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## *Political and Institutional Obstacles to Reform in Costa Rica*

JORGE CORNICK AND ALBERTO TREJOS

### **From Near Success to Reform Paralysis**

With a population of 4.4 million in 2006 in an area of just 51,000 square kilometers, Costa Rica is one of the smallest countries in Latin America. Yet it is an interesting case to analyze in the context of the CGD project. In recent decades Costa Rica has applied some but not all of the conventional policies pursued by the rest of the region, with varying degrees of intensity, while protecting and enhancing social policies—including but not limited to welfare policies—that were not discussed as part of the Washington consensus, except perhaps as sources of fiscal deficit. The results can be characterized as a near success: steady but not spectacular growth; reduced but still comparatively high inflation; and a rapid reduction in poverty in the aftermath of the early-1980s crisis—all in a context of economic and democratic stability.

Yet the pace of reform has consistently slowed in recent years, while the capacity of many public institutions to deliver essential services has diminished. The fall in the poverty rate has stagnated in recent years, and income inequality has increased. And, to add paradox to an already interesting story, recent growth has been robust, foreign direct investment (FDI) is growing, the central bank is quickly accumulating reserves, and for the first time in decades there is a fiscal surplus—all precisely at the same time that the public sector seems to be verging on

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paralysis.<sup>1</sup> Clearly, although the new reforms under discussion are extremely difficult to approve and implement, the results of the old reforms, and of day-to-day economic management, have been positive. Yet problems remain: the political system and public sector administration move very slowly and often ineffectively, as a result of self-imposed rules that have transformed “checks and balances” into “chokes and strangleholds.” Both for its achievements and for its failures, therefore, Costa Rica seems to be a promising ground on which to apply the CGD framework.

### *Growth Performance since the Early 1980s*

According to cross-country data from the International Monetary Fund, Costa Rica recorded the second-highest economic growth rate, corrected for purchasing power parity (PPP), in Latin America over the 1983–2007 period, lagging behind only Chile. Real annual GDP growth averaged 5.1 percent and even reached 6.1 percent in the last five years. GDP per capita in 2007 surpassed \$5,560; corrected for PPP, that figure is equivalent to almost \$11,300, one of the four highest in Latin America. According to household survey data from the National Institute for Statistics and Census, real wages more than doubled between 1983 and 2003; meanwhile the poverty rate fell from 55 percent during the 1982 crisis to 32 percent in 1986 and 17 percent in 2007. Compared with other countries in the region, Costa Rica has enjoyed not only comparatively high but also quite stable growth. There has not been a single fiscal, balance of payments, exchange rate, banking, or political crisis since 1983, and growth has been positive in every single year during the same period.

Costa Rica’s economy has grown even though total factor productivity (TFP) has risen very little; the increase in output is due almost exclusively to the accumulation of inputs. Rodríguez, Sáenz, and Trejos (2002) performed a TFP decomposition for the second half of the twentieth century and found that productivity increases were rarely a driving force over that long period, and in fact TFP growth was negative for the sluggish 1995–2000 period. Although a similar exercise for the 2000–07 period would be far beyond the scope of this paper, there is some evidence of TFP recovery after 2002.

Zettelmeyer (2006) highlights a number of stylized facts that characterize Latin America’s disappointing growth of the last few decades. Costa Rica shares some of these features, notably the lackluster performance in TFP before 2000 that Loayza, Fajnzylber, and Calderón (2005) found for the region as a whole. With respect to some other stylized facts, however, Costa Rica is an outlier: as already noted, it has not shared with other countries in the region the pattern of frequent

1. These paragraphs were written in early 2008. As of July of the same year, the country’s economic prospects seem distinctly less positive, as a consequence of high international commodity prices and the global economic downturn.

output collapses, nor has the current expansion been short lived. Rather, Costa Rica has been on a single sustained “growth spurt” for a quarter of a century, with growth in GDP per capita between 1983 and any given year since then exceeding 2 percent a year. Thus, Costa Rica has managed to escape the pattern of isolated, short-lasting growth spurts, frequent crises, and high output volatility described by Zettelmeyer. This is the case even though the national income accounts are probably biased downward, as that author suggests, by the fact that the country reduced its barriers to trade very quickly and maintained pre-opening relative prices in valuing output (as mentioned above and quantified in Rodríguez, Sáenz, and Trejos, 2002).<sup>2</sup>

Earlier, in 1980–82, Costa Rica went through a deep economic crisis, which resulted in a cumulative loss of income per capita of nearly 20 percent. The crisis was the consequence of structural problems similar to those afflicting the rest of Latin America, of external shocks that exposed these internal weaknesses, and of internal financial mismanagement that exacerbated them. After the crisis, Costa Rica decided to pursue a more prudent fiscal policy, to open the economy to trade and capital flows, and to gradually do away with some of the heavy-handed economic planning instruments in use at the time. Some timid attempts at deregulation were made, but, over all, red tape has probably increased rather than decreased since the 1980s.

Unlike in many other countries in the hemisphere, public utilities (water, electric power, and telecommunications) were not privatized, and the budget for key social services was protected. Costa Rica thus implemented a somewhat heterodox reform package, but one that, broadly speaking, fit within the policy consensus of the time.

Opposition to reform was vocal but politically weak. Critics denounced the reforms as “inequitable” and “neoliberal” and claimed that economic adjustment was increasing poverty, when in reality the poverty rate fell 20 percentage points during the stabilization phase.

Despite the depth of the crisis, the bipartisan political system that had been in place since the 1948 civil war remained intact. Democratic discourse enjoyed widespread legitimacy; governance was, if not outstanding, at least good enough; and major policy initiatives could be successfully negotiated between the government and the opposition. The “sensible center” seemed to have won the day, and the only viable political choice seemed to be between two centrist, ideologically broad parties, the social democratic Partido Liberación Nacional and the slightly more conservative Partido Unidad Social Cristiana. To their extreme left, the

2. Costa Rica’s story also fits the Zettelmeyer growth covariates: besides having the region’s second-highest growth rate, Costa Rica has had comparatively less growth volatility, has one of the region’s most equitable income distributions, and is fairly open to trade. Political crises have also been extremely rare. Of course, when compared with the developing world as a whole, Costa Rica’s record is not particularly exemplary in terms of growth, volatility, or equity.

Marxist political parties were in retreat, and although they managed to hold some seats in the legislature, all the wide-ranging far-left alliances imploded. At the other extreme, not a single far-right political party ever had any strength. Occasionally, small regional parties, content to offer their support of the government in power in exchange for regional earmarks, would get a few members elected to Congress.

### *The Recent Near Paralysis of Reform*

Despite the mostly positive performance of economic policy since the 1980s crisis, progress with economic reform has lately become increasingly difficult: reform fatigue seems to have set in. This section attempts to identify both the key reforms that still need to be implemented and the key constraints that have slowed or halted implementation. More fundamentally, we try to explain the economic and political processes that have generated reform fatigue despite the positive performance of past reforms.

#### REFORM FATIGUE

If the results of reform in terms of economic growth have been so good, why has further reform become so difficult? The situation is all the more puzzling because the reform agenda has succeeded in other areas besides growth: inflation, while remaining persistently above 10 percent, seldom strays much higher; the public finances have been significantly strengthened, both in the government itself and at the central bank; the liberalization of key sectors and a profound transformation of the structure of the economy have been achieved in a short time, while exports and FDI have grown rapidly; unemployment has been consistently low.

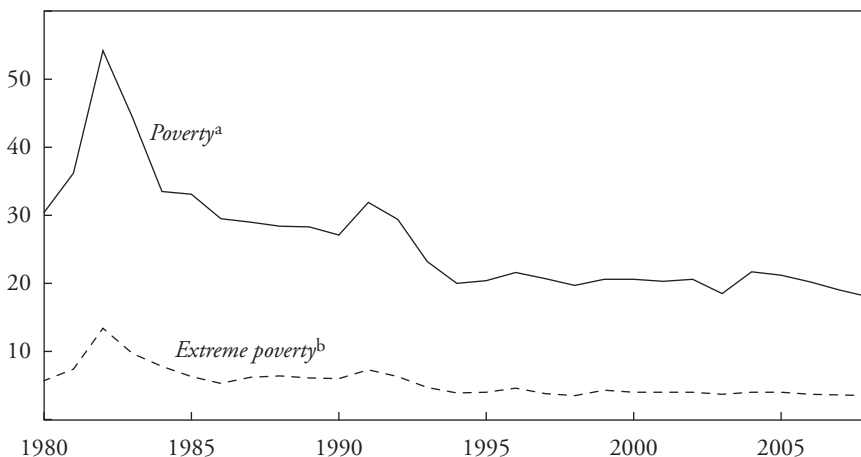
Three factors seem to account for Costa Rica's turnabout from solid progress at reform to almost complete reform paralysis. First, the distribution of income has worsened, robbing the political and economic system of some of its legitimacy. Second, a necessary transformation of the public sector was simplistically confused with mere downsizing, rendering the Costa Rican state ineffective and breeding new opponents of reform. Third, political events, including some high-level corruption scandals and their consequences, have reshaped the ideological and party structure of the political system, leading to congressional atrophy and paralysis.

#### PERSISTENT POVERTY AND WORSENING INCOME DISTRIBUTION

Although economic growth was steady and poverty fell rapidly in the late 1980s and early 1990s, since then the decline in the share of the population living below the poverty line—currently 16.7 percent—has been much slower. This is low by Latin American standards, but that is little solace for those Costa Ricans who remain poor and have little hope of escaping poverty. Figure 1 shows both the poverty rate (the fraction of the population living in households that cannot afford the minimal consumption basket) and the extreme poverty rate (the fraction that

Figure 1. *Costa Rica: Alternative Measures of Poverty, 1961–2008*

Percent



Source: Annual Household Survey, National Institute for Statistics and Census.

a. Fraction of the population living in households that cannot afford the minimal consumption basket.

b. Fraction of the population living in households that cannot afford the minimal food basket.

cannot afford the minimal *food* basket), both baskets as defined by the National Institute for Statistics and Census.

Inequality has always been a significant problem in Costa Rica, even if less so than in neighboring countries. The country's Gini coefficient,<sup>3</sup> already high in the 1970s, increased dramatically during the 1980–82 crisis, but then fell back below historical levels during and immediately after the postcrisis stabilization. The Gini then gradually crept up again during the 1990s, and in the last few years it has oscillated wildly. Other indicators of income dispersion display similar patterns.

Does this mean that the relatively rapid growth enjoyed in the last two decades was not pro-poor? In a loose sense, following Leipziger (2005), growth has been pro-poor by definition, given that the poverty rate fell; in the very strong sense used by Kakwani and Pernia (2000), however, growth was not pro-poor, because the segment of the population below the poverty line saw its income per capita grow at a slower rate than average income per capita. To be precise, in the 1988–2007 period, according to the family income data reported by the national household survey, the poorest 40 percent of the population (the relevant group for this purpose, as the poverty rate varied between the current 16.7 percent and 33.1 percent in that period) saw its income per capita grow by an average of about 1.9 percent annually, while the population as a whole enjoyed average annual

3. The following discussion is based on analyses by Juan Diego Trejos with data from the household survey and the national census.

growth of 3.3 percent, and the richest 40 percent saw annual growth of 3.6 percent. Had all income brackets enjoyed the same rate of growth, the fall in the poverty rate would have been larger, especially since a large number of people had incomes within a few percentage points of the poverty line. But this result does not hold throughout the period. For example, between 2004 and 2007—years of unusually rapid growth—average household income among the poorest quintile grew by 28 percent, while that for the population as a whole grew by 19.1 percent; thus, growth was extremely pro-poor in those years, even by the strong definition.

One should be careful, however, in interpreting this result. On the one hand, comparison with other Latin American countries is not easy, because in some of those countries, unlike in Costa Rica, “the poor” (as conventionally defined) represent a majority of the population. On the other hand, one should take into account the immigration into Costa Rica of between 300,000 and 450,000 Nicaraguans during precisely the same period (Consejo Monetario Centroamericano, 2004). According to Lizano and Monge (2006), 89.3 percent of immigrants in 2005 were in the poorest fifth of the Costa Rican population and accounted for 24.3 percent of Costa Rica’s poor. If one corrects for the effects of immigration, which include not only the numbers of poor immigrants but also their competition for jobs with the poorest locals, the fall in the poverty rate in the period under consideration was larger, and it is easier to argue that growth has been pro-poor.

Even if one accepts the interpretation of the data that growth has *not* been pro-poor, it is not necessarily the case that the pro-growth reforms caused poverty. In our opinion, the incomes of the poor would have been no higher in the absence of these reforms; on the contrary, the poverty rate would have been higher. And the main reasons (besides immigration and the worldwide increase in the education premium) why income redistribution was not more successful are some of the same ones we highlight below as limitations on growth: congressional institutions that delay the legislation required to further economic reform; low government revenue that forces the postponement or cancellation of public investment, both social and economic, required to strengthen the growth foundations; and administrative restrictions that render the public sector, or at least large portions of it, increasingly ineffective.

#### A WEAKER PUBLIC SECTOR AND A MORE CONTENTIOUS POLITICAL SYSTEM

Costa Rica’s relatively strong economic growth record is more than matched by its remarkable record on social policy: literacy, at 97 percent, and life expectancy at birth, at 78.7 years, are at developed-world levels; 98 percent of the population has access to drinking water; net primary and secondary school enrollment rates are 98.6 and 66.1 percent, respectively. Also, by our calculations 87.6 percent of the population has health insurance, 98.3 percent has electricity in their homes,

and there are 575 telephone lines (main and mobile combined) per 1,000 people. None of this could have been achieved without a public sector capable of both designing and implementing effective public policies, including the construction of large infrastructure projects. Strong institutions and a political system dominated by two political parties alternating in power, with sufficient common ground to reach agreements on the broad outlines of public policy, form the background of these accomplishments.

However, in recent years Costa Rica's public sector seems to be slowly collapsing. Many government agencies are less and less capable of discharging their duties. Years of cost-cutting efforts and administrative atomization, the misdirection of anti-corruption and other regulations, and financial and personnel problems are taking their toll. Whole areas of government activity, especially those that involve investment and a long-term mindset, have been weakened. The most notable examples are education and transportation infrastructure (the latter is discussed in detail below).

Public sector reform in Costa Rica has too often been simplistically confused with downsizing. The resulting loss in public sector effectiveness has turned the same public servants who would ordinarily be in charge of implementing policy and reform into an active and aggressive political force against reform. Meanwhile a drastic reduction in public sector capital expenditure, particularly in infrastructure and education, ensured that after the crisis was over, public expenditure would continue to be managed under a crisis mindset. Thus, a perception that government does not deliver became widespread, weakening the mandates of reform-minded administrations.

To make matters worse, a new political reality emerged. Since the mid-1990s, Costa Rica has witnessed the emergence of a new political opposition, fiercely globophobic, highly organized and vocal, electorally successful, and including an influential strand of what, in our opinion, can only be described as a hard core of well-organized groups that do not believe in the democratic system.

In the two-party political system that prevailed before this change, both sides shared ample common ground, an ability and willingness to negotiate and execute agreements, and an expectation of alternating in power. The executive also possessed some effective tools—such as control of disbursement of earmarks—to enforce party discipline. After the change, new parties have emerged to capitalize on the anti-system mentality, while the old ones have been considerably weakened; there is now a multiparty Congress and very little basis for consensus. Yet meanwhile the country has kept the same parliamentary procedures and political habits as before. The combination of these old rules with the new composition of Congress has led to near paralysis, which can only be overcome through time-consuming and presumably costly negotiations, as each individual member of Congress has the ability to delay any vote almost indefinitely. It is extremely hard for both the executive and individual legislators to get any bill passed within a

reasonable time frame, even if it enjoys the support of a strong majority: the status quo is king.<sup>4</sup>

How did this change in the country's politics come about? Although the poor were protected during the postcrisis stabilization phase, and in fact a broad segment of the working classes thrived during the recovery, thus partly addressing the *broad sharing of the benefits of growth* (one of the five growth foundations identified by the CGD framework), a large portion of the middle class did not share in the fruits of the rapid growth achieved in that period. These were mainly people who worked or expected to work in the public sector, but also some professionals and clerical workers in the private sector. As it happens, these middle class workers were the backbone of the Costa Rican political system. Neglect of their economic needs and aspirations, compounded by political mistakes, weakened political support for the traditional, "sensible center" political parties. This, in our opinion, is the key element that explains both the emergence of the new, anti-reform political organizations that now enjoy broad electoral support and the current impasse in public policymaking.

### *Successes, Near Successes, and Failures: Which Policies Matter Most for Future Growth?*

As argued above, Costa Rica has arrived at a juncture at which the design, approval, and implementation of growth-enhancing, middle class–strengthening reforms are almost impossible, unless Congress somehow recovers its ability to produce legislation at a reasonable pace and the rest of the public sector recovers its effectiveness. The congressional rules that worked, almost in spite of themselves, for decades have ceased to work in the wake of the political realignment. Consequently, the legislature is paralyzed, and any reform requiring legislation is so likely to be delayed indefinitely that many proposed bills are simply shelved without ever being put to a vote. To the extent that this problem can be solved, it is this reform that opens the door to many other areas of reform that address one or more of the foundations of growth identified in the CGD framework. Hence, we will begin our analysis of reform by looking at *legislative reform*, because of its importance for progress across the whole spectrum of growth foundations.

Meanwhile the public sector, as a result of botched reforms in the past, is no longer able to deliver the services expected from it efficiently and on time. Thus, *administrative reform* is the second area addressed in our analysis. This administrative weakness is manifest in several areas, but none more important than the provision of transportation infrastructure. Our discussion of administrative reform therefore focuses on that sector, both because the administrative difficul-

4. Recently, a "fast track" rule has been approved and now has been tested at the Constitutional Court. Although not exactly "fast," this rule allows Congress to set a definite number of sessions after which a bill must be put up for a vote.

ties encountered there are emblematic of those observed across the whole public sector, and because the poor present state of the country's transportation infrastructure specifically affects performance on each of the growth foundations. Just as Costa Rica's entire reform agenda today is being thwarted in Congress by procedural potholes, detours, and gridlock, so, too, in the most literal sense, its progress on growth-enhancing reforms is being held up by an outdated and inadequate transport network.

Once Congress, the executive, and the rest of the public sector are able at some point in the future to discharge their duties effectively, the most salient weaknesses in the Costa Rican growth foundations can be addressed. These have to do with lack of *equality of opportunities*, insufficient *economic competition*, and the fact that the gains in terms of *macroeconomic stability* have been significant but not complete. Thus, our other three priority reforms relate mainly to those weaknesses.

First, government needs more revenue, both to consolidate the *macroeconomic stability* already achieved and make it sustainable (for example, by reducing debt, absorbing the quasi-fiscal deficit of the central bank, and reducing inflation) and to strengthen the public networks and institutions that are critical to improving the country's income distribution and thus to improving *equality of opportunities* and to *sharing more broadly the benefits of the country's growth*. Improved tax collection has already not only reduced the public sector deficit but also, more recently, generated fiscal surpluses. Nevertheless, existing revenue is still far from sufficient to finance the country's long-postponed and direly needed public sector investments. Thoroughgoing tax reform is necessary to attend to these needs while preserving stable public finances. *Tax reform* is therefore our third area of study.<sup>5</sup>

Second, an area of particular importance for greater *economic competition* and a more dynamic business environment is reform of the country's antiquated and clearly inadequate telecommunications regime. Telecommunications is an area in which strong political sensitivities have prevented progress for years. As a consequence, the system's performance is so poor that it is affecting most of the other growth foundations, including *macroeconomic stability*, because so large a share of the state's resources is tied up in this public sector monopoly, and *equality of opportunity*, because the existence of this monopoly excludes would-be entrants. On the bright side, the years of stagnation have left many low-hanging fruit for reform to pick. The current system clearly delivered major achievements in the past, but standards in several parts of the market are very low; *restoring a competitive telecommunications system* is thus vital for a series of critical industries, ranging from software to business services, and from tourism to computing.

5. It has been suggested to us that given the paramount importance of education in Costa Rica, this chapter should examine reform in that area as well. We agree that education is a high priority for the growth foundations and that it has deteriorated in Costa Rica, but we believe that most of the problem in this field, just as in infrastructure, is a manifestation of the country's fiscal and administrative problems rather than a separate problem with its own distinct origins.

Third, although the successful reform of the trade and investment regime has been perhaps the most critical element in the country's postcrisis recovery and growth, a significant pending agenda in *trade liberalization* remains, with overwhelming obstacles in its path. As with telecommunications, reform in this area is primarily aimed at strengthening *economic competition*, but by lowering entry barriers to a range of activities, it is also important for enhancing *equality of opportunities*. Success in the foreign markets opened to trade should also contribute positively to Costa Rica's balance of payments, thus assisting *macroeconomic stability*.

Table 1, which identifies the relationship between each of the above sets of policies and the foundations of growth (following the authors' admittedly somewhat subjective judgments), is intended to clarify the connection between these reforms and the CGD framework. The table groups a number of specific reforms into several policy areas. We think this organization is useful for understanding some of the paradoxes of Costa Rica's economic performance. For example, rapid economic growth in the country that possesses Latin America's last remaining telecommunications monopoly seems easier to understand when placed in a context of market-based policies in which, over all, the "progress score" is not bad, even if telecommunications reform lags behind the rest.

The question marks in table 1 identify those cases where the impact of reform is unknown or ambiguous. In many cases this ambiguity is the result of a definition of reform that is, perhaps, a bit too broad. For example, privatization of the telecommunications monopoly would be expected to strengthen macroeconomic stability, all else equal. But liberalization without privatization, leaving the public utility to compete with private providers (and thus facing the possibility of bankruptcy), could create potentially large contingent liabilities that would work against macroeconomic stability.

## **Economic Reform and the Growth Foundations**

In the previous section we used the CGD framework to identify five areas of reform that are key to Costa Rica's future economic performance. Here we pursue a deeper understanding of these reforms, their relevance to the foundations of growth, the steps necessary to move them forward, and the barriers likely to be confronted in the process. As already noted, we find that political and institutional obstacles to implementation are particularly important, and therefore we begin with those.

### *Legislative Reform*

A coherent body of law and respect for the rule of law are obvious prerequisites for economic growth and development in a modern market economy. Only slightly less obvious is the need for an effective, representative, and efficient system for revising and updating the laws and promulgating new laws as needed. A

Table 1. *Costa Rica: Importance and Actual Impact of Potential Future Reforms on the Growth Foundations*  
5 = most important

Reform	Property rights		Equal opportunities		Competition		Broad sharing of the benefits of growth		Macroeconomic stability	
	Importance	Actual impact	Importance	Actual impact	Importance	Actual impact	Importance	Actual impact	Importance	Actual impact
<i>Public sector reform</i> <sup>a</sup>	5	—	5	3	5	4	4	3	2	3
Legislative reform	5	2	5	2	5	2	5	2	5	2
Administrative reform	5	2	5	2	5	2	5	2	1	2
Anti-corruption	5	2	5	2	5	2	4	2	1	2
Judiciary reform	5	2	5	2	5	2	2	2	?	2
<i>Tax and budgetary reform</i>	<i>n.a.</i>	—	4	3	4	2	5	3	3	3
<i>Developing competitive markets</i>	3	3	5	5	5	?	?	?	?	?
Trade liberalization	1	4	5	4	5	4	3	4	?	?
Financial liberalization	3	4	5	4	5	4	2	4	?	?
Privatization <sup>b</sup>	1	5	5	5	5	5	1	5	?	?
Telecommunications demonopolization	2	5	5	1	5	1	3	1	5	?
Insurance demonopolization	3	4	5	1	5	1	2	1	?	?
Antitrust policy	3	4	5	2	5	2	2	2	?	?
<i>Public services development</i>	4	4	5	4	4	5	5	4	2	4
Education	4	4	5	4	4	4	5	4	4	4
Health	4	4	5	4	4	4	5	4	1	4
Security	5	3	3	3	1	3	2	3	1	3

Source: Authors' analysis.

n.a. = not available; ? = unknown or ambiguous impact.

a. Scores for broad policy areas (in *italics*) indicate overall importance of that area.

b. Other than utilities.

well-functioning legislature is thus vital for the proper functioning of the economy, which it affects through every one of the growth foundations. If the laws are flawed and cannot be rewritten without interminable delay, *property rights* are at risk of being usurped, either outright or by exploiting that delay. A legislative body whose makeup is poorly aligned with the actual distribution of the population will be prone to decisions that favor those who are better represented; this inevitably impacts both *equality of opportunities* and *the broad sharing of the benefits of economic growth*. The rules under which the legislature operates determine whether *political competition* leads to open debate and good-faith negotiation, and so to legislation that serves the national interest, or to gridlock and paralysis. And both *macroeconomic stability* and healthy *economic competition* frequently depend on timely and responsible legislative decisions on the government budget, fiscal stimulus, fair taxation, antitrust, and a host of other matters.

The existing congressional system in Costa Rica has two major problems. One is the inefficiency of the existing rules of order and parliamentary procedures and the ease with which they can be used to delay or block action. The other is the unrepresentative manner in which members of Congress are elected.

#### CUMBERSOME RULES AND PROCEDURES

The formal parliamentary procedures of the Costa Rican Congress give political minorities enormous power to make themselves heard by indefinitely delaying votes that they oppose. This creates a power vacuum that is often then filled by judicial activism, as new interpretations of the existing law substitute for new legislation. Delay also leads the executive to abandon efforts at reform that require new legislation, and instead to push reform through executive action, only to find that its power to do so is extremely limited. Because most reforms require supporting legislation to some degree, the extreme difficulty in passing laws is obviously an obstacle to growth.

The most controversial areas of political debate in the last few years have been the worst victims of congressional deadlock. These include a variety of laws to enhance *economic competition*, for example through telecommunications reform or trade liberalization. Also affected have been laws linked to *macroeconomic stability*, such as fiscal initiatives. Finally, the existing programs that seek to alleviate poverty and reduce the gap between the rich and poor, thus generating *equal opportunities*, were designed many years ago, in response to a different distributional challenge in a very different country and economy. It is necessary not only to inject fresh resources into these programs, but also to create *new* programs designed for the new order. The topic is naturally controversial, and as long as parliamentary procedures require near unanimity, it is very unlikely that changes of the necessary scope and magnitude will be enacted.

Among the most problematic of Congress's rules and procedures are the following. A two-thirds quorum is required not only when votes are cast but even

during debate: written discussion and submissions for the record are not allowed. Bills must be voted on once in committee and then twice by the full Congress. Questions concerning a law's constitutionality are referred to the courts between the first and the second vote; a minority of members may even send the bill to the courts before the first vote. Every member may propose an unlimited number of amendments to a bill and is allocated a certain amount of time to argue for each proposal. Each motion to amend is debated and voted on separately, may be raised and re-raised in committee, and then raised and re-raised again before the full house.

Bills before Congress are discussed on a first-come, first-served basis unless a supermajority agrees otherwise, so a new and urgent proposal may have to wait years before being discussed. During some months every year, bills are discussed in the order the executive requests, but, unlike in other countries with a similar rule, the executive cannot force a vote on those bills. The chair has some tools to accelerate the proceedings, provided a two-thirds majority agrees, and even then the mechanics are very fickle and the dissenting minority can easily prevail. Any member may question the procedure and raise it before the Supreme Court. If the court finds any procedural mistake, even in form, the process must go back to the point where the mistake happened, even if this implies the invalidation of a vote.

These rules, cumbersome though they are, did not impede decision making for many years because they operated in a bipartisan setting, in which the two major parties used the rules of order as a bargaining tool, not as a means to paralyze a polarized Congress. The two leading parties held most of the seats in Congress and usually alternated the presidency. Because each party expected that it would someday be taking the place of the other, neither perceived any benefit from obstructionist practices. Both parties had knowledge of how public sector institutions worked, and the skills necessary for effective public management were preserved in a semi-professional political class. Although the parties had real and nontrivial ideological differences, they also shared core ideological values that made negotiation and agreement possible. Even the small regional parties that occasionally won seats in Congress could be brought to the table through the executive's authority to block the disbursement of local budgetary allocations. Anti-system parties, when they reached Congress, were weak enough to be easily neutralized.

These same rules in a Congress that is both multipartisan and ideologically polarized lead not to negotiation but to near paralysis. Even if the major players reach agreement on the agenda and on the content of key bills, any single member can filibuster any bill, because cloture requires a supermajority, which can rarely be achieved. Several parties in the current opposition are ideologically rather than regionally based, and so their agenda is nonnegotiable. Their members have very little high-level government experience and little expectation of winning actual power, so they have no vested interest in keeping things moving. On the

contrary, some members respond to a constituency that, finding no basis of agreement with the majority, *wants* to see things blocked and the system collapse.

#### A REPRESENTATIVE PROCESS THAT DOES NOT REPRESENT

Congressional elections in Costa Rica take place every four years, concurrently with presidential elections. Incumbents may not run for reelection—Costa Rica is one of the very few countries in the world where this rule applies.

Each province is allotted a number of congressional seats in proportion to its census population. Parties field lists of candidates for each province, and each party is awarded seats roughly according to the fraction of the total vote that its list receives.<sup>6</sup> These seats are assigned starting from the top of the list, regardless of how the votes are distributed across the province. Thus, members are not elected as individual representatives of a specific geographic area but represent the province at large.

Candidates on the lists are selected by party national assemblies, akin to party conventions in the United States. Although it is not compulsory, the candidates whose names end up on the list often have won nonbinding internal elections in their counties or regions. Nevertheless, the final decision of who shall appear on the list is made by the assembly as a whole, including the representatives elected from other regions. The all-important order of names on the list usually follows the size of the counties represented. Hence, the largest city or county in each province usually gets the top several spots on the list in each party, and thus several seats in Congress; candidates from smaller regions are usually put lower on the list, and thus these regions get no representation.

In the case of San José, the largest province by far and the one where most government, professional, and academic activity takes place, the top of the list is dominated not by local representatives, but rather by nationally known figures who are not linked to a particular county or town. Once elected, these members are even referred to as *diputados nacionales*, although on paper they represent San José.

What is wrong with these arrangements? One problem is that they make members of Congress largely unaccountable to the population. Most representatives are thought of as representing a county, and act accordingly, but in fact they are elected from a provincial party list. It is quite possible for a given candidate's party to lose in the candidate's county but (thanks to the votes cast for the other members on the list) win the province as a whole, in which case that candidate is sent to Congress instead of the candidate who actually won in that county, and instead of some of the candidate's fellow party members who won in their counties. If the reader finds this totally confusing, that is the point—so does the electorate. Nor

6. The formula used to calculate how many seats are allocated to each list assigns them relatively close to proportionality among those parties that meet a certain minimum vote. The minimum vote is smaller, the larger the number of seats allocated to the province.

is it surprising that, under this system, the representative's allegiance to his or her county often weakens once in Congress, all the more because the representative may not run for reelection and thus will not be facing the voters again.

In addition to this lack of accountability, there are marked asymmetries in party representation between different places in the country. The basic electoral unit is the province, and the country's provinces vary greatly in population (and thus in the number of representatives). Limón, the province with the smallest population, elects four members of Congress, and San José, with five times the population, elects twenty. As a result, what it takes to get elected to Congress differs from one place to another: small parties are viable in San José, but not in the rest of the country.

There are also large differences in the representation of different localities. Many places in Costa Rica effectively have no congressional representation at all, in the sense that nobody who actually campaigned there got elected. Thus, residents of these places have no local leader to turn to for support or intercession, and the result is limited *political competition*, which in turn limits the *broader sharing of the benefits of growth*. In other countries, small towns may not have a congressional seat of their own but are part of larger geographic units that do. In parts of Costa Rica, for example the sparsely populated counties in the north of Alajuela province, the answer to the question "Who is your congressman?" is, quite frankly, "Nobody."<sup>7</sup>

#### HOW TO DEAL WITH THESE OBSTACLES

The fundamental problem facing legislative reform in a system like Costa Rica's is that any such reform would take power away from those now impeding action, and they will surely use the power they have to prevent that from happening. Legislative reform requires legislative action, which, ironically, is almost impossible without legislative reform. The only way to resolve this catch-22 is through public awareness of the problems and their consequences, so that those who insist on preserving the status quo realize the ultimate political cost. Costa Ricans in general know that their political system is not producing the results they desire, and they are fairly discontented with it, but most are not well informed about the specific problems or the possible solutions, which in our view include the following.

The rules for elections should be changed. Electoral units should be smaller and all of uniform size, rather than coinciding with provinces. Then candidates who happen to come from smaller towns and counties will be running for office in a unit that is larger than their base community, rather than for unelectable spots

7. As an illustration of these asymmetries, consider the contrast between Puntarenas, the largest county in the province of that name, and Tibás, a large suburb north of San José. Because Puntarenas is always at the top of the provincial list for each party, Puntarenas County usually has three or four congressional seats. Tibás, with the same population, rarely holds one.

on provincial lists. This would leave no doubt about which members of Congress represent which voters. Accountability would be strengthened, and each citizen, no matter where he or she is from, would have equal representation in Congress. There is no reason in such a scenario to forbid reelection.

If the institution of *diputados nacionales* is to be preserved, as is probably convenient, these members should be explicitly elected from the country at large, rather than from the top of the San José list. This would require a separate ballot listing candidates for a specified number of national at-large seats, with all voters choosing individually from that list. The relationship between the citizen and the local member of Congress should apply no differently to residents of San José than to the rest of the country.

The above proposals relate to how representatives are selected. Obviously, something also needs to be done about the rules under which they operate once seated in Congress. First, bills before Congress should be subject to a fixed time period within which a vote on the bill has to be held. This period could be shortened under a cloture rule or extended, but only by explicit vote and with a supermajority; otherwise, debate should cease when time has expired. Rules limiting the ability of members to filibuster or otherwise block legislation should be strengthened.<sup>8</sup> Filibustering should not be completely outlawed, as it provides a means for a determined minority to be heard on matters of critical importance to it. But neither should it be easy, and in particular it should not be the mechanism that routinely determines the outcome of any debate.

Second, the executive should have the authority not only to set the congressional agenda during part of the year, but also to require that any initiatives that it introduces be voted on (not just debated) by the end of that period. The executive should also have a limited power to declare certain bills urgent, and subject to a shorter deadline, as is done in Chile, for example.

Third, members should be granted alternative ways of putting forward their positions on legislation before the house and of placing them on the record, for example by filing their opinions in writing, or presenting them orally during sessions when a quorum is not present. A quorum should be required only for votes, not for debate. There should also be a mechanism for proposing amendments that does not delay the proceedings of the full Congress.

Also in need of attention is the new law that allows matters to be settled by referendum. This law passed its first test with flying colors on the CAFTA (Central American Free Trade Agreement) vote. Of course, because the law requires that a minimum of 30 percent of voters (40 percent for certain types of laws) participate in order for a referendum to be binding, as a practical matter few issues can be

8. Recently, Congress instituted a new practice (rule 41.bis) that allows a limited version of cloture to be applied when two-thirds of the members so decide. This is a step in the right direction but still falls short of what is needed.

taken to a referendum between national elections.<sup>9</sup> But a number of issues could be decided by referendum on the same day as a national election, thus securing the minimum participation. The elections themselves may provide an opportune environment for those matters to be discussed, and for the people to empower a new government by passing beforehand some of its desired legal reforms, or to limit it by rejecting them. The advantage of a referendum is clear: the vote happens on a fixed date with no possibility of filibuster, the results are binding and highly legitimate in the eyes of the population, and, by construction, vocal minorities are less important than silent majorities.

### *Public Sector Administrative Reform*

For all its past (and some current) achievements, the Costa Rican public sector has become a slow, cumbersome, and inefficient machine. Whereas financing was the binding constraint on the public sector in the immediate aftermath of the crisis of the 1980s, it is clear that an acute deterioration of managerial abilities, loss of talent to the private sector, a tangled web of regulations and audits, atomized authority, and overlapping jurisdictions are now crippling the public sector, even as the country's fiscal constraints have eased considerably. As a result, the Costa Rican public sector has lost much of its ability to deliver the services expected of it promptly and efficiently. Insofar as public sector action is needed to strengthen the growth foundations, the managerial and administrative problems just listed clearly have an impact on all of them.

Among the government agencies most affected by these problems are those in charge of education, public infrastructure, and social assistance. This has a direct impact on two of the foundations: *equality of opportunities* and the *broad sharing of the benefits of growth*, both of which are obviously connected to those areas of policy. *Economic competition* is also affected: for example, in a country like Costa Rica, which despite its small size has areas that are remote and physically isolated, the failure of the state to provide an adequate road network allows local providers of goods to enjoy considerable monopoly power. More generally, failure by the public sector to provide the essential services expected of it, and for which taxes have been paid, effectively dilutes *property rights*, as does arbitrary and time-consuming decision making by government agencies on matters that affect business operations. Inefficiencies in public administration also raise the cost of government itself, thus contributing adversely to *macroeconomic stability*.

How did this loss of public sector effectiveness come about? During the 1980s, and to some degree during the 1990s, government expenditure was severely restricted as the government struggled to rescue the economy from the

9. Initiating a referendum requires the signatures of at least 15 percent of the adult population, or a two-thirds vote of Congress, or the approval of the president and at least half of Congress. Tax bills and constitutional amendments may not be taken to referendum.

crisis of the 1980s and to restore fiscal and monetary equilibria. However, the indisputable fact that the public sector deficit had to be brought under control, together with the undeniable failure of heavy-handed state interventionism, was confused with the quite different and controversial thesis that government should simply be made smaller. What was really needed was to make government more efficient.

Making matters worse, it proved too difficult politically to conduct this downsizing according to well-defined priorities. Instead, restrictions on expenditure were imposed across the board, and a “voluntary labor mobility” program was put in place to reduce the number of public sector workers. Not surprisingly, those who decided to participate were by and large the best qualified, who had a reasonable chance of finding a good job in the private sector, and the most recently employed, who did not benefit from the *anualidades* (annual bonuses) that increase public sector wages each year, independent of performance or inflation adjustments. As the best, the brightest, and the youngest left, the general perception that public workers were less than competent was validated, thus supporting a trend toward government salaries dramatically lagging incomes in the private sector. In turn, the reduced prestige and pay of a government position made it difficult to recruit new talent into public service. Those workers who have remained in the public sector are entrenched by civil service legislation that conspicuously lacks performance-based incentives.

Only those institutions funded outside the general budget of the executive branch, such as the health care system and the state enterprises, were spared from this drain of human resources, and then only partly: legislation was passed that allowed the central government to put caps on investment and expenditure even on theoretically decentralized or autonomous institutions. Meanwhile hostile sentiment prevailed among those public servants who remained, prompted by feelings of persecution, the frustration of limited resources, and the stigma of being seen as “the ones who could not leave.” Consequently, opinion among government workers started shifting toward the anti-reform camp, making it very difficult to implement policy.

At the same time, in an effort to better control corruption and pursue more advanced management techniques, an increasingly complex set of horizontal control regulations was put in place. Rules regarding public sector purchases became stricter, and rules regarding the formulation and execution of public sector budgets became more sophisticated in theory, but increasingly unmanageable in practice for a bureaucracy that was now much less talented than that for which the rules had been designed. Ironically, as the downsizing did not seem to follow a clear pattern, in some cases new institutions had to be created to manage the new controls and fill the most salient voids. These new supervisory agencies became politically important, as a perception of generalized corruption within government became widespread. As a result, controls became more rigid, making the interac-

tion between private parties and the government more difficult.<sup>10</sup> The result, in short, has been paralysis, waste, and inefficiency, even in the provision of such basic functions of the state as public security and the administration of justice.

#### AN EXAMPLE: BUREAUCRATIC GRIDLOCK IN PUBLIC TRANSPORTATION INFRASTRUCTURE

A case study will illustrate the kind of administrative ordeals that now afflict the public sector. Although several examples could be used, perhaps none is more telling than the case of the institutions that provide transportation infrastructure, and in particular the Ministry of Transportation and Public Works (Ministerio de Obras Públicas y de Transportación, or MOPT). The problems described here are not unique to MOPT; rather, it is used here as an example of a malaise that affects many agencies of government.

Historically, Costa Rica's infrastructure has been quite acceptable for a country at its level of development. The quality and density of roads, ports, power networks, telephone lines, and potable water systems were among the best in Latin America by the 1960s and 1970s. This infrastructure was built in a very bottom-up fashion, with the result that key "arteries" were often barely sufficient, but small-scale and regional "capillaries" were abundant, dense, and of high quality. Even today, what remains of these works is a valuable national asset; for example, Costa Rica still leads Latin America in kilometers of paved road per square kilometer of territory.

The slowdown and eventual halt of infrastructure development during and immediately after the 1980s debt crisis was hardly unique to Costa Rica. The building of public works came to a standstill everywhere in Latin America. What is peculiar is that Costa Rica continued on a path of very low investment even after the crisis was over.

The poor quality of roads and other public works today is a commonly expressed concern.<sup>11</sup> This is not surprising: between 1984 and 2005 the share of households that own a car rose from 14.1 percent to 35.1 percent, the population itself grew from 2.4 million to 4.5 million, and GDP climbed from \$4.9 billion to \$27 billion, yet not a single major road or highway was built. No one has gained any political capital by creating this problem. Tourists' complaints about potholes and road quality finally became so commonplace that the tourism industry, unable to do anything about the roads themselves, started advertising "adventure driving" as an attraction.

10. We are not arguing here that controls are unnecessary, but rather that the ones in place are very poorly designed. To give an example: a public works project may not start as soon as a bid has been awarded; instead, all grievances and appeals must first be resolved by the comptroller's office. In other countries such damages are settled and any guilt assessed and punished *after* the project has been completed.

11. According to the competitiveness index published annually by the World Economic Forum, Costa Rica ranked 52nd (among 125 countries) in overall competitiveness in 2006, but 73rd in infrastructure and 102nd in perceived road quality.

Not only are few road projects even attempted; those that are started frequently get frozen in their tracks. Public bids for the San José–San Ramón highway (the busiest part of the Inter-American Highway as it crosses Costa Rica) have been solicited several times, never to be completed. Perhaps even more dramatic is the construction of the highway from San José to Caldera, the country's main port on the Pacific. Half of the road (from San José to the exurb of Ciudad Colón) has existed for thirty years; the other half remains to be built, despite several attempts. Year after year has passed, and the section of the highway that connects Ciudad Colón with Caldera, plus all the main exchanges, remains unbuilt. Under a separate contract, several bridges were built (and paid for) and today stand idle, awaiting the road that someday will connect them. The project was funded by the Inter-American Development Bank almost thirty years ago; the loan was disbursed and was, in principle, payable. The problem was not the money: the contract has been awarded—twice, to no avail. At the time of this writing, after the highway has been contracted out for the third time in thirty years, there are reasons for mild optimism, yet the work has not begun.

Even small-scale projects are often delayed. After the need for a series of pedestrian bridges on the main highways near San José was given priority and notoriety in 2003, only in 2007 were the bridges finally built. Again the delay was caused not by lack of money, but rather by a series of institutional, legal, and administrative impediments that thwarted progress every time. The problem is the result of a strategic shift in the operation of MOPT that was only partially implemented, and of a growing web of verifications and approvals, which a downsized public sector lacks the capacity to handle.

During the downsizing of the public sector, the decision was made to transform the MOPT from a large construction company into a planning and supervising agency, contracting out some projects and overseeing build-operate-transfer (BOT) contracts where feasible. It was expected that this would result in significant efficiencies and savings. The ministry would no longer need such a large payroll, as private contractors, not the ministry, would hire construction workers and civil engineers. Nor would there be any need for the ministry to maintain a large stock of construction equipment.

This change in direction might have made perfect sense in a favorable fiscal situation. However, many crucial elements needed to make the strategy successful were not put in place. In particular, it was easy to strip the ministry of the resources it had needed in its former role, but what proved much harder was setting out the laws, rules, practices, and administrative capacities that would enable the institution to perform its new functions.

Building a road is not just a matter of engineering. It is, first of all, an administrative and legal problem. In Costa Rica the appeal of administrative decisions is a particularly lengthy process, the cost of filing frivolous appeals is negligible, and often public works construction is halted until the issues are solved. In other

countries the works are continued and any damages paid ex post if the appeal is successful.

The operation of the legal system is costly and cumbersome. Until very recently, oral statements were invalid in civil matters; everything had to be in writing. Private written documents are also generally invalid unless notarized, yet only lawyers may notarize a document. Thus, a formality that costs about a dollar elsewhere can cost 1 percent of the value of the contract in Costa Rica. Requirements about form are unclear, and form very often prevails over content. The authorities may not, even for good reason, waive unneeded prerequisites or allow the correction of clerical mistakes. Mistakes in form either invalidate a bidder or take the project back to square one; efforts to expedite the process, even in good faith, put the public officials responsible in danger of criminal prosecution.

Audit procedures have also become increasingly cumbersome, in the mistaken belief that this makes them more effective. The Costa Rican public sector works under an ever-increasing and ever more complex set of horizontal verifications. The state comptrollers verify every aspect of policy and every step taken. The budget authority oversees everything and must preauthorize even the smallest expenditures. The planning ministry publishes each year an intractable National Development Plan, and by law every proposed investment must be justified in relation to the priorities and designs of that plan. Every government agency has its own internal auditor with extensive powers, with whom it is dangerous to honestly disagree. The National Secretariat for the Environment must approve many economic initiatives, even if the environmental effect is negligible.

The cost and difficulty of compliance are constantly increasing, and considerable administrative resources have to be devoted to these tasks alone. Whether or not these controls are actually necessary, it is clear that they could be made simpler with no loss of effectiveness. The requirements imposed on public sector management have been increasing at the same time that its capabilities have diminished. The result, quite predictably, is decreasing effectiveness of the public sector.

Finally, the personal and civil responsibilities and the potential for criminal liability faced by poorly paid public sector workers (including those at the cabinet level) who make the final decisions are daunting. In an attempt to prevent corruption, the law now punishes the bureaucrat who makes an honest mistake almost as harshly as one who profits illegally. The consequence is that even small decisions become daunting, and decision-makers are tempted to take any opportunity to annul or delay a public act, or to make decisions on formalistic grounds rather than on content.

#### DEALING WITH THE OBSTACLES

There is universal agreement that the nation's public services have serious problems, but the solutions are controversial and cut across several political debates. Private sector participation in some services is a big part of the answer, but unfor-

tunately, enough political power still lies with those who miss the old, state-centered system that any proposal along these lines becomes a matter for interminable dispute. At the same time, however, strengthening public institutions will require additional resources and perhaps a larger public sector payroll, both of which are opposed by those who still regard the downsizing undertaken to date as an important and difficult achievement. Finally, freeing the process from unnecessary audits and redundant rules might be perceived or portrayed by some as an attempt to facilitate corruption, especially in the context of recent, widely publicized scandals. Indeed, in the wake of these scandals, the conventional wisdom seems to be that even more regulation is needed, when in fact the reverse is true.

Nevertheless, it is clear that in order to recover the ability of the state to implement policy and provide the services expected of it, actions need to be taken on several fronts. First, the *administrative, managerial, and technical capacities* of the public sector need to be strengthened. This will require a different system of selection, recruitment, and retention of civil servants, one that facilitates the firing of corrupt and incompetent employees and the hiring of honest and capable ones. Among other things, this implies both paying higher wages and raising the public perception of government service.

Second, the *legal framework* needs to be modified. This includes, but is not limited to, minimizing the number of opportunities for appeal; revising the procedures governing BOT and other public-private contracts along the lines that have worked in other countries; and simplifying red tape by making all defects of form more readily solvable, while encouraging officials to base their decisions more on substance and less on form. It also means making comptroller, audit, and court decisions punitive in nature rather than preventive: legal controversies should be dealt with through ex post settlement rather than ex ante delay, except in areas, such as the environment, where this would be dangerous.

Third, although the government no longer faces the same stringent fiscal constraints as in the past (in part precisely because worthwhile public investments were delayed), increasing spending will not solve the problem by itself. More resources are needed, but it is also important to restore some notion of *budgetary priorities*, so that direct provision of services by the state in key areas does not come at the expense of hard-won fiscal stability. No solution is going to work if it has to be applied across the board.

### *Tax and Budgetary Reform*

Although Costa Rica has made significant progress toward macroeconomic stability and has avoided financial crisis for over twenty-five years, the job is not complete. As we have already seen, fiscal balance has been achieved at the cost of reducing and postponing capital expenditure, and the consequences have built up over the years. “No matter what we do, it is always a war economy,” complained a former president. Even after enormous sacrifice, government finances have often

been frail. There is also a persistent quasi-fiscal problem in the form of a central bank deficit; this has fueled inflation, which, although lower than in the past, stubbornly remains between 10 and 15 percent year after year. Costa Rica went from having the second-lowest inflation rate in Latin America in the mid-1980s, to the second-highest in 2005.

According to official data, Costa Rica emerged from the 1980–82 crisis with a public debt in excess of 135 percent of GDP, most of which was owed abroad. This debt burden fell consistently in the 1980s and early 1990s and has fallen very quickly since 2005, so the debt burden is expected to be under 40 percent by the end of this year, and only a third of that is foreign debt. Central government deficits have averaged around 3 percent of GDP since stabilization—at the cost of very tight budgeting—and have turned into surpluses in the last couple of years. As a consequence of administrative improvements in the tax authority, central government revenue as a fraction of GDP has risen consistently in the last ten years, although it still barely reaches 15 percent.<sup>12</sup> Despite this progress, revenue still falls short of what is needed to raise infrastructure, education, and social expenditures to adequate levels and further secure financial stability.

#### IMPACT ON THE GROWTH FOUNDATIONS

Stated quite simply, the revenues of the Costa Rican state are insufficient to its needs, and this fact has a negative impact on all of the growth foundations. In particular, true *macroeconomic stability*, under a government that fulfills the expectations of its population, will require that more resources be directed to the government. A substantial tax reform is needed.

Some of the other growth foundations would benefit from tax and budgetary reform. The *broader sharing of the benefits of growth* requires a government that can afford to make certain public investments, including in education and transportation infrastructure. An increasingly equitable income distribution will require expenditure on a variety of support and redistributive activities and the provision of basic services. A government that can attend to those needs without sacrificing fiscal stability is perhaps the key to bringing about sufficiently *equal opportunities*. But it is precisely these types of investments and expenditures that are being sacrificed in Costa Rica, at an enormous cost, in the pursuit of preserving an erratic macroeconomic stability in the absence of higher tax collections.

Yet even that frugality is not enough. Congress has frequently passed small tax adjustments, barely enough to maintain the status quo, only to be followed by a

12. This number does not include all parts of the Costa Rican public sector, which contains a series of institutions that are funded separately from the central treasury and function somewhat better. Notable among these is the national health care and social security system, managed by the Caja Costarricense del Seguro Social, which gets its resources from a tax on wages and handles them independently of the central government. Another separately funded agency is the job training institution (the Instituto Nacional de Aprendizaje, or INA).

new tax bill a few years later, usually at the beginning of a new administration: every new administration but one in the last twenty-four years has submitted a tax bill to Congress early in its tenure. The finances of the other nonfinancial public institutions have also been kept under tight control, at the very significant cost of postponing for decades necessary investments in infrastructure as well as upgrades and improvements in social services, so as to keep public sector deficits within narrow margins.

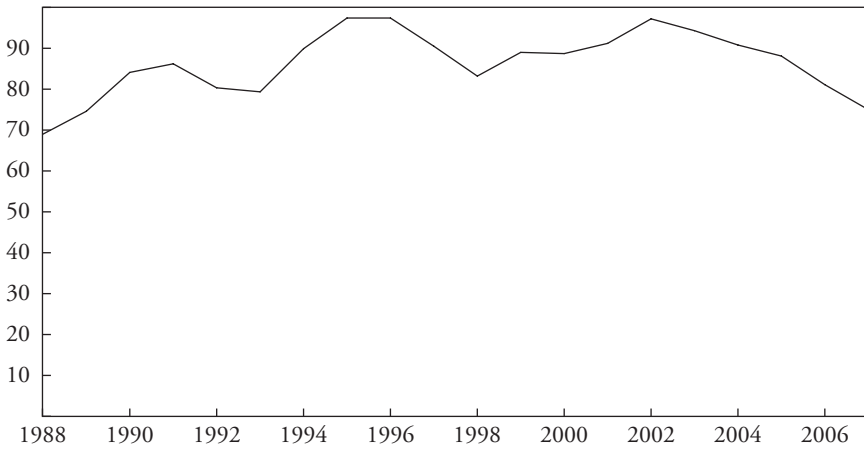
The pursuit of stable public finances without adequate tax collection also causes political difficulty. The government that most Costa Ricans expect, and that many anti-reform forces—including public sector workers—remember fondly, is much bigger than the government that the country can currently afford. The government of that earlier era also had the flexibility to budget strategically and according to priorities, which today's government does not have.

This lack of flexibility is due to the fact that an overwhelming majority of fiscal revenue is needed just to cover payroll, debt service, pensions, and other pre-allocated expenses that are fixed by law or, in some cases, by the constitution itself, and therefore difficult to change. Budgetary stability has thus been achieved at the expense of any discretionary spending that can be postponed in the short run, including strategic projects and, of course, investments in sustained long-term growth. Preallocated expenditures include, among other things, not only spending on social programs but also government salaries and collective action agreements with public sector unions; special, treasury-funded pension regimes; interest payments; legal mandates (earmarks) to transfer certain percentages of specific taxes to predetermined uses (such as road construction or certain special social programs); and constitutional mandates to transfer fixed percentages of revenue to the public university system, the judiciary, and local governments. Figure 2 shows the fraction of tax revenue spent annually on these entitlements over the last two decades. In many years over 90 percent of revenues were precommitted under these provisions, and even then some of the constitutionally mandated items were in fact not met.

Meanwhile the central bank has incurred losses every year since the mid-1980s, usually well above 1 percent of GDP. The government has been able to absorb only part of the resulting quasi-fiscal debt, and these payments, together with greater exchange rate flexibility, have allowed the central bank to bring down inflation somewhat in recent years. But it is becoming difficult for the central bank to sterilize the impact of its financial losses even to the tune of 1 percent of GDP, because it has had to adopt a more contractionary stance to offset other sources of money creation in the economy. Either the government will have to absorb a larger share of the central bank's losses, which means raising taxes since it cannot do much to lower expenditure, or inflation will remain high. As with several other reforms, the technical solution is plain, but the political solution has been so far impossible to discern.

Figure 2. *Precommitted Government Revenue, 1987–2007*

Percent of total revenue



Source: CEFGSA, using statistics from the Central Bank of Costa Rica.

The recurring theme here is that fiscal balance, although a good thing in and of itself, has been achieved at the expense of investment in the country's long-term growth, and at the cost of moderately high inflation, which grows out of the country's quasi-fiscal problems and the choice of monetary policy. To recover the capability of the national government to spend—without sacrificing stability—on infrastructure, education, and income redistribution; to deliver on the broad set of public goods and services that Costa Ricans expect from the state; and to lower inflation to international levels, taxes need to be raised by perhaps 2 or 3 percent of GDP or more. This increase in revenue, moreover, should not come solely from higher tax rates, but mainly from an expansion of the tax base and the closing of loopholes, which might even allow for rate reductions in some cases. The adjustment should be fair, thus eliminating the odd asymmetries in the tax burdens often confronted by Costa Ricans with similar incomes. It should certainly be progressive, because income distribution has worsened significantly over the years. It should allow for further improvements in the effectiveness of tax collection, of the kind that has been enjoyed in the last three years. Finally, it should be politically viable, not only because any reform will have to pass Congress, but also because a broad discussion of the costs and benefits of government is important if the country is to return to cohesion in national politics and chart a clear path forward.

#### OBSTACLES AND SOLUTIONS

Taxes can be modified only through changes in the law, and this means going through Congress. As we have seen, in Costa Rica the perception that government

should do more is so widespread that a majority of parties already agree in principle to a progressive and comprehensive increase in the tax burden. Yet as we have also seen, current parliamentary rules and procedures make it very easy to postpone or even prevent a vote on any law that faces forceful opposition, even one that has majority support.

And tax increases do face forceful opposition. At the very least, the Libertarian Party, for which lower taxes are the dominant issue on the agenda, is large (five members in Congress) and vocal enough to act as a severe bottleneck. Past experience also indicates that even when the two largest parties agree on the general principle (in this case, a progressive increase in the tax burden), they find it impossible to agree on any of the important details. Other parties that have acted as allies of the administration on other issues, but that have no expectation of returning to the presidency any time soon, probably would not support tax reform. These problems loom all the larger because tax laws cannot be passed by referendum.

Other obstacles lie ahead on the path to tax reform. First, such reforms tend to be complex, because part of what is needed relates to administration, collection procedures, and the structure of the tax authority. Second, any tax reform also tends to have large numbers of small winners (the many citizens who would like government to do more) and small numbers of large losers (those who today enjoy exclusions and loopholes), and the latter usually win. Third, tax reforms easily run afoul of ideological divisions, and even parties that agree on the general principle of progressive taxation have never failed to disagree on which taxes are progressive and which are not. Fourth, many Costa Ricans may feel that the problem will fix itself, given that tax revenue has grown faster than the economy since 2000, without any new taxes being enacted, because of administrative improvements in the tax authority, technological changes (collection becomes easier as more transactions involve credit cards, bank instruments, or international payments instead of cash), and the virtuous cycle that sets in as government borrows less, interest rates fall, the deficit falls further, and so on.

But even all these factors together will not be enough to provide the needed revenue; new taxes are necessary. Their approval in Congress will depend, of course, on the political attractiveness of their design and on finding a solution to the legislative procedural problems discussed above. The following strategic considerations may help to make tax reform politically viable:

- It is important in any tax reform to create winners. There have to be identifiable groups that benefit from the expansion of the tax base, the lowering of the tax rate, or the funding and credibility of any earmarked expenses.
- It may be easier to pass tax changes individually rather than as a comprehensive reform. The argument that no government has enough political capital for more than one tax reform, and that therefore it is better to load everything into one package, has yet to be validated in practice.

- The weaknesses of the current tax system allow some profound changes to the system to be defended as “closing loopholes” (always a popular argument) rather than levying new taxes. For example, under current law a company paying sales tax on the purchase of an input may not claim a credit for that tax payment when it sells the resulting output, and this creates incentives for both parties to hide the transaction. Allowing the credit would likely generate more net revenue by bringing more of these transactions into the open. It is also hard to defend the present exemption of several hundred products from sales tax. Another example is Costa Rica’s territorial tax treatment of foreign income: residents pay Costa Rican income tax only on income generated in Costa Rica. This made sense when the country’s tight balance of payments situation provided a reason for the government to encourage Costa Ricans to earn money abroad. But a move to worldwide taxation, in which all income is taxed whether generated in Costa Rica or abroad, would raise more needed revenue without raising tax rates or introducing “new” taxes. Although returns to offshore capital would be hard to identify, returns to labor would not be.

- Under the present income tax structure, each source of personal income is taxed separately, impeding true progressivity. For example, in Costa Rica, a worker with a full-time job faces a higher marginal tax rate, and thus pays more tax, than another worker who earns the same amount at two part-time jobs, because the tax system treats the latter the same as if he or she were two separate individuals. This system needs to be replaced with a global personal income tax in which each individual reports all income from all sources on a single tax form and pays accordingly.

- The current corporate income tax regime has too many deductions and exemptions. Eliminating these would both make filing simple and allow a lower tax rate, which would be politically popular as well as easier to administer. Depending on the rate chosen, it could also generate more revenue, especially if the base were broadened at the same time.

- Taxing obvious displays of wealth and ostentatious consumption at higher rates would be popular, progressive, and a quick, effective way of raising revenue. A proposal is already before Congress to increase the tax rate paid on houses that exceed a certain value and on second homes.

- Current penalties for tax evasion, even when it involves flagrant misrepresentation and perjury, are weaker than they should be, and limited to fines rather than prison sentences. Strengthening these penalties and their enforcement would be not only politically tolerable but even popular, except of course among those who get caught.

### *Telecommunications Reform*

Telecommunications is the most important economic activity still operating as a monopoly in Costa Rica, and therefore reform in this area is key to promoting *economic competition*. Reform should aim not only at increasing the number of

participants in the provision of telecommunications services. It should also seek to improve market access, reduce risk, and lower transaction costs, so as to extend access to better telecommunications services to the general population, with positive effects on competition throughout the economy. These reforms also would reinforce *macroeconomic stability*, as the contingent liability resulting from the state monopoly's operations currently poses a threat to fiscal balance.

Telecommunications is also one of the few areas in which a broad problem of undefined *property rights* exists in Costa Rica. The effort to sustain a legal monopoly in the sector after the economic and technical foundations of a natural monopoly disappeared has led to the emergence of a gray (and in some cases a black) market. Operators in this market lack secure rights to conduct their business, whether through an explicit concession, for services that exploit goods in the public domain, or a clear-cut legal permit, for other services. Some of these services include Internet cafés, Internet telephone (VoIP) services, and direct satellite access to the Internet.<sup>13</sup>

It now looks as if, finally, competition in some telecommunications services will happen in 2009 or 2010, as part of the implementation of CAFTA. However, attempts to liberalize the sector go all the way back to the administration of José Figueres in 1994–98, which raises the question of what has taken Costa Rica so long to get rid of a technologically obsolete monopoly. By many measures, the performance of the government monopoly, Telecomunicaciones ICE, in the more modern telecommunications services, especially cellular phones and Internet access, has been quite disappointing. Freeing the company from some of its current financial and administrative constraints will quite probably not be enough, and it involves some risk. It is worth noting that the repeated attempts at telecommunications reform under the last three administrations not only all failed but also turned the issue into the most heated topic in the political debate.

#### COSTA RICANS ARE FOND OF THEIR PUBLIC UTILITIES

Reform efforts in the telecommunications sector have aimed at moving from a state monopoly to regulated competition. The arguments against a publicly owned monopoly have been twofold: a privatization argument and an anti-monopoly argument:

- Privatization arguments are of different kinds: ideological (the government is incapable of running a large business efficiently), fiscal (the sale of public assets will reduce the public debt), and opportunity cost–based (if the private sector is willing to invest in telecommunications, public resources should not be devoted to the sector but instead focused on areas where private investment is not forthcoming).

13. DirectTV is offered in the country, but the company may not offer Internet access. Some companies set up their own antennas, and the telecommunications monopoly spends considerable resources trying to prevent such illegal connections.

- On the other hand, standard economic theory provides very sound efficiency arguments against monopolies, which need not be repeated here, but these have nothing to do with privatization.

Unfortunately, these two lines of argument have frequently been confused in discussions of privatization in Latin America, and this helps explain why reform has proved so difficult in Costa Rica.

Privatization arguments have not had much traction in Costa Rica, and for good reason: the publicly owned telecommunications company delivered services of good quality cheaply, with extensive coverage and access to at least some services (public telephones) for a large percentage of the population. Meanwhile the opportunity cost argument had no merit: the telecommunications utility has consistently funded itself from its own operations, not from general government revenue. Nor has the fiscal argument had much relevance, or at least it has not today: the public sector debt is shrinking and the government finances are in surplus.

However, three factors eventually resulted in a growing sense of frustration with telecommunications services and in support for market liberalization (but not for privatization):

- investment restrictions placed on the telecommunications utility as a means of restraining central government deficits;
- changes in technology that turned a natural monopoly into a potentially competitive market; and
- “capture” of the company both by its unions and by corrupt politicians, resulting in (to put it euphemistically) inefficient resource allocation.

Technological change seems to have posed a particularly difficult challenge: in the absence of competition, the public telecommunications company had no incentives to adapt, innovate, and learn. It even tried to prevent the adoption of new technologies (such as VoIP) and clung to old-fashioned technology (switches instead of routers). Mobile services were cheap but of low quality, cumbersome to acquire, and with long waiting lists.

Why hasn't telecommunications reform advanced in Costa Rica at the pace it has in other countries? First, since for most of its history the state monopoly had provided adequate service, especially in fixed lines and electricity (the same company also operates the electric power monopoly), many assumed that the problem was not the lack of competition, but rather the details of implementation. Meanwhile, in the heated political debate, confusion was created between opening to regulated competition, on the one hand, and privatization, on the other. Aware of ill-designed and poorly executed privatizations in other countries, many Costa Ricans opposed any reform, fearing it was a Trojan horse for privatization. Furthermore, corruption scandals involving two former presidents, among other public officials, raised suspicions about any and all reform proposals. All these reasons were craftily exploited by a well-organized and well-funded union in the state monopoly with a vested interest in preventing competition, and by disgruntled

anti-reform leaders on the left and in the public sector, who saw the state monopoly in such an important business as the most visible survivor of the former, more statist economy they still venerated.

#### HOW TO DEAL WITH THE OBSTACLES TO REFORM

With the approval of CAFTA by popular referendum on October 7, 2007, liberalization of some segments of telecommunications (mobile telephone services, private networks, Internet services) has become a legal mandate. The implementing legislation was passed on June 4, 2008. Because this came after a popular vote on this specific subject, and after a thorough debate, the political momentum indicates that regulated competition is finally going to happen. It is equally important that the implementation of this new legislation be technically flawless, that regulators perform the tasks prescribed in the laws, and that the leaders of the public company, which will remain in business but no longer as a monopolist, prepare it to thrive under the new reality.

*Transparency* in this process is key. Any hint of wrongdoing in the liberalization process—in particular, in the assignment of the first concession for mobile services—will be cited by opponents as proof that they were right and that liberalization should be reversed. The necessary institutions are in place to make the process transparent, with no political tampering. If the authorities want this process to succeed, they should exercise exceptionally close oversight to make sure the process works as expected, without so much as a hint of corruption.

Also, the introduction of one private operator does not by itself create a competitive market; true competition will emerge only with broad market entry. International experience demonstrates consistently that mobile telephone services retain a highly concentrated structure, especially, and for a longer period, when the starting point is a dominant operator with sole control of all the infrastructure and very strong incentives to deny, delay, or otherwise hinder interconnection with the backbone. Therefore, a *strong regulatory authority* that is not shy about using its power is crucial to prevent abuses or anticompetitive practices on the part of either the incumbent or new entrants.

Finally, the key element that may tip the balance in favor of a liberalized market is *customer education*. Unlike foreign investors and locals with foreign exposure, most Costa Ricans have no experience of anything beyond the service that the government monopoly now provides. They have nothing to compare it with and therefore do not know what they have a right to expect and demand. A better-informed public will exert stronger market discipline on all participants in the sector.

#### *Trade Policy Reform*

Trade liberalization (in particular, export promotion) and the attraction of FDI have been key policy initiatives over the last twenty years, and the results have been mostly successful. Despite this progress, however, trade policy remains a critical

area for further reform, because it affects all of the growth foundations, although some more than others.

Any business environment in which new products are constantly emerging, producers are forced to compete, and activities with high employment potential are unleashed is conducive to greater *equality of opportunities*. Such an environment is more likely to develop in a dynamic, diversified economy that is open to foreign trade. Unskilled workers in such an economy—for example, in the textile sector—find manufacturing employment where before they only had access to lower productivity jobs in the services or in agriculture; professionals in certain fields find private sector jobs where in the past only government jobs existed.

#### THE FIRST FRUITS OF TRADE AND INVESTMENT REFORM

In Costa Rica, export-led growth has been accompanied over the last decade by widespread job creation, and the emergence of dynamic, internationally competitive technology and services sectors has allowed a trained and educated workforce to command a higher premium for their human capital, thus allowing the *benefits of growth to be shared more broadly*. A recent study by PROCOMER (Costa Rica's export promotion agency) indicates that out of a workforce of 1.5 million, 294,000 workers have jobs in firms that export directly 20 percent or more of their output. According to the national income accounts, export value added accounted for 50.6 percent of GDP in 2006. It is well established that labor, the relatively abundant factor in a poor country, is better rewarded under trade than under autarky.

High import barriers turn small markets into oligopolies, limiting *economic competition*. They also make the protection of those barriers the main driver of profitability, allowing concentration of political power and reducing *political competition*. Also, in several key services—telecommunications, electric power generation, and insurance—where the government has monopoly rights and the lack of competition is very damaging, the path to more competition goes through trade. Meanwhile export-led growth has helped improve the fiscal balance, stabilize the foreign exchange market, and allow the central bank to accumulate reserves, thus also contributing to *macroeconomic stability*.

Costa Rica was a largely closed economy from the 1950s until the mid-1980s. Since then the country has pursued integration into international markets, promoted export-led growth, and sought to attract FDI. This shift in policy was originally prompted by the urgency of the balance of payments situation during the 1980s debt crisis, and by the aspiration toward export-led growth at times when the local market was under tight financial constraints. Over time these objectives evolved, and Costa Rica came to focus more on the diversification and sophistication of its exports and on using FDI to pursue the transition to a knowledge-based economy.

The results have been fairly impressive; indeed, trade has been the main driver of economic growth. Since the early 1980s, exports have multiplied twelvefold

and have diversified and become much more sophisticated; FDI per capita is among the highest in the hemisphere—and eight times China's. Real growth in goods exports accounted for 64.7 percent of total GDP growth between 1995 and 2004, with exports of services accounting for an extra 19 percent.

Even as traditional exports (coffee, bananas, and sugar) doubled between 1982 and 2007, a series of new agricultural products (mostly tropical fruits, tubers, ornamentals, fish, and processed foods) emerged, making Costa Rica the world's sixth-largest agricultural exporter on a per capita basis. Manufacturing exports were less than \$300 million in 1982 and went entirely to the protected Central American Common Market; by 2007 they had grown to over \$7 billion, including a number of high-technology products, both from local firms and from affiliates of foreign multinationals. Costa Rica has also become an important worldwide provider of services ranging from ecological and adventure tourism to business services, "nearshoring," and information technology. As they have grown, exports have become more diversified: traditional commodities fell from 61 percent of total exports in 1982 to only 13 percent today. They have also become more sophisticated: many of Costa Rica's goods and services exports are intensive in human capital, technology, and advanced inputs.<sup>14</sup>

The stock of FDI has been estimated at nearly \$6.7 billion in 2006; FDI inflows rose from around \$200 million annually in the 1980s, to \$600 million in the 1990s, to \$1.4 billion in 2007. These flows have been of fairly high quality, involving relatively sophisticated companies, dominant in their markets, in sectors that are considered strategic for the country. Most of this FDI is greenfield—new capital entering the country to create new private productive capacities—rather than the acquisitions, purchases of mining rights, and privatizations prevalent in the rest of Latin America.

Trade policy reform since the mid-1980s has been implemented gradually but consistently through a variety of instruments. Much liberalization has taken place through unilateral reduction of import barriers: tariffs fell from an (unweighted) average of 54.9 percent in 1986 to 3.3 percent in 2005. Like many other countries, Costa Rica offers tax incentives for investment in the form of a free trade zone (FTZ) regime, for mobile FDI that meets a minimum export performance requirement. Companies in FTZs pay no indirect taxes on domestic purchases, international trade, profits, or dividends and have access to special, simplified administrative procedures for all imports and exports. Exporters also have enjoyed a competitive exchange rate: to avoid overappreciation of the local currency and volatility in export returns, from 1984 to 2007 the central bank maintained a nearly constant real exchange rate by applying a system of daily small corrections

14. Lall, Weiss, and Zhang (2006) develop an index of export sophistication, which relates products to the income per capita of the country that exports them. They find that Costa Rica's exports are more than one standard deviation more sophisticated than predicted by its income per capita—despite the fact that the index treats tropical agricultural products as unsophisticated.

in the nominal exchange rate, targeted to offset the differences in inflation between Costa Rica and its trading partners. Before 1998 there were also incentives for exports, in particular a subsidy (known as CAT) for exports of new products equivalent to 15 percent of the gross exported value. This controversial instrument eventually became too expensive and distortionary and a temptation for corruption; early on, however, it was an effective incentive for local firms to enter international markets.

More strategically, the Costa Rican government has procured preferential market access to most of its major export markets, through participation in preference regimes established by developed nations, membership in the Central American Common Market, bilateral free trade agreements with a majority of its trading partners,<sup>15</sup> two dozen bilateral investment treaties, and active engagement in multilateral negotiations. It has also developed a series of support institutions for trade, including a dedicated ministry (the Ministerio de Comercio Exterior, or COMEX) for trade policy and international negotiations. Within COMEX a specialized office oversees the implementation of the country's international trade agreements, and PROCOMER, a hybrid public-private institution, is in charge of export promotion, logistics and tax collection in the export-import process, and the administration of the FTZ regime. A private nonprofit institution, CINDE, is charged with the tasks of attracting FDI, promoting the country "brand," identifying and luring potential investors, and acting as a think tank on issues of business climate and competitiveness.

#### THE REMAINING REFORM AGENDA

Past achievements notwithstanding, the pending trade and investment agenda is very important. National productivity and competitiveness require further attention and a fully articulated national policy where now only certain uncoordinated elements, for example in tourism and nontraditional exports, are in place. Also needed is an enhancement of PROCOMER's activities in helping small and medium-size producers reach the international market, as well as more technical assistance from other agencies.

A variety of measures of bureaucratic costs and barriers indicate that these are on the rise (see World Bank, 2007). Most important, the weakness of the government agencies in charge of infrastructure and education, plus the lack of competition in telecommunications and problems with the national energy strategy, significantly increases the cost of doing business in Costa Rica and limits

15. Free trade agreements are in place with Mexico, Canada, Chile, the Dominican Republic, and CARICOM; pending ratification with the United States; and pending implementation with Panama. Negotiations have been started with the European Union. These agreements have also been instrumental in obtaining commitment to some necessary reforms and establishing competitive rights for investors. Once all these agreements are implemented, Costa Rica will have secure, enhanced market access in the countries that currently absorb 93 percent of its exports.

competitiveness. A number of recent projects by the private sector offer some hope of filling the gap left by the public sector's lack of capacity. These projects include, among others, the analysis of competitive clusters by INCAE, a prestigious business school; efforts by CINDE to reduce the backlog in second-language education; and a strategy for national technological development proposed by a leading group of scientists. But sufficient momentum is so far lacking.

A more pedestrian, but urgent, need is to fix the FTZ regime. Rulings by the World Trade Organization indicate that middle-income countries like Costa Rica will no longer be in compliance with GATT regulations if they maintain a regime of tax incentives based on an export performance requirement after 2013. Although this presents a difficult legal problem, it also provides an opportunity to give the regime a needed overhaul. This could include differentiated incentives for firms established in less developed regions of the country: FDI (except for tourism and agriculture) has tended to concentrate in the San José metropolitan area, where infrastructure is better and human capital more abundant. Another important task is to eliminate the extra administrative burden when inputs are of local origin, which acts as a disincentive for FTZ firms to source locally. Finally, there are currently no instruments linked to training, R&D, or other strategic activities. The problem, here as elsewhere, is that any solution has to go through Congress.

Some FTA negotiations are still pending. The Association Agreement with the European Union has huge potential and promises to reduce dependence on the U.S. market. Central America is one of the world's leading providers of bananas, sugar, fruits, and textiles, and the EU market is large. The challenge is not just to achieve an agreement, but to ensure that it provides adequate market access. Central America would be the first FTA partner of the European Union that directly competes with former European colonies, so there is pressure to avoid the erosion of their preferences. Another negotiation that will require much thought is that on the transformation of the Central American Common Market into a customs union. Although this is bound to be a lengthy process, recent progress has been remarkable. Finally, the enactment of CAFTA is, as of this writing, almost complete but not guaranteed. Even after the popular vote ratified the agreement into law, the implementing legislation was successfully delayed by an opposition filibuster in Congress.

Another challenge is to reduce market concentration in the logistics and commercialization of imported goods. The oligopolistic organization of these markets implies that some of the gains from the phase-out of trade barriers will be appropriated by importers and fail to reach the final consumer. The government institutions that oversee and regulate competition need to be strengthened, and anti-competitive practices in international trade need to be more clearly contained.

Finally, further success in international trade requires progress in the other areas of reform discussed in this chapter. The legal and administrative constraints

choking much of the Costa Rican state affect specifically the provision of education and infrastructure. Certain plant-level manufacturing skills are becoming increasingly scarce, because the education and training systems cannot churn out graduates fast enough in areas such as metal mechanics. The scarcity of some white-collar skills, including in information technology, at both the professional and the pre-college level, is also becoming acute. Also prominent is the need to enhance investment in the foreign language skills of the country's technicians and professionals. Similar weaknesses afflict logistics and transportation infrastructure.

An important step toward maturity has been reached in some industries for a broad spectrum of firms, where it is no longer a case of looking for a pioneer investor or the first exporter, but rather trying to integrate backward or to develop strategic linkages. These broader industry objectives will require strategic policy action.

In Costa Rica, as in all countries, there are opponents to market-oriented reform. They have a large variety of motivations and objectives but are increasingly focused on halting or reversing trade liberalization. Anti-globalization feelings seem to outrank other political objectives. Policy opposition to further market-driven reform—and electoral opposition, in the form of new parties hoping to get elected by capturing the anti-reform vote—see trade reform as the front line; to stop it is to stop other reforms.

Broad consultation within the country and internal negotiation with key local commercial interests are key to overcoming these political obstacles. The consultation process must be conducted in a way that benefits participants, first of all, by listening to them, and then keeps them politically committed to what they have said and accepted. Documenting the process is perhaps just as important.

Meanwhile the opportunities generated by trade should be made more widely accessible. There has been significant progress: many small agricultural producers are now exporters, for example, and many jobs have been created, through trade and investment, for professional, skilled, and unskilled workers alike. But geographic barriers remain to be overcome: the dynamic new sectors have concentrated in the country's central valley, because incentives, infrastructure, and training facilities are lacking in the rest of the country. And those with access to better education certainly gain more than the rest.

## **Lessons from the Costa Rican Experience**

The previous section analyzed five areas of reform that we consider particularly relevant and interesting, both in the context of explaining Costa Rica's growth performance and in the context of applying the CGD framework. We now focus our attention on the latter.

Latin America's economic performance seems, at first glance, to fit the framework. In the case of Costa Rica, *property rights* are comparatively well

established, even in the most complex areas such as intellectual property. Costa Rica has also improved its *macroeconomic performance* quite dramatically since the crisis of the 1980s, achieving stability in terms of debt reduction, fiscal performance, financial market regulation, and balance of payments sustainability. The result has been twenty-five years without a macro-financial crisis. More important, Costa Rica built a broad network of infrastructure and government services throughout the twentieth century, including significant investments in human capital, which allowed a much *broader sharing of the benefits of growth* than its neighbors enjoyed, as well as political stability and huge potential for raising productivity. *Political competition* has long existed in this old democracy, which is full of mechanisms for allowing minority opinions to be heard. Once a degree of economic liberalization had taken place, along with aggressive and successful trade and investment policies, Costa Rica also saw greatly enhanced *economic competition*, whose benefits, through massive job creation and the higher valuation of human capital, were widely (but unevenly) shared. As a result, growth was relatively rapid. In these matters Costa Rica ranks, in our opinion, second only to Chile in the hemisphere in the post-debt crisis period. And the fact that Costa Rica also ranks second only to Chile in accumulated growth is a strong endorsement, again in our opinion, of the CGD framework.

Yet the paradox that we pointed out at the beginning of this chapter—how success at reform has been accompanied by strong (but still minority) hostility to further reform—also fits this theoretical framework. What explains the paradox, in our view, is the fact that, in the last few years, the two most salient characteristics that separate Costa Rica from the pack of Latin American countries—the broad sharing of growth benefits and the country's relatively equitable income distribution—have eroded.

As we have seen, Costa Rica did a fairly good job of protecting the poor and reducing the poverty rate in the aftermath of the 1980s crisis. Although progress in reducing poverty later stagnated, social programs were protected, so that even the poor had access to health care, education, potable water, and other support services. But pressures on the equality of income distribution have grown worldwide in the last few years, and policies aimed at confronting them have not emerged at the same pace.

We should underline that it is neither economic growth itself nor the policies that Costa Rica has enacted in the pursuit of that growth that have allowed the income distribution to deteriorate. Other countries with more lackluster growth performance have also suffered a rise in inequality. And in Costa Rica, as shown above, the subperiod of the last twenty-five years that recorded the fastest growth (2003–07) was also one in which growth was pro-poor, even under a strong definition. Those with little human capital and serious social problems, who as a consequence find themselves in the bottom 20 percent of the income distribution,

require more than employment opportunities and overall economic growth to improve their lot. We believe that reversing the policies that have increased growth would do nothing to enhance equity; instead, what is needed is to complement these policies with stronger and more innovative social policies aimed directly at the distribution problem. This has not happened, perhaps in part because of the real financial constraints faced by the Costa Rican state (and the perception on the part of some that the state needs to remain small and neutral), but also in part because of the institutional and political barriers to action that we have described and that affected not only economic policy reform but reform of social policy as well.

Although Costa Rica's income distribution deteriorated during most if not all of the last twenty-five years, the *broad sharing* foundation also weakened, as another group in the population besides the very poorest has failed to share fully in the benefits of growth, namely, the segment of the middle class that works (or expects to work) in the public sector. This group has been affected by the slowdown of job creation in the public payroll, by the relatively low wages that the government pays its skilled workers, and by the weakening of their benefits and of their standing in society. Their active opposition to reform, their participation in the "globophobic" sentiments now being widely voiced, and their attraction to anti-democratic political forces are easy to understand in these circumstances, and these factors have given rise to new parties that could flourish in the country's unique institutional and political milieu.

In conclusion, both the rapid and accelerating economic growth that Costa Rica enjoyed during 1983–2007 and the political and institutional limitations that have hindered policy reform and challenged the prospects for future growth are successfully explained by the CGD framework. The framework is also a rich one in that it allows an explicit role for profound changes in society, including political change, such as greater democratization; administrative change, such as the fight against corruption; distributional change, such as improvements in health care and education; as well as technological and environmental and other types of change. Like mainstream economic theory, which assigns key roles to both productivity and human capital, but unlike the political fashions of the 1980s, the framework stresses these issues as key to *achieving* growth, rather than as luxuries that a society can afford *only after it achieves* growth. On the contrary, Costa Rica—like Chile and Uruguay, the two other countries in the region with the fastest growth over the last two decades—created institutions that put those "luxuries" first; Costa Rica's experience is a reminder that *fundamentals are fundamental*. They are not "second generation" matters that can come later.

We believe that the Costa Rican story offers some other lessons:

- Although the framework does not address these explicitly, the timing, sequencing, and pace of reform, and the interactions between reforms, are critical. The Costa Rican story suggests that it is a good idea to do things sequentially

and gradually, building on initial successes. The slow progression of the economic transformation after stabilization may have seemed frustrating, but it may have prevented those reforms from being reversed.

- The framework gives due importance to macroeconomic stability, prominently including fiscal sustainability. This is, of course, correct, and without a doubt Costa Rica has benefited from the rapid improvement in and continued attention to its macroeconomic indicators since the mid-1980s. But Costa Rica's story is also a reminder that not all macroeconomic equilibria are created equal. In the effort to cut expenditure and restore balance in the public finances, extra sacrifices were made in some areas to ensure that other public institutions and social services continued to function well even in times of austerity. Although this strategy might seem to be a sign of lukewarm commitment to achieving macroeconomic stability, it proved in fact to be critical for the political sustainability of reform and for keeping certain other essential growth foundations intact. Countries that pursue fiscal probity and macroeconomic stability in the short run, perhaps under the encouragement and supervision of international financial institutions, without caring about the long-run political sustainability of their reforms, will probably show good economic numbers only for a little while.

- Although Costa Rica preserved essential social services from the cutbacks of the early 1980s, its failure to boost tax revenue implied that fiscal stability could only be achieved by postponing key investments and weakening important institutions. A well-functioning state requires the right people in positions of authority, working under the right incentives, laws, rules, and procedures. The lack of these capable people and sound institutions gave rise to institutional and administrative problems, which became a serious obstacle to growth in Costa Rica. In this, as in all human endeavors, the devil is in the details.

Finally, although the framework does not address politics directly, because the political context varies from country to country, reform will not happen if the political groundwork is not laid correctly, as both Costa Rica's successes and its failures illustrate:

- It is necessary to construct *a base of short-term beneficiaries* from the initiatives of government. When a group of people can clearly and concretely see how they themselves profit from a particular policy, they will lend it legitimacy, fight for it, and increase the political cost of reversing it. They will also act as a buffer and first line of defense for the policy, ahead of the technocrats who originally proposed it for complex analytical reasons, and ahead of the politicians, whose motives may be suspect.

- It is important for *reform-minded political parties to maintain a link with academia and with other groups in society*, so that once in government, politicians can rely on a battery of intellectual support and take advantage of open channels to communicate, explain, and negotiate.

- *Reform should have an ideological underpinning, and leaders should educate for change.* It is not only important for policy to be designed as an instrument to achieve a well-defined goal. It is also critical, if that policy is to be implemented successfully and sustained in the long run, that those well-defined goals be agreed upon as stemming from a common set of values and worldviews.

Costa Rica's economic performance has followed a unique course, full of contrasts and paradoxes, successes and failures, and it is a tall order to understand it well. It is a telling achievement of the CGD framework that it can be applied to understanding this story in a flexible and simple way. Nevertheless, this complex story also requires focusing on issues of implementation, politics, and institutional development that also deserve attention.

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