Economic and Financial Reform in Costa Rica: Challenges and Opportunities to 2025

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This paper begins with a brief review of Costa Rica's history, vital statistics, and recent economic and political highlights. Costa Rica, a small tropical country located in a politically and economically challenged region, is without the benefit of world-class domestic resource and manufacturing sectors. Using a well-known framework to assess the performance of a national economy within the context of the wider global economy, I identify the strengths and weaknesses of the Costa Rican economy, that, in turn, need to be exploited or addressed to the end of enhancing the performance of the economy and future living standards.

INTRODUCTION

While Europe continues to struggle with its sovereign debt crisis and the United States economy generates only anemic growth in the wake of the Great Recession that continues to be accompanied by persistently high rates of unemployment and dysfunctional fiscal and monetary policies, Latin America has been experiencing impressive growth since 2004, with only a brief downturn in 2009 (United Nations, 2011). This is most likely the result of "more pragmatic policies, including flexible exchange rates, inflation targeting by more or less independent central banks, more responsible fiscal policies, and tighter regulation of banks, as well as social policies aimed at the poor" (Reid, 2010, p.3).

The favorable international economic environment until 2008 along with more responsible economic policies and/or improvements in the legal and tax environments for business in some countries in Latin America, i.e., Brazil, Chile (and most recently in Peru), resulted in higher economic growth rates and improved living standards. In fact, the eight years to 2011 were Latin America's best since the 1960s and 1970s, with economic growth averaging 4.2% per year and inflation generally in single digits (United Nations, 2011).

However, in countries such as Argentina, Bolivia, Ecuador, and, of course, Venezuela, ideologically left and populist policies have raised political tensions and have triggered discontent among large swaths of the population. While these policies may have contributed to short-term gains for some segments of the population, they have introduced some deep-rooted distortions into the economy which are unfavorable for long-term growth, and that are likely to impair the improvement in future living standards. The most obvious example of this is Venezuela where, throughout the last decade, annual inflation, every year, has been in double digits, and net foreign direct investment has been negligible, and even negative in four out of the last six years (United Nations, 2011).

In Argentina, official rates of inflation have such low credibility that The Economist magazine stopped publishing these highly suspect statistics in its weekly Economic and Financial Indicators.

(Please see the source material accompanying the indicators in the issues published since mid-2012). On the same subject, most recently, the International Monetary Fund warned Argentina that it risks expulsion if it fails to publish accurate inflation data (Financial Times, 2012).

This paper begins with an overview of Costa Rica's vital statistics that provide some measures of the nation's relative material wellbeing as compared with some of its regional neighbors. In addition, I review the historical political landscape that influenced the creation of some of the unique attributes that characterize Costa Rica, the current -- both domestic and international -- political environment that affects the performance of the Costa Rican economy, and then some of the major economic and political events of the last few years that have shaped the country's economic and financial policies. Part 2 provides a review of some recent research regarding some of the "ingredients" judged to be important for a well-performing national economy that is participating in the wider global economy in the second decade of the 21st century. These "ingredients" are used in the next section to assess the current state of the Costa Rican economy -- both its strengths and weaknesses. I conclude by examining ways that the country can draw on its strengths to reinforce and expand its adhesion to the global economy to the end of improving the performance of its economy and increasing living standards for all segments of the population.

PART 1. VITAL STATISTICS, THE (PAST AND PRESENT) POLITICAL LANDSCAPE, RECENT ECONOMIC AND POLITICAL HIGHLIGHTS, AND A BRIEF OVERVIEW OF THE REGION

Vital Statistics

Costa Rica is a tropical country located on the isthmus of Central America between the Caribbean Sea to the east, the Pacific Ocean to the west, and between Nicaragua to the north and Panama to the southeast, lying between 8-12 degrees north of the equator. The country has a total area of around 51,100 sq km, slightly smaller than the US state of West Virginia. In 2011, Costa Rica's population was approximately 4.6 million people, its population growth rate was estimated at 1.3% per annum (p.a.) -- somewhat below the Latin America average of 1.6% p.a. -- and the country continues to experience net **in-**migration, mostly from Nicaragua, both legal and illegal. (According to the US Central Intelligence Agency (2012), there are an estimated 300,000-500,000 legal and illegal Nicaraguans in Costa Rica, comprising about 9% of the population).

Life expectancy in 2011 was reported at 77.9 years, higher than in the US, and the infant mortality rate in Costa Rica was 9.45 per 1000 live births, as compared to 6.06 in the US. Almost two-thirds of Costa Ricans live in urban areas, and the rate of urbanization is 2.1% p.a. The country's ethnic breakdown is 94% white (including mestizo), 3% black, 1% Amerindian, and 1% Chinese. Costa Rica boasts greater than 95% literacy for those 15 and older, and in 2009 the country spent 6.3% of its GDP on education (Central Intelligence Agency, 2012). The World Bank classifies Costa Rica as a middle-income country, and per capita GDP in 2011 was estimated at $11,900 US on a purchasing power parity (ppp) basis (Central Intelligence Agency, 2012).

With respect to the composition of GDP during the 2006-11 interval, agriculture accounted for 6.3% of GDP (but employed 14% of the approximately 2.16m people in the labor force, a figure that excludes Nicaraguans living in Costa Rica); industry for 22% of GDP; and services for approximately 72% of GDP. In 2011, official unemployment was above 7.5%, and Gross Fixed Investment as a percentage of 2011 GDP was reported at 21.3%, a rate that would be consistent with moderate growth in future living standards.

The Past and Present Political Landscape

On his fourth voyage to the New World in 1502, Christopher Columbus "discovered" and named Costa Rica. Throughout colonial times Costa Rica was contained in the Captaincy General of Guatemala. The absence of large deposits of mineral resources and of an abundant indigenous supply of labor that could be profitably exploited relegated the province to the status of a "poor relation" relative to Spain's other territories in the hemisphere, but at the same time this contributed to the development of a relatively homogeneous and egalitarian -- though poor and isolated -- society (EIU, 2008). As a result, early on, relative to its neighbors, Costa Rica became a "rural democracy" since the province was composed of small farmers working their own land rather than the more usual establishment of large haciendas staffed by forced labor.

Central America gained independence from Spain in 1821, and Costa Rica soon became a province of the newly formed Federal Republic of Central America. Once again its relative isolation from the seat of power provided unintended benefits for Costa Rica: as a result of poor communications links and considerable distance from Guatemala City to the Central Plateau (where most of the population lived), residents of Costa Rica had little affiliation with, and less allegiance to, the seat of government of the Federal Republic. Therefore, after the collapse of the Federation in 1838 and after resolving internal political differences, Costa Rica formally declared its independence in 1848.

Either by chance or design, even after becoming a sovereign country, Costa Rica consistently resisted deeper political ties with her Central American neighbors, frustrating efforts for greater regional integration. With the ratification of the Dominican Republic-Central American Free Trade Agreement (DR-CAFTA) in 2007, this policy of "benign" or "deliberate" neglect of the region may have come to an end. (More about this below).

Independence brought economic prosperity and a liberal political and institutional framework. The second half of the 19th century brought economic development: the large-scale production and export of coffee (1830s) and bananas (1880s); the introduction of commercial banking (1830s); and the construction of the railway (1870s-1880s).

Since the beginning of the 20th century civilian rule was interrupted only twice: a short military dictatorship in 1917-19, and a brief civil war in 1948. In the former, after the dictator, General Federico Tinoco Granados, was overthrown and exiled, the military declined in size, resources, and political clout. In the latter, an armed uprising following a disputed presidential election in 1948 led to a 44-day civil war, that resulting in more than 2,000 dead, and was the most violent event in Costa Rica during the 20th century.

The rebels, led by José Figueres Ferrer, formed a government junta that oversaw a new constitution drafted by a democratically elected assembly, one of whose articles abolished the military entirely. (In 1993 Costa Rica went further and proclaimed permanent neutrality). Uncharacteristically for Central and South America, since the first democratic elections in 1953, the international community has judged all the successive elections fair and peaceful. Costa Rica's long period of unbroken democracy, is arguably considered the most stable democracy in Latin America, and it is often referred to as the "Switzerland of Latin America" (O'Grady, 2011).

Between 1948-2006, over an interval of more than 50 years, Costa Rica was governed by two main political parties: the center-left PLN, the Partido Liberación Nacional and the center-right PUSC, the Partido Unidad Social Cristiana. The left-of-center PAC, the Partido de Acción Ciudadana, a faction of the PLN, was created in 2000 as a result of voters' disillusionment with the two mainstream parties over legislative gridlock and made gains in the wake of a series of high-level corruption scandals in 2004. Even with this relative instability since 2000, because consensus is so highly valued and so much a part of the social fabric of the country, there are few substantive policy differences between the major parties. Consequently, the country has remained stable despite the changes in the party system (EIU, 2008).

Recent Economic and Political Highlights

In recent decades -- since 1990 -- the PLN has been torn between its technocratic branch with its convictions firmly planted in market-oriented policies and those favoring a return to the traditional "statist" policies of the center-left. Oscar Aries, who was awarded the 1987 Nobel Prize for Peace for his role in pacifying Central America after two decades of civil wars, has served two terms as president, from 1986-90 and, again, from 2006-2010. He played an indispensable role in shepherding Costa Rica's ratification of the long-delayed DR-CAFTA treaty through a national referendum. (More about this below). On the other hand, Ottori Solís, the founding leader of the PAC, has steadfastly opposed the treaty because of the changes in national law that would be required in order to bring Costa Rica into compliance with the treaty. (More about this, too, below).

In October 2007, in a first-ever national referendum, Costa Rican voters narrowly approved the DR-CAFTA treaty -- concluded in 2004 -- that will lead, over time, to the elimination of almost all tariffs on exports to the United States. In return, Costa Rica has agreed to improve protections of intellectual property rights, and obliges Costa Rica to open its telecoms, electricity, and insurance sectors to competition that have historically operated as state monopolies. Opposition to ratification was centered mostly in the labor unions, which opposed opening these sectors to competition.

The next stage is the implementation of the treaty that requires the approval of 13 pieces of legislation that would bring national law into compliance with the treaty's provisions (Thomson, 2007). During the remainder of the second Arias administration the focus was on formulating investor-friendly policies and improving social welfare measures through increased spending on education, pensions, and health care.

In May 2010, an Arias protégée, Laura Chinchilla was installed as Costa Rica's first woman president. A social conservative, she opposes gay marriage and the disestablishment of the church, in addition to supporting restrictions on abortion and the morning-after pill, and she has allocated more funds to the police to combat recent outbreaks of violent crime triggered by increased inequality (say the left) and drug gangs (say the right).

In addition, President Chinchilla favors more funding for education, improving the business environment to attract foreign direct investment particularly in the semi-conductor and medical equipment sectors, as well as attending to the "unfinished business" regarding amending Costa Rica's remaining laws that are incompatible with the DR-CAFTA treaty (The Economist, 2010).

Most recently, the centerpiece of the president's economic agenda -- a comprehensive fiscal reform program that includes a major tax overhaul -- looks doubtful for passage in the legislature owing to the ruling party's loss of control in the legislature, the government's strained relations with the opposition, and the growing unhappiness of most Costa Ricans with the President's performance that was exacerbated by a series of corruption scandals in her government. Of those polled in July 2012, 75% responded that the government is corrupt (EIU, 2012c). (More about this below).

Central America: A Brief Overview of Costa Rica's Neighborhood

As was mentioned above Costa Rica has historically resisted forging strong ties with its neighbors. The data presented in Table 1, below, provides some justification for the country's apparent aloofness from the other Central American countries.

According to The Economist (2011), the isthmus of Central America is the "most routinely murderous region on earth". Living in a "bad neighborhood" has almost doubled Costa Rica's homicide rate over the decade, and is one of the reasons addressing gang (and drug) -related violence is such a "front burner" issue for Costa Rica, as was mentioned above.

Natural disasters are also part of the landscape. Four of the seven countries in the region have been classified as among the most vulnerable in the world to destructive weather or other acts of nature including hurricanes, floods, landslides, earthquakes, and volcanic eruptions (The Economist, 2011).

And then, of course, there is the human condition illustrated by the data in Table 1, where, clearly, Costa Rica appears to be much better off, judging by the respective poverty rates and years of schooling relative to the rest of the region. (Panama, too, has better "vital statistics" than most of the other Central American countries, but readers should recall that Panama has historically had much stronger ties -- for better or for worse -- with the US).

Civil wars plagued many Central American countries during the 1970s and 1980s that were linked to the then ongoing Cold War between the US and the Soviet Union with the dictators being backed by the former, and the guerrillas supported by the Soviet Union and its regional proxy, Cuba.

TABLE 1
CENTRAL AMERICA: A SNAPSHOT OF THE REGION[a]

Country	GDP Per Capita (2011 US$, ppp)	Population (millions)	Poverty Rate (% of pop.)	Years of Schooling (average)	Homicide Rate[b] (per 100,000 pop.)
Belize	8,200	0.3	na	9.2	32
Costa Rica	**11,900**	**4.6**	**18.9**	**8.3**	**10**
El Salvador	7,500	5.7	47.9	7.7	60
Guatemala	5,100	14.0	54.8	4.1	45
Honduras	4,400	7.5	68.9	6.5	65
Nicaragua	3,200	5.7	61.9	5.7	10
Panama	14,100	3.5	26.4	9.4	22

a. Latest available data
b. Approximate
Sources: Central Intelligence Agency (2012); The Economist (2011)

Over the last decade, Central America has been in the frontline of the drugs trade and organized crime since it is wedged in between the world's largest cocaine-producing countries (Colombia, Peru, and Bolivia) and the world's largest consumer market for cocaine, the United States. In addition to the increased violence and insecurity that accompanies the drugs trade, according to the World Bank, the economic cost imposed on the economies of the region by the drug-related crime and violence has been estimated at approximately 8% of the region's GDP, about **twice** the relative cost of the US's annual defense budget (The Economist, 2011).

PART 2. THE METHODOLOGICAL FRAMEWORK

Before discussing the areas in which reform will be needed to improve the long-term performance of the Costa Rican economy to the end of raising living standards, it is worthwhile reviewing some of the alternative "paths to prosperity" that have been proposed by the leading development experts -- individuals and institutions -- over the last half century.

The ideas of Raúl Prebisch (1959) and Hans Singer (1964) provided the intellectual firepower for the development blueprint anchored in "import substitution" because their thesis was based on the declining terms of trade for primary products and the dynamic benefits to the economy of a vibrant manufacturing sector. These concepts became operational policy in most of South America in the 1960s-70s, ensuring a large and growing role of the state in the economy through supportive taxes and subsidies if not direct ownership of productive capacity.

The role of state involvement in the economy for development purposes that is a corollary of the Prebisch-Singer thesis was actually the foundation of the work proposed earlier by Paul Rosenstein-Rodan (1943) and P.C. Mahalanobis (1955), which stressed increasing returns to scale and kick-starting growth through large-scale investments, and accelerating economic development by government encouragement of heavy industry, respectively.

These "inward" winds of economic development shifted in favor of more "outward" and "market-oriented" strategies that were advanced during the 1970s by Balassa (1971), Bhagwati (1978), Krueger (1978), and Little, Scitovsky, and Scott (1970). The "market-based" approach to improving the performance of the economy and to enhancing living standards reached its zenith with the views of a group of Latin American economists and policymakers, the World Bank (1991), and various academic and "think tank" development experts such as John Williamson (1994) with the so called "Washington Consensus" of the 1990s.

For example, in its 1991 World Development Report, the World Bank articulated four broad requirements that characterize a national economy as "battle ready" to meet the challenges of the fiercely competitive world economy. They included:

A. A stable macro-economy characterized by both fiscal and external balance and low and stable inflation;
B. the adoption of a competitive micro-economy that includes a substantial reduction in state ownership and management of productive assets and the elimination of price distorting subsidies and taxes;
C. strong global linkages that include adherence to GATT (now the WTO), low and uniform tariff rates, absence of non-tariff barriers, a uniform and market-determined exchange rate, a liberalization of the rules governing capital flows and direct foreign investment, and;
D. an active government policy that promotes social and economic investment, especially in the areas of education, infrastructure, and health.

In its 1997 World Development Report (World Bank, 1997), the Bank expanded the reach of the fourth requirement to include the promotion and enforcement of property rights, reducing the level of corruption in the country, and ensuring a reliable legal system -- some of the so-called “second tier” reforms.

The “Washington Consensus” (WC), which was originally compiled in 1990 and published by John Williamson (1994), enumerated a list of desirable conditions that, if adopted and adhered to, would, over time, put reforming countries on the path to success in the global economy. (Please see Table 2, below, for a list of its main points). Since the late 1990s, because of its alleged failure to address the issue of poverty reduction directly, the Washington Consensus was subjected to heated intellectual debate within academia and the major international organizations such as the World Bank (Beattie, 2000). Nevertheless, this framework continued to assume a central role in the debate on development strategies for low- and middle-income developing countries during the first decade of the 21st century. (Readers interested in this debate are referred to Rodrik (2010) for an up-to-date review of this subject).

In light of the experience of the late 1990s (increasing poverty rates and stalled economic growth due to an adverse external environment), proponents of the Washington Consensus amended the original framework to ensure that fiscal policy is counter-cyclical to support economic growth in an economic downturn, and to focus on reducing income inequality by ensuring that the poor have access to assets, i.e., education, land titling, micro-credit and land reform, that will enable them to work themselves out of poverty (Williamson, 2003).

TABLE 2
MODIFIED "WASHINGTON CONSENSUS"

A. Fiscal and monetary discipline
B. Redirection of public expenditure priorities towards health, education, and infrastructure
C. Tax reform and improved tax administration
D. Unified and competitive exchange rates
E. Modernization of government and "quasi" government institutions
F. Deregulation
G. Trade liberalization and regional integration
H. Privatization
I. Elimination of barriers to direct foreign investment
J. Banking reform and financial liberalization

While the "reform decade" of the 1990s did restore growth in GDP and GDP per capita in Latin America when compared with the "lost decade" of the 1980s -- growth in GDP and GDP per capita from 1991-98 was 3.5% and 1.7% p.a., respectively compared with 1.0% and -1.0% p.a. in the 1980s (United Nations, 1998) -- many observers of Latin America contended that the "neo-liberal" reforms of the 1990s have not only "failed to deliver sustained growth, but have made the region more vulnerable and increased unemployment, poverty and inequality. As a result of all this, some political pundits asserted that Latin America was sinking back into populism and/or anti-market leftist nationalism" (The Economist, 2003). At the end of 2012, this last statement is borne out for many countries in South America, in particular Argentina, Bolivia, Ecuador, and Venezuela.

In a recent review article of economic development blueprints, Dani Rodrik (2010) reviewed the experience of China, which over the last three decades arguably has had the most successful growth and poverty reduction program in recorded history, and notes that there does not appear to be any single orthodox Western economic plan that was adhered to by Chinese economists and policymakers. Rodrik also observed that even in (now prosperous) Chile -- which was recently admitted to the Paris-based club of "rich" countries, the Organization of Economic Cooperation and Development (OECD) -- during the 1970s-80s a strict universally scripted development plan was abandoned and a more heterodox (and indigenously articulated) strategy was adopted even during the tense Pinochet era.

It now appears, according to Rodrik, that a more fruitful approach to prescribing a successful path to economic growth and development is one that is based on "diagnostics', as proposed recently by Hausmann, Rodrik, and Velasco (2008) and Hausmann, Klinger, and Wagner (2008). In place of a "boiler plate" set of rules and a rigid, unyielding approach to growth these development economists propose to identify a country's binding constraints and then prioritize the policy reforms given the political and social realities of the country involved. These authors argue that the earlier, carefully scripted paths to growth and development have not lived up to their expectations:

> "The currently prevailing view, as reflected in the World Bank's (2005) report on the lessons from the 1990s or by the blue-ribbon Commission on Growth and Development (2008), accepts the importance of outward orientation but places much less emphasis on trade liberalization and is much more willing to condone a measure of industrial promotion in order to achieve and sustain high growth" (Rodrik, 2010; p. 40).

Rodrik praised China's so-far successful development approach of grafting a market system on top of a heavily regulated state sector (that was the orthodoxy of an abandoned Communist economic system) with China's development plan evolving over time as their binding constraints change: first in agriculture; then in industry; then in foreign trade; and eventually in finance, the environment, and pension reform.

It is important to note that despite its impressive poverty reduction cum economic growth program now in its fourth decade, China enjoys enormous leverage in the world because of its population of 1.4bn people -- almost 20% of the world's population -- that is increasingly willing and able to become "21st century consumers". China's voracious appetite for fuel and nonfuel minerals (Sohn, 2008a; Sohn, 2008b), "first world" foods and diets, electricity and other infrastructure goods, along with its abundant and still relatively inexpensive labor force provides it with enormous "monopoly-like" and "monopsony-like" power on world resource, factor, and product markets. For example, China's policy regarding "local content" requirements for equipment used in the production of wind energy, the "Notice 1204" directive, is certain to be in violation of World Trading Organization rules. The directive has since been revoked, but not before its major objectives were achieved (Bradsher, 2010). The market access that it provides for the goods and services of global companies confers on China tremendous leverage regarding the terms it dictates for foreign (inward and outward) investment, the aid programs it operates, its carefully-controlled foreign exchange and capital account regimes, and, above all, its (lightly criticized and) stunted state of political and human rights best exemplified by the official treatment of Chinese dissident Liu Xiaobo, the 2010 recipient of the Nobel Peace Prize.

To be sure, particularly in the wake of the 2008-9 global financial crisis and the need for substantial global rebalancing, China’s trade, savings, investment, capital account, and exchange rate policies are exacerbating the adjustments that are needed and increasing the political and diplomatic tensions in the world. The jury is still out as to whether China’s one-party political system can be maintained in light of ongoing globalization and technological change.

Nevertheless, over the last few years, after a prolonged internal debate, even the thinking of the International Monetary Fund, in juxtaposing the harsh economic and financial consequences of the 1997-98 Asian crisis with the relative calm in China in the aftermath of the 2008-09 global financial crisis, has evolved on the need for, and desirability of, capital account liberalization as the complement of already liberalized current accounts for developing countries. This new ‘institutional view’ recognizes that liberalizing “developing countries capital accounts before they have reached a certain level of financial and institutional development is highly risky” (Plender, 2012).

Recently Daron Acemoglu and James Robinson argued in favor of the critical role played by economic institutions in explaining the enormous differences in living standards across the world (Acemoglu and Robinson, 2012). They contend that these institutions determine the economic incentives and the resulting allocation of resources, investment, and innovations needed for growth. Ultimately, it is politics that shape these institutions and their evolution. It will, of course, be interesting to track, during the next few decades, the evolution of China’s political system, and if the changes that are introduced support the “right” economic institutions as argued by Acemoglu and Robinson.

In the next section -- which takes the measure of the Costa Rican economy -- I rely heavily on the “ingredients” prescribed in the market-based and outward-looking approach to economic growth and development noted in the above-mentioned World Bank reports, while at the same time being mindful to incorporate the contributions made by those advocating a more tailored approach to development that identifies binding national constraints and priorities in the quest for economic modernization over the next two decades, in addition to the important role of institutions as stressed by Acemoglu and Robinson that was discussed above.

PART 3. THE STATE OF THE COSTA RICAN ECONOMY: STRENGTHS AND WEAKNESSES

Macroeconomic Stability

With a view towards improving the performance of the Costa Rican economy during the next decade it is useful to take the measure of the current state of the economy following the World Bank’s “recipe” articulated in the early 1990s and described in Part 2, above. The first of the four broad requirements needed for a well performing national economy is macro-economic stability, generally characterized by both fiscal and external balance, low and stable inflation, and high levels of employment.

Before examining the above macroeconomic variables over the last five years it would be of interest to note how the Costa Rican economy actually performed over the time frame, that is, actual GDP growth from 2007-11. According to the data reported by the United Nations (2011) and United Nations (2012), real GDP growth slowed dramatically from 2007 to the end of the decade (Please see Table 3, below). The much higher rates reported for 2005-06, 5.9% and 8.8%, respectively (that do not appear in Table 3) and for 2007 (7.9%) are no doubt due to the booming world economy, and in particular, strong growth in the US, which is Costa Rica’s major trade and investment partner. GDP growth fell off sharply in 2008 with the onset of the US and global slowdown, and in 2009 the economy contracted by 1.3% in the aftermath of the housing and financial sector problems in the US and the EU, but by 2010 and 2011 growth was restored, though it was still below regional GDP growth in the 33 countries included in the Latin American and Caribbean region as the US emerged from the its worst recession since the 1930s (United Nations, 2011).

TABLE 3
RECENT MACROECONOMIC DATA: COSTA RICA AND LATIN AMERICA, 2007-2011

Macroeconomic Variable		2007	2008	2009	2010	2011
Gross Domestic Product (annual % change)						
	Costa Rica	7.9	2.7	-1.3	4.2	4.2
	Latin America	5.6	4.0	-2.0	5.9	4.3
Gross Fixed Capital Formation (% of GDP)						
	Costa Rica	20.9	22.6	20.6	20.0	21.3
	Latin America	21.0	22.1	20.5	21.9	22.7
Central Government Balance (% of GDP)						
	Costa Rica	0.6	0.2	-3.4	-5.2	-4.1
	Latin America	0.3	-0.8	-3.4	-2.3	-2.2
Consumer Prices (annual % change)						
	Costa Rica	10.8	13.9	4.0	5.8	4.7
	Latin America	6.5	8.1	4.6	6.5	6.9
Urban Unemployment Rate (avg. annual %)						
	Costa Rica	4.8	4.8	8.5	7.1	7.7
	Latin America	7.9	7.3	8.1	7.3	6.7
Employment Rate[a] (average annual rate)						
	Costa Rica	54.4	53.9	55.4	54.8	56.0
	Latin America	54.2	54.5	54.2	54.9	55.4
Central Government Budget (% of GDP):						
	Total Revenue					
	Costa Rica	na	na	14.0	14.4	14.6
	Latin America	na	na	23.6	23.8	24.2
	Total Expenditure					
	Costa Rica	na	na	17.4	19.1	18.7
	Latin America	na	na	26.9	26.1	26.4

a. Employed population as a percentage of working age population
Sources: United Nations (2011); United Nations (2012)

Examining some of the other macroeconomic components in Table 3 reveal some of the problems that need to be addressed by Costa Rican political leaders and policy-makers. For example, since the 2009 recession the central government fiscal deficit has been increasing, though it receded to 4.1% of GDP in 2011 because of improvements in tax collection and stronger actual than projected GDP growth. Most analysts attribute this deficit to a structural weakness: total revenue as a percent of GDP raised by the government is the lowest in the region, save Guatemala, and is considerably below the already low regional average (United Nations, 2011). This, of course, results in higher public debt ratios that, in turn, have adverse consequences for future growth prospects. These serial problems are discussed in detail below.

Over the last decade Costa Rica's main policy failure in the sphere of macroeconomic management has been the inability to implement comprehensive fiscal reform that would -- over time -- eliminate the structural budget deficit and stabilize the public debt as a percentage of GDP whose growth is reducing the growth prospects as private sector investment risks being "crowded-out" in the domestic credit markets because of increasing interest rates.

While part of this results from the need to increase public sector revenue (please see Table 3, above), an issue that can eventually be resolved in the political process, another impediment to closing the deficit is constitutionally driven: many public agencies are legally entitled to a share of government revenue, reducing the government's flexibility to modify its budgetary allocations (EIU, 2008).

The need to increase government revenue, mainly through increasing tax revenue, has become more critical in the wake of an expected reduction in government tariff revenue as the DR-CAFTA treaty, ratified in 2007, is implemented over the next few years. Since the fiscal reform initiative began many "trial balloons" have been floated to the end of increasing tax revenue: introducing a universal income tax that treats all income equally and applies the same tax rate to all sources of income; a value-added tax (VAT) to replace existing sales taxes that would also be applied to services which are currently exempted; introducing a 15% income tax on companies operating in the "duty free zone" currently enjoying tax free status; broadening taxable income to include "world-wide income" that would assess a tax liability on income earned outside of Costa Rica, which is similar to the US where citizens are taxed on their "global income" by the US tax authorities; exempting 200 basic goods and medicines, and public utilities from sales taxes; and setting a maximum tax rate of 2% on purchases of educational and health-care services, both of the latter designed to make the tax system more progressive, equitable, and fair.

As a result of ongoing domestic political wrangling and numerous constitutional challenges in addition to a number of high profile tax and corruption scandals in the ruling party and the resulting loss of confidence of the public in the fiscal plan -- a recent survey indicated that 75% of those polled were opposed to it (EIU, 2012a) -- the government decided to turn to its Plan B: introducing piecemeal, tax and other revenue enhancing, measures to prevent a substantial deterioration in the nation's fiscal accounts.

The agenda in mid-2012 was to increase government revenues by a more modest 0.8% of GDP instead of the initially planned 2.5% of GDP. "Plan B" includes sales of government-owned assets; introducing electronic invoices for businesses to prevent sales tax evasion; eliminating the tax exemptions on several luxury items; setting a 4% growth cap on current expenditures, net of interest payments; swapping more expensive to finance domestic debt with debt issued in foreign currency to reduce the interest cost of debt and simultaneously mitigating the "crowding-out" effect in the domestic capital market; and a reduction in the quantity, and/or an improvement in the quality, of spending on education, health, and security. While these measures are likely to contain the fiscal deficit for 2012 below 5%, Costa Rica's public debt ratio is expected to reach 50% by 2013-14 (EIU, 2012b).

With regard to another critical macro-economic component, the inflation rate, in the five years leading up to the 2009 recession consumer prices rose in excess of 12% per year, considerably above the regional average (United Nations, 2011). The economic slowdown in 2009 reduced inflationary pressures, and annual inflation rates since 2010 averaged about 5% per year, below the regional average. One reason why inflation may be better behaved over the last three years is because the central bank is gradually moving towards a formal policy of inflation targeting -- with a range between 4-6% per year -- and the existing "crawling band" exchange rate regime is gradually being replaced by a more flexible (managed float) exchange rate. The Central Bank is extremely vigilant regarding monthly inflation data, especially since annual fiscal deficits continue to be in excess of 4% of GDP.

One unfortunate by-product of the Central Bank's aggressive inflation policy is the increase in the rate of unemployment, which receded only marginally from the recession high of 8.5% to average 7.8% over the last three years. While the recovery in Costa Rica has been characterized as a "jobless" one like in the US, the high unemployment rate may be due, in part, to the increase in the participation rate of the economy from 57.7% in mid-2011 to 65.7% in early 2012 (EIU, 2012c). The labor force is expanding faster than jobs are being created. To that end, the government is aggressively wooing foreign direct investment, and as the DR-CAFTA treaty is integrated into the economy, the government is hopeful that strong employment growth will be among the benefits of "globalizing" the economy. (More about this issue, below).

The Adoption of a Competitive Micro-Economic Environment

According to the World Bank (1991), improving the micro-economic foundation of the national economy includes, among other things, a substantial reduction in state ownership and management of productive assets, and the elimination of price distorting subsidies and taxes.

The Costa Rican Constitution declares the state to be the sole owner of hydroelectric power (that generates more than 70% of the nation's electricity), hydrocarbon deposits (coal, gas, and oil), wireless services, railways, ports and airports, and, as a result, the public administration includes a number of decentralized autonomous agencies that are responsible for providing energy, communication, and transportation services for Costa Rica (EIU, 2008).

Needless to say several of these autonomous agencies such as the Instituto Cosatrricense de Electricidad (ICE, the electricity and telecommunications monopoly), the Junta de Administración Portuaria y Desarrollo de la Vertiente Atlántica (Japdeva, a port administration and development agency of the Caribbean region), the Instituto Nacional de Seguros (INS, the state insurance underwriter), and the Caja Costarricense de Seguro Social (CCSS, the Costa Rica Social Security Institute) enjoy monopoly privileges in their respective sectors of the economy.

Since 2000 there have been attempts to break the energy and telecoms monopolies, but strong public opposition, particularly from organized labor, has prevented any liberalization in these sectors for years. However, the ratification of DR-CAFTA (more about this, below) by national referendum on October 2007 requires opening the telecoms market to competition and obliges lawmakers to amend 13 national laws to bring the nation's legal code into compliance with the articles of the international treaty.

It is worthwhile noting that some of these state-run monopolies are easier to liberalize than others, as has been the experience in the developed countries since the 1980s. It is also important to make the distinction between privatization and deregulation. Some utilities operate in sectors where "natural monopolies" i.e., a single producer of the service, because of the sector's cost structure, continues to be efficient (electricity generation and distribution), but even in this case the ownership and management could be transferred from the state to the private sector.

For others, such as telecoms, because of the technological advances introduced over the last quarter century, in some segments of the sector, such as mobile telephony, on both technical and economic terms, both privatization and deregulation should be pursued in the public interest. Therefore, the liberalization program that Costa Rica is now following is just the beginning of a process that could require a decade to implement and even longer before tangible benefits to Costa Rican society are realized.

In 2011, after a three-year process following the passage of a law opening up the national telecoms market to competition, two private foreign companies, Telefónica (Spain) and América Movil (Mexico), began offering mobile phone services. It is not surprising that the telecoms market is the first to be exposed to competition because the technological advances in the sector makes entry into this once "natural monopoly" sector more amenable. In 2011, Costa Rica recorded a 100% penetration rate in mobile telephony, and 92% of households had at least one mobile phone (EIU, 2012a).

The process of liberalizing the decades-old utilities and financial monopolies will be slow and cumbersome because of the natural resistance of those groups adversely impacted by the changes -- labor and management in the affected companies -- and even though ICE, in early 2012, still captured 95% of the sector's customer base, it appears that analysts are already beginning to observe some changes as a result of liberalization in the telecoms market. For 2011, ICE recorded US$ 44.2m of losses, of which 70% were generated in its telecoms division that is now exposed to competition since the end of 2010 (EIU, 2012c). We are likely to see considerably more pressure on ICE in terms of the quality of its services and pricing policy as these competitive forces become firmly anchored in the sector in particular, and the economy, in general.

In the area of financial services the state continues to play a dominant role in the banking sector. In late 2007, a year before the national referendum on DR-CAFTA, state-owned banks accounted for almost half of the assets in the national financial system, and there has been an ongoing process of consolidation in the sector not unlike the trend experienced in other developing -- and developed -- countries around the world.

The state-owned banks dominate the retail banking market, while half the foreign banks are owned by investors from Central America, Mexico, and the United States. Because of the high degree of concentration in the sector -- a proxy for the absence of competition in the sector -- there is, not surprisingly, a large wedge between borrowing and lending rates, in addition to evidence of excessive fees (and administrative costs) borne by both creditors and borrowers (EIU, 2008).

The INS, the national insurance institute, administers the state monopoly of insurance and is the only entity authorized to underwrite insurance policies. This agency is a leading candidate for privatization, and the insurance market in general is a target for deregulation under the requirements of DR-CAFTA (EIU, 2008).

Global Linkages

Adhesion of the national economy to the larger global economy is becoming indispensible to improving a nation's material well being. It is without doubt that the successful development model implemented by China over the last three decades is, in part, due to China's re-engagement with the world economy after decades of economic autarky. Consumers benefit from liberalized trade by having more choice of goods, often at lower prices and/or with higher quality. More competition faced by domestic producers from imported goods reduces domestic producers' pricing power, and provides crucial incentives to enhance efficiency and productivity. The prospects of higher exports (in part to pay for increased imports) raise both national employment and income.

Liberalization of the capital account, provided the domestic banking system is sufficiently strong, along with a unitary and market-based exchange rate, can confer benefits to both borrowers and investors alike. Lower interest rates for borrowers, and improved risk/reward tradeoffs for investors, as well as greater discipline on the public finances imposed by these open capital markets complement the benefits provided by a liberalized trade account. It is important to note that policy experts are still debating the cost/benefit calculus for developing countries of full capital account liberalization in light of the Asian financial crisis at the end of the 1990s and the financial meltdown in the US and Europe a decade later (Beattie, 2011; Plender, 2012). Finally, providing a "state-of-the-art" legal, tax, and regulatory environment for foreign investment is critical for attracting and maintaining much-needed financial capital, new technology, and managerial talent for the national economy.

Over the last two decades Costa Rican policy-makers have aggressively pursued an array of policies to "globalize' the national economy. The establishment, in 1990, of Free Trade Zones (zonas francas or FTZs) and a Maquilla regime in 1995 -- plants that assemble manufactured products for either re-export or for the domestic market -- were designed to encourage foreign direct investment (FDI) by multi-national high-tech manufacturers whose goal was to generate jobs and foreign exchange. The companies operating in these FTZs enjoy tariff exemption on raw materials and machinery imports. As a measure of their success, FTZs, by 2007, accounted for more than 50% of Costa Rica's export earnings from merchandise exports (EIU, 2008).

The failed fiscal reform package discussed above included a provision to assess a 15% income tax on companies operating in the FTZs, despite the likely adverse effects this tax would have on the competitiveness of Costa Rican exports, attracting new FDI into the country, generating export-related jobs, and creating uncertainty regarding the future business environment in Costa Rica. Despite all this, taxing the FTZs is still on the burner (EIU, 2012a).

At the time the FTZs were established Costa Rica became a member of the General Agreement on Tariffs and Trade (GATT), the predecessor of the World Trade Organization. While Costa Rica, to date, has forged free trade agreements (FTAs) with Canada, CARICOM, Chile, China, Peru, and Singapore; has concluded free trade talks with the European Union; is negotiating an FTA with South Korea; and is planning closer trade links with South America, the centerpiece of Costa Rica's free trade initiatives over the last 20 years is unquestionably the Dominican Republic-Central American Free Trade Agreement (DR-CAFTA) with the United States, its largest trading partner, which imports approximately 27% of Costa Rica's exports in value terms (EIU, 2012a).

Costa Rica was the last of seven signatories to the treaty in 2007 that, once fully implemented, will provide virtually all of Costa Rica's exports tariff-free access to the large US market. In exchange for this access to the US market, as was discussed above, Costa Rica agreed to amend its national laws to enable a liberalization of its telecoms, insurance, and, eventually, electricity sectors, all of whom, until recently, were enjoying the benefits of being a state monopoly.

The Chinchilla Administration continues to woo foreign direct investment. To date, Costa Rica hosts an Intel microprocessor assembly plant, a number of medical-equipment manufacturing plants (Abbott Laboratories and Baxter Health Care), and back-office operations of Hewlett-Packard and Proctor & Gamble (The Economist, 2011).

With the country's expanding array of FTAs, its proximity to the large US market, few restrictions regarding FDI, its relatively educated labor force, and its famed political stability and respect for the rule of law, the newly liberalized sectors -- telecoms, insurance, and, electricity in the near future -- should attract substantial amounts of new investment from abroad.

Costa Rica's much-touted eco-tourism sector permits the country the luxury to run large merchandise trade deficits, but its swollen current account deficit, which was 5.3% of GDP in 2011 (World Bank, 2012), is a matter of concern for policy-makers. Both the recovery in the tourism sector as the developed countries restore growth, and the recent market-opening initiatives in the telecoms and insurance sectors are expected to lead to large infusions of foreign investment to plug the growing current account deficits.

Finally, the Central Bank is gradually abandoning the crawling-peg exchange rate system, in place since 1993 that preserved export competitiveness with "mini-devaluations", and is expected in 2013 to move to a managed float exchange rate regime, moving the country closer to a market-determined exchange rate.

An Active Government Policy to Promote Social and Economic Investment

The last of the four World Bank "ingredients" to be included in a well-managed national economy that is ready to meet the challenges of -- and reap the benefits from -- the global economy of the 21st century is an active government policy that promotes social and economic investment, especially in the areas of poverty reduction, health, education, and physical infrastructure, including transport, telecommunications, and energy.

During the 1960s and 1970s rapid economic growth increased living standards that -- in addition to rising per capita income -- was manifested through marked improvements in nutrition, greater access to health care and education, and, as a result of all of the above, significant increases in life expectancy and reductions in infant mortality rates.

In its most recent Human Development Report, the United Nations Development Program (UNDP, 2011) ranked Costa Rica 69th out of 187 countries in its key metric, the Human Development Index. Costa Rica's score was above the regional average, and second in Central America, behind Panama. The index measures the average achievement in three basic dimensions of human development; a long and healthy life; knowledge; and a decent standard of living. Costa Rica's higher ranking in this index, in part, reflects the increased state funding of education, health care, and pensions by the Arias administration (2006-10). While the Chinchilla administration is determined to maintain spending on these social welfare programs, they are being challenged to do so because the economy is now much more integrated into the global economy: Costa Rica has open trade and capital accounts; it is competing with a global labor force with China and India firmly anchored in the world economy; it must adjust to the ongoing rapid transfer of technology around the world because of advances in telecommunications and information technology; and the need to have in place competitive tax, legal, and regulatory regimes. This 21st century economic and financial environment is the principal cause for the chronic fiscal deficits described above, which are increasingly being characterized as structural rather than cyclical in nature. Not surprisingly, some of the symptoms of the national economy being incompletely adapted to the global economy are now appearing in the official statistics: increased poverty rates -- more than one in five Costa Ricans was living below the poverty line (and 6.5% of Costa Ricans were living in extreme poverty) (EIU, 2008) -- increased income inequality, increased unemployment rates -- above 7.5% of the urban labor force in 2011 (United

Nations, 2011), although some of the increase is due to a new measurement series that began in 2009 -- increases in violent crime, and increased drug trafficking. All of these issues are visible on the political radar screen as national elections approach in less than a year.

To be sure, addressing all of these issues will require a long-term commitment of state resources for spending on security, labor-training (and re-training) programs, a broadening of the tax base and a more efficient tax administration, and expanded income-subsidy programs for poor families, like those instituted in Brazil, that consist of a monthly payment to families that is conditional on the family's children attending school on a regular basis.

The increase in state spending on education over the last decade or two is showing results: In 2011, according to the United Nations Development Program (UNDP, 2011), the mean years of schooling of adults was 8.3 years, while for children it was 11.7 years. In addition, the rate of illiteracy (for those 15 years and older) fell from 15% to 5.1% in the course of a generation (EIU, 2008). However, going forward, the supply of a better educated labor force will be critical for increasing living standards, so just having a "literate" labor force will not ensure having an "educated" one equipped with 21st century skills needed in this globalized economy. Therefore, even if the mean schooling for young Costa Ricans is now 11.7 years, 50% of young Costa Ricans still do not graduate from high school (EIU, 2008). The important issue of teacher quality must also be addressed: in 2008, approximately 20% of teachers lacked formal qualifications (EIU, 2008).

Finally, Costa Rica's main energy source, hydroelectric power, provides about 75% of the produced electricity, and the national electricity grid reaches about 98% of the population. Electricity generation is dominated by ICE, the state-owned, and this is another sector of the economy that is facing liberalization in the next few years in compliance with Costa Rica's DR-CAFTA-related obligations.

CONCLUSION

Over the last quarter century political leaders and policymakers in virtually every country in the world have been confronted with the same question: In the wake of widespread political, technological, and institutional change around the world, what changes must be introduced into the economic and financial architecture of a country's economy that is firmly anchored in the world economy of the 21st century that will lead to improvements in the nation's material well-being? From China to Brazil, from Russia to South Africa, from Japan to Australia, from India to North Africa, and, most recently from the United States to Western Europe, all have struggled, or are struggling, with this "existential" problem.

The objective of this paper has been to describe the predicament of Costa Rica, a small country, that is located in a relatively politically and economically dysfunctional region of the global economy. As was mentioned above, Costa Rica is a country without endowments of fuel and non-fuel mineral resources and without an economically viable manufacturing sector that produces durable consumer goods. So, how does Costa Rica arrange its "assets" -- its geography, its climate, and its human capital -- to improve the living standard of its population within the framework of the fiercely competitive global economy?

The first step is to identify the country's strengths and weaknesses, and then, through the political process and in collaboration with its business leaders and policymakers, to develop and implement the necessary policies to reduce or eliminate these weaknesses on the one hand, and, on the other hand, to nurture and provide the necessary incentives to exploit the country's strengths.

This paper has emphasized the need for Costa Rica to confront its chronic fiscal deficits aggressively, its microeconomic shortcomings (most of which will have to be addressed because of DR-CAFTA), and its global challenges that include attracting much-needed foreign direct investment that can be combined with Costa Rica's relatively educated labor force, combating the global scourge of drug trafficking (and its inevitable co-product, violent crime), and growing its specialized "niche" sectors (biodiversity and ecotourism) to complement its exports of bananas, coffee, and other traditional exports.

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