A Successful Journey: Costa Rica’s Economic Reforms, 2015-2020

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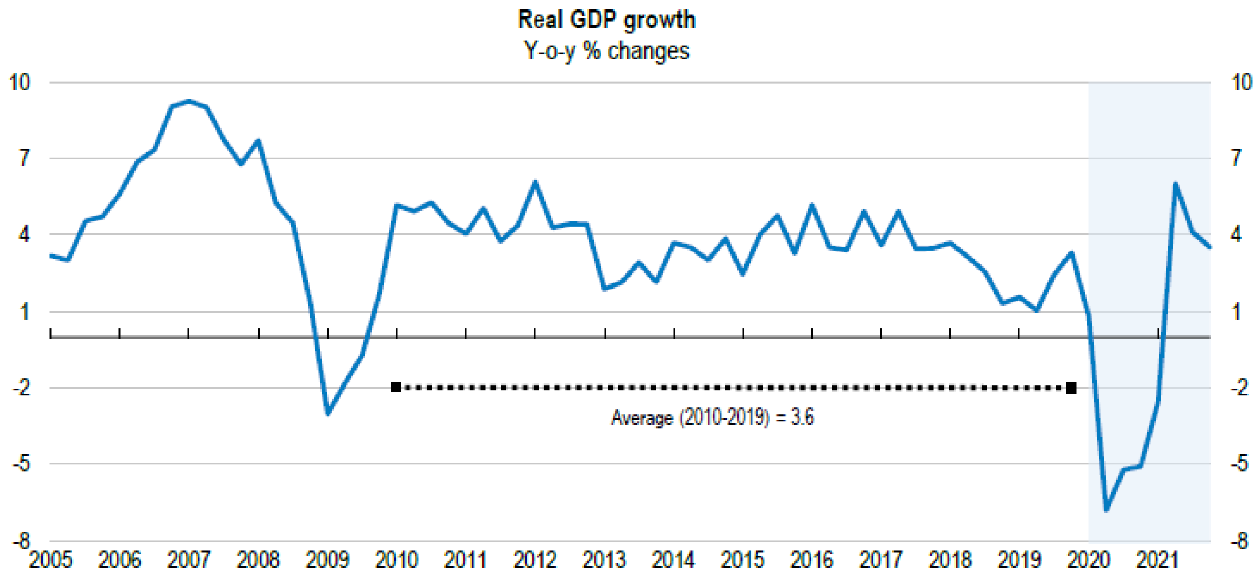
On 15 May 2020, Costa Rica was invited to join the OECD as its 38th member, marking the successful completion of a thorough review by the organisation, including three OECD Economic Surveys (OECD, 2016; OECD, 2018a; and OECD, 2020). This “journey” towards accession involved multiple reforms to boost the country’s economic growth and distribute its benefits to all Costa Ricans. Thanks to these ongoing reforms, Costa Rica is better prepared to confront the COVID-19 crisis and to boost its long-term growth.

Steady and resilient growth

With a strong commitment towards trade openness, Costa Rica has attracted large inflows of foreign direct investment, helping to move up the value chain and upgrade the composition of its exports. The country has also been a magnet of international tourism thanks to its rich natural capital, especially its biodiversity and rainforest, and policies to protect it. These factors, together with rising real incomes, have sustained steady and resilient growth, with quick rebounds following exogenous shocks (Figure 1). Real GDP per capita has consequently tripled over the past 30 years and reached nearly USD 20 000 in 2019, close to the Latin American average (OECD, 2018a).

The COVID-19 outbreak has however inflicted a severe hit to economic activity, jobs, and the well-being of Costa Ricans. Innovative policy measures introduced to provide cash and liquidity support to households and firms will help to avoid long-term damages. However, the return to a normal situation is mired with very large uncertainties and depend on epidemiological developments and the speed of the global recovery.

Figure 1: Despite external shocks, growth has been steady and resilient



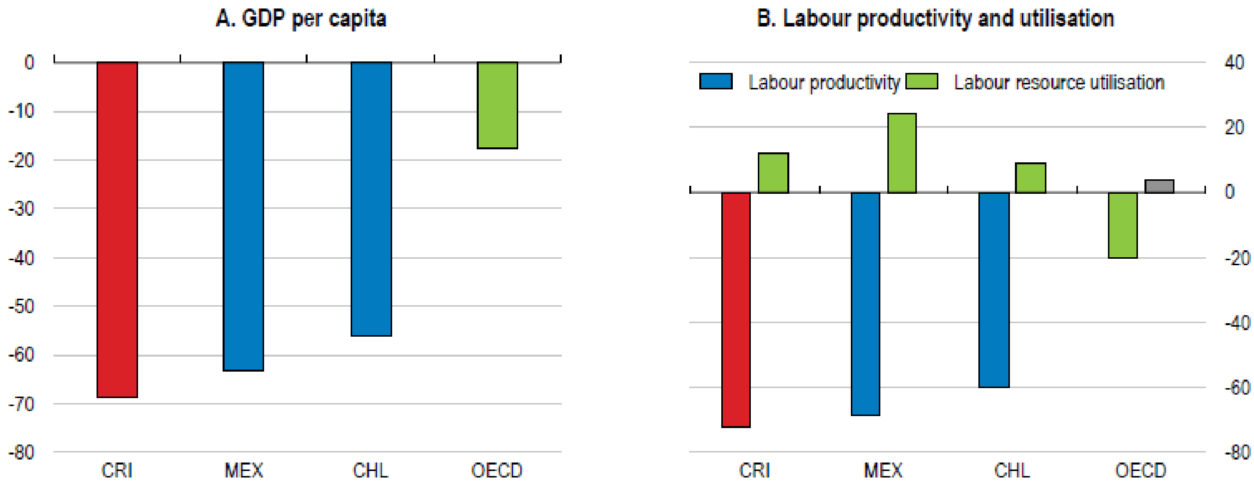
Note: Data for 2020 and 2021 reflect the "Single-hit" scenario described in the OECD Economic Survey of Costa Rica (2020).
Source: OECD Economic Outlook 107 database.

Recent reforms will boost the productivity of local firms

Apart from the coronavirus outbreak, Costa Rica faces several challenges to continue its past performance. The process of income convergence in emerging economies typically involves increasing productivity towards the "frontier" prevailing in advanced economies. However, in Costa Rica labour productivity growth has lagged peers for many years. Low productivity levels explain to a large extent the income gap with OECD countries (Figure 2). In 2016, GDP per hour worked was only USD 18.6 compared with an OECD average of USD 51.9 (OECD, 2018b).

Openness to foreign direct investment can help to revert these trends. Research published by the OECD shows a positive correlation between the presence of foreign firms and the productivity of local Costa Rican firms in both the manufacturing and the services sectors (OECD, 2018c). Research has also found that public policy to boost linkages between foreign-owned and local firms helps knowledge diffusion (Alfaro-Urena et al., 2019). Nonetheless, Costa Rica remains a dual economy, with a modern sector in free trade zones and traditional enterprises outside them. To boost aggregate productivity the government policy should therefore continue to stimulate the productivity of local firms.

Figure 2 – Low productivity explains the income gap with OECD countries



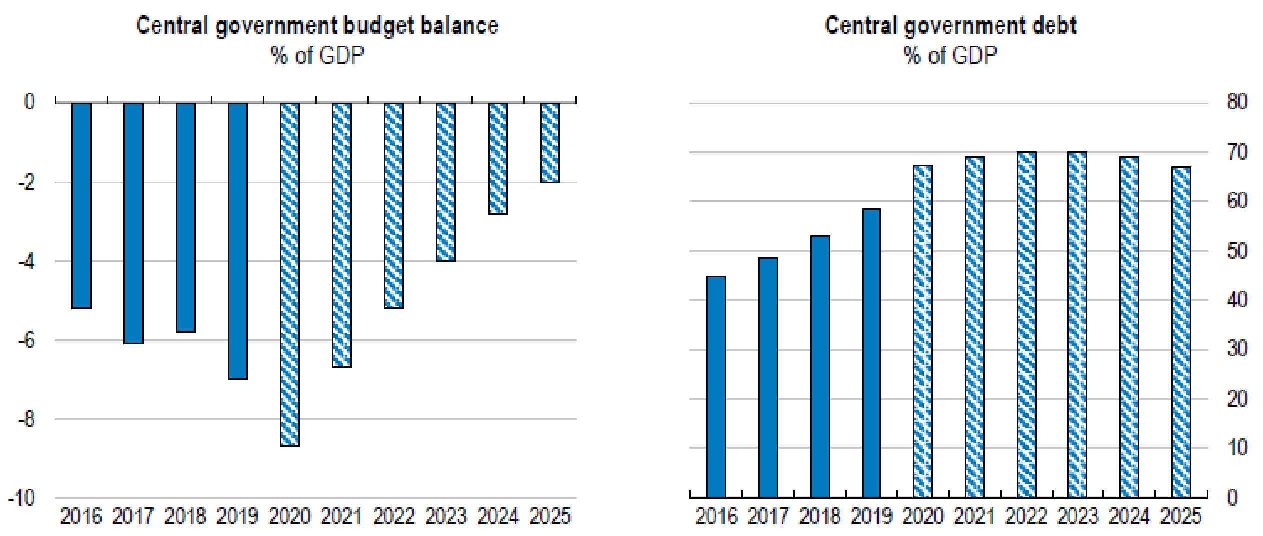
Note: Compared to the weighted average using population weights of the 18 OECD countries with highest GDP per capita in 2018 based on 2018 purchasing power parities (PPPs). The sum of the percentage difference in labour resource utilisation and labour productivity does not add up exactly to the GDP per capita difference since the decomposition is multiplicative.
Source: OECD National Accounts database; OECD Productivity database; and OECD Economic Outlook 107 database.

Recent reforms have sought to stimulate business dynamism by enhancing product-market competition and levelling the playing field between state-owned firms and the private sector. As a part of the OECD accession process, legislation adopted by Congress has strengthened the competition authorities and curtailed political interference in state-owned enterprises. Tentative estimates suggest that these two reforms, when fully implemented, could boost the level of GDP per capita by nearly 10% within 5 years – a very significant improvement (OECD, 2020). Closing existing gaps in transport infrastructure, particularly roads, would also have a large productivity pay-off (Pisu and Villabos, 2016).

A fiscal reform to address budgetary challenges

The COVID-19 crisis will increase budget deficits around the world. This along with large drops in nominal GDP will result in higher public debt ratios. Costa Rica is not an exception, with its budget deficit projected to reach 9% of GDP in 2020. This is a large deficit but is, to a large extent, attributable to the deteriorated fiscal position inherited from the past (Figure 3), which has limited the government's capacity to respond to the COVID-19 shock. Before the pandemic struck, high public debt and low ratings from credit agencies put Costa Rica's borrowing costs above those of peer Latin American countries. With fast-rising interest payments and large borrowing requirements (projected to reach 15% of GDP in 2021), government policy will need to focus once again on reducing the budget deficit.

Figure 3 – Full implementation of the fiscal reform would restore fiscal sustainability



Note: Data for 2020 onward are forecast.
Source: Costa Rica Finance Ministry.

The ambitious fiscal reform approved by Congress in December 2018 will provide the necessary framework to bring down public debt. The approval of this reform, which had been in the works for nearly two decades, has been a major step toward restoring fiscal sustainability. The legislation introduced a VAT system, more progressive income tax rates, and a spending rule constraining government outlays when public debt reaches specific thresholds. If fully implemented, the reform is expected to yield cumulated savings of 3.9 % of GDP over 2019–23. Policy efforts will need also to rationalise the remuneration of public sector workers, which has been growing above private sector wages for a long time, contributing to a high level of income inequality (González-Pandiella and Gabriel, 2017).

Costa Rica's journey towards OECD membership has already involved many important reforms, which have the potential to boost long-term economic growth and inclusiveness, and improve fiscal sustainability. But, achieving the OECD membership is not the end of the journey. As a member of the OECD, Costa Rica will be in a better position to design and implement better policies by exchanging views, policy lessons and best practices with other member countries. This can inform the national dialogue and political debates on policies to boost economic performance and share its benefits among all Costa Ricans. Other countries will also learn from Costa Rica's valuable experiences in areas such as attracting foreign direct investment, diversifying the exports basket, preserving natural resources or ecotourism, making it a really good journey for all.

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