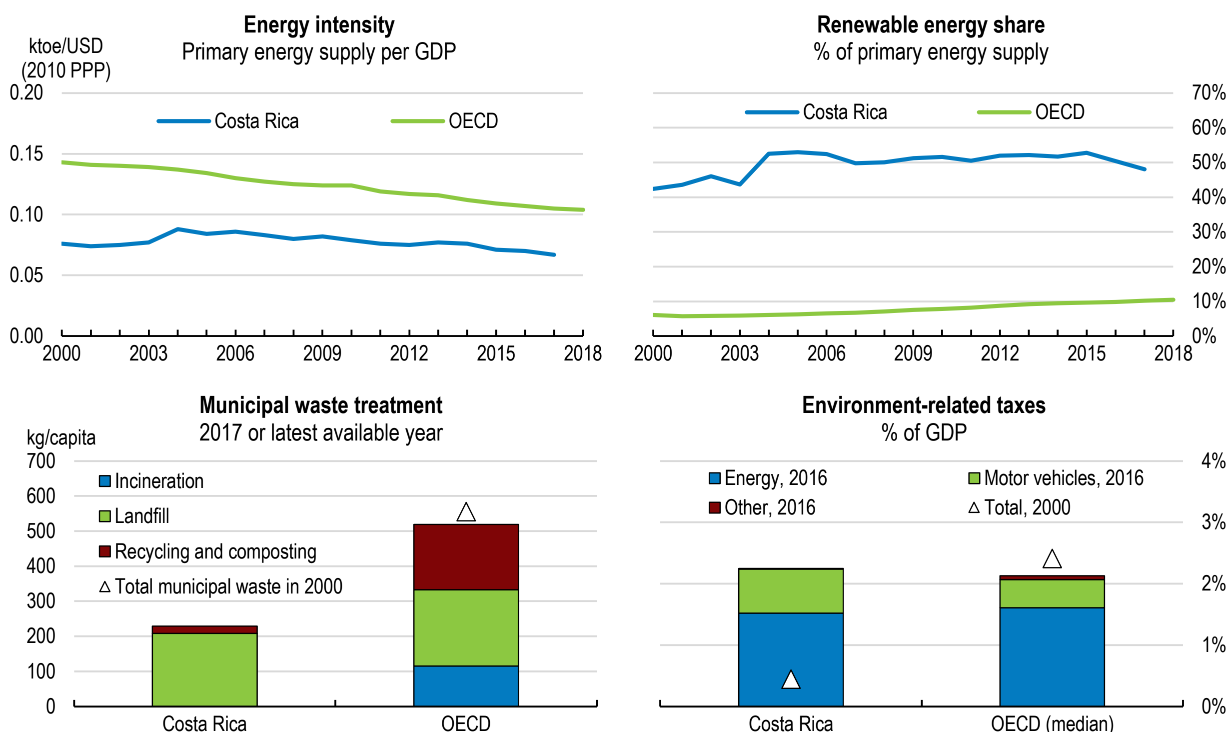
factors such as national economic interest do not influence the sanctioning of foreign bribery cases. It should also improve guidance and transparency for non-trial resolutions and collaboration agreements.

Green growth

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

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

Figure 1.40. Green growth indicators (selected)



Source: OECD Green Growth Indicators.

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

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

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

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

Table 1.14. Past OECD recommendations on green growth

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

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

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

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