

Tackling the three main challenges in Costa Rica: fiscal reform, reverting the slowdown in productivity and reducing inequality

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Costa Rica's economic, social and environmental achievements are impressive. It has succeeded in combining rising living standards, virtually universal health care, pension and primary education systems with sustainable use of natural resources. Incomes per capita have nearly doubled in real terms over the past three decades and some well-being indicators (health, environment and life-satisfaction) are comparable with or even above the OECD average. However, as the latest Economic Assessment of Costa Rica highlights the country faces old and new challenges that will need be addressed to continue developing in a sustainable way.

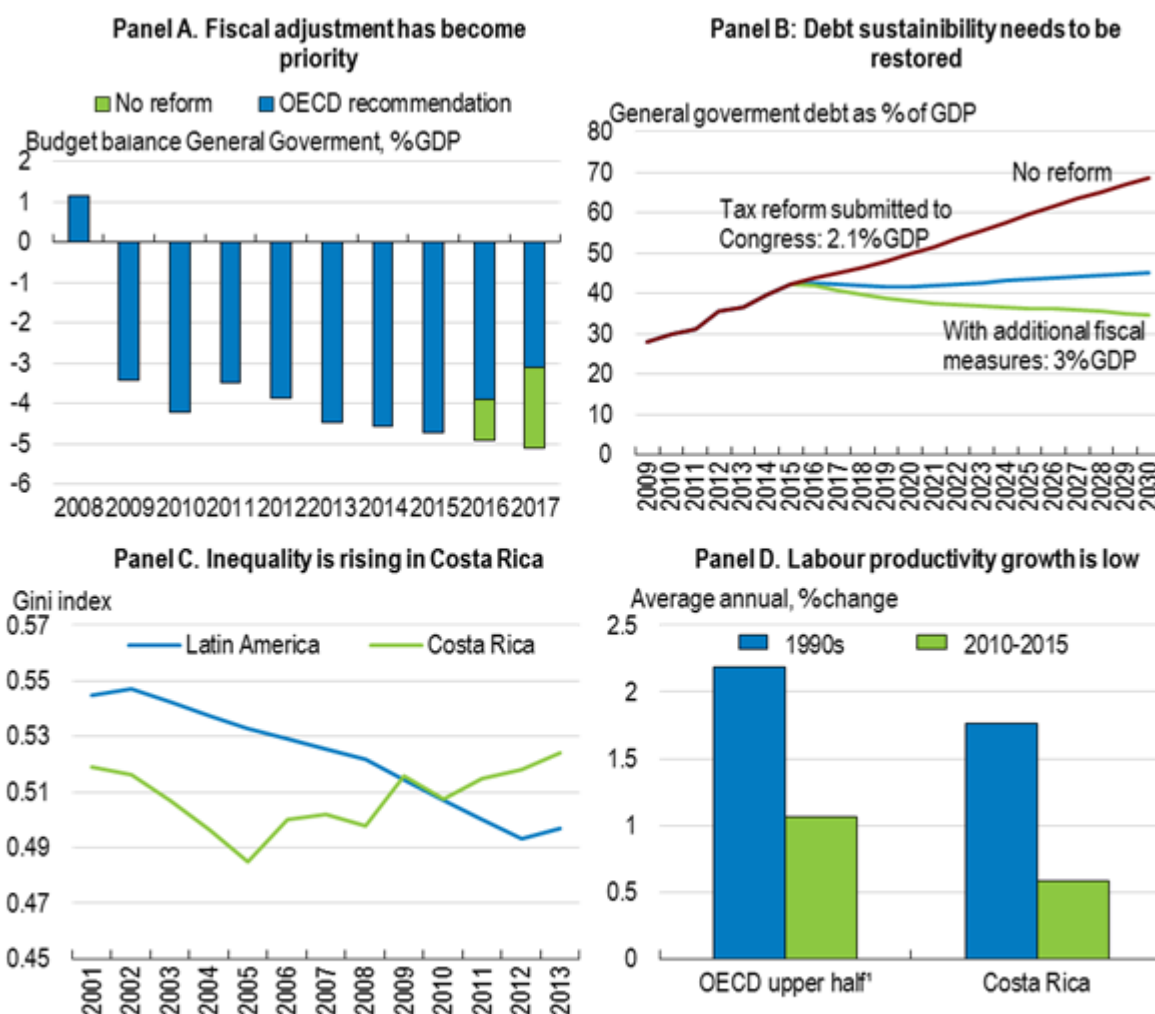
In the period 2008-2015, the public debt-GDP ratio almost doubled to 42.4% (Figure 1, Panel A and B) and interest payments on government debt rose from 15 to 19% of central government revenues. The budget deficit reached 6% of GDP in 2015. Measures to restore fiscal sustainability are now urgent.

In addition, Costa Rica faces long-standing structural problems:

- Inequality has been increasing since the mid-1990s to high levels by OECD standards. This is in stark contrast with many other Latin American economies, which have

recently made significant progress in reducing inequality and poverty (Figure 1, Panel C).

- Labour productivity growth has been disappointing mainly because of sluggish technical progress. This has taken place despite policies promoting international markets openness and attracting foreign direct investment (FDI) inflows (Figure 1, Panel D).



1. OECD refers to the 17 upper half countries based on GDP per capita; GDP is expressed in 2011 PPP.

Source: OECD (2016), OECD EO99 database; OECD calculations based on the Conference Board Total Economy Database.

How can policymakers address the three challenges?

The fiscal challenge is the priority. The two bills the government proposed in 2015 – as part of a tax reform package – to replace the sales tax with a full-fledged VAT system and reform the income tax are still under discussion in the legislative assembly. It is urgent to approve them as soon as

possible. The VAT and the income tax reform would cut the deficit by about 2% of GDP over the following two years (mostly due to the introduction of the VAT) and would help stabilise the debt-GDP ratio. The two bills are well thought out and consistent with OECD advice: broadening tax bases and relying more on VAT are growth friendly ways to raise tax receipts. Also, most OECD countries have VAT systems, including Mexico and Chile. Additional fiscal or expenditure control measures of 1% of GDP will be needed to put debt on a firm downward path (Figure 1, Panel B). These should focus on reforming the public employment system to prevent excessive automatic salaries increases and raise public sector efficiency. Reforming the public employment system is key to boost productivity and lower inequality as public administration inefficiencies hamper business dynamism and public sector employment contributes to rising inequality in Costa Rica.

Structural reforms and institutional changes are necessary to increase productivity and build a more inclusive society by reducing inequality and poverty.

The three main areas of reforms to boost productivity include: 1) improving the framework of competition policy by strengthening the power of the competition authority and improving the governance of state-owned enterprises, which play a dominant role in many key sectors such as banking, electricity, insurance and telecoms; 2) enhancing links between the foreign and domestic firms and encouraging innovation by local enterprises through better links with universities; 3) improving transport infrastructure by simplifying the sector institutional framework and accelerating project execution.

Reforms to increase productivity need to go hand in hand with making Costa Rica a more inclusive society, especially for women. This will require improving the quality of education – and not just increasing spending on it – enhancing the

effectiveness of cash transfers– by reducing programmes' fragmentation and improving targeting – and lowering informality – by strengthening enforcement, reducing administrative burdens to entrepreneurship and enabling the poor to become formal workers. Costa Rica should also reinforce environmental protection by reducing emissions from the transport sector and improving wastewater treatment.

Find out more:

OECD (2016a), *OECD Economic Surveys: Costa Rica 2016*, OECD Publishing, Paris.