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El blog del FMI sobre temas económicos de América Latina

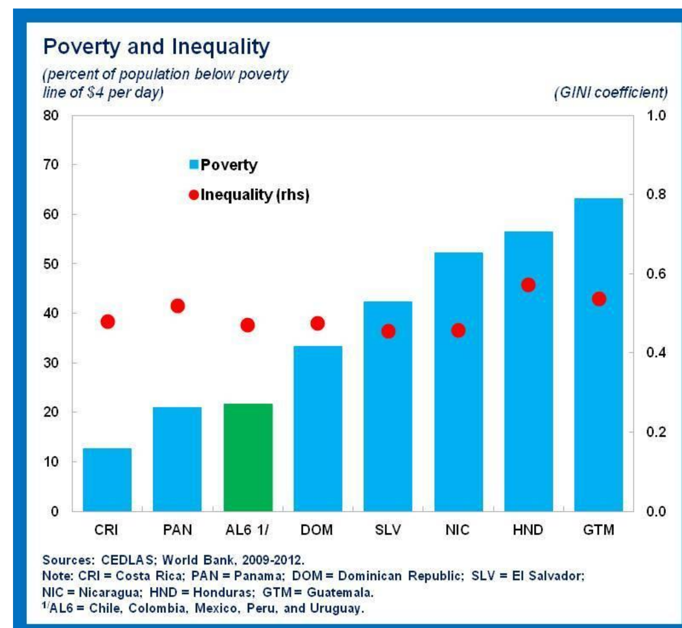
Restoring Costa Rica's Fiscal Health

By Mario Garza
February 10, 2015

Costa Rica has traditionally been a role model for social progress and a leader in attracting foreign investment in Central America. Thanks to the pursuit of appropriate macroeconomic policies, the economy recovered rapidly from the global financial crisis and is now enjoying solid growth and low inflation, in contrast to the double-digit inflation seen in the previous 30 years.

But Costa Rica's economic and social gains are being eroded by large fiscal deficits. At nearly 6 percent of GDP in the past two years, such high deficits will increase public debt rapidly over the coming years. So delaying a fiscal correction would greatly harm the future stability of the economy and hurt Costa Rica's social achievements.

As highlighted in our recent report on Costa Rica the authorities are rightly embarking on an ambitious fiscal adjustment program. But its adoption will not be easy, given the prospects for tightening financial conditions abroad and the need to quickly secure the support of the Costa Rican society. In addition, fiscal adjustment will not be enough to solve other challenges. Costa Rica needs to firmly anchor low inflation, ease vulnerability to financial risks, and upgrade productivity. Thus, complementary policies are needed to reduce risks to macroeconomic stability and to boost inclusive growth.

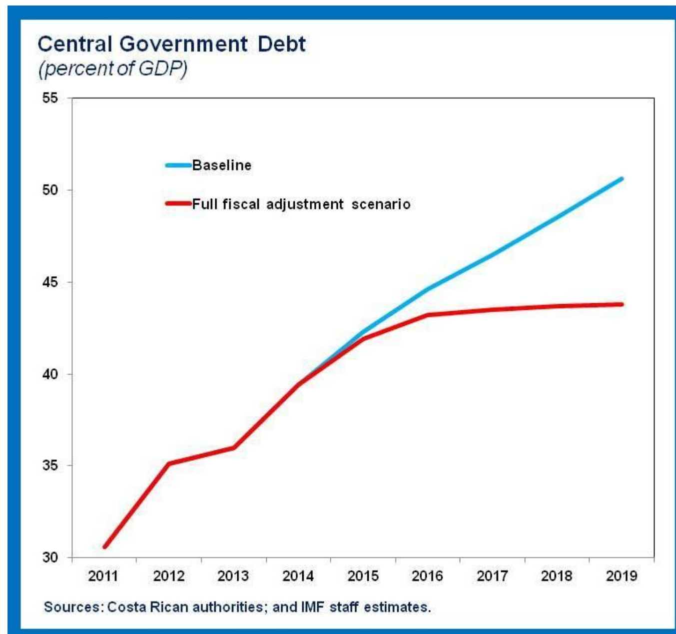


Clouds ahead

The outlook for Costa Rica's economy in the next 5 years looks favorable. Growth is expected to increase—from 3½ percent in 2015 to over 4¼ percent on average over the next four years—owing mainly to strong economic recovery in the United States. At the same

time, inflation is projected to stay low (4 percent). The external current account deficit is projected to remain large (nearly 5 percent of GDP), although it is expected to be partly financed by foreign direct investment.

But the outlook is being tarnished by the weakening fiscal performance. The outlook assumes that the government will adopt the fiscal measures that are at an advanced stage of elaboration but not yet implemented (equivalent to 2¼ percent of GDP). While these measures will offset higher planned spending on education, the fiscal deficit will remain large (at 5½ percent of GDP) and public debt will continue to rise (and reach over 50 percent by 2019). But if these measures are not implemented, for instance, owing to political opposition, public debt could end up much higher (63 percent of GDP by 2019).



These considerations highlight the need for steady reductions in the fiscal deficit, over and above what is already internalized in our projections. Not tightening fiscal balances could elevate the risks of an abrupt shift in investor sentiment and force a disorderly macroeconomic adjustment in the next few years.

Time to tighten the fiscal belt

Fiscal consolidation is essential not only to diminish these macroeconomic risks, but also to slow inflation further and reduce the external current account deficit. In our report, we estimate that a fiscal correction of 3¾ percent of GDP (1½ percent of GDP more than what is assumed in our projection)—with one-third of the correction in 2015, followed by further gradual adjustments over the next four years—would lower and stabilize public debt at 44 percent of GDP. This gradual adjustment pace will also greatly limit the impact on growth and jobs. Beyond this adjustment, achieving financial equilibrium of the pension system in outer years will complete the process of fiscal consolidation.

On the composition of fiscal adjustment, we are of the view that about two-thirds of the effort should come from stronger revenue, which will align Costa Rica's tax collection with other emerging economies. This can be achieved by continuing with the plans to broaden tax bases and phasing out exemptions. These measures will need to be reinforced with higher rates on the value-added and personal-income taxes for high incomes, while making sure that the poorest segments of society are protected. On the expenditure side, savings have to come mainly from the wage bill and current transfers, while allowing for growth-friendly increases in priority investment.

The authorities' plans, which we welcome, are in line with our policy advice regarding the size, pace, and composition of the fiscal adjustment. But most of the actions required for bringing down the deficit need the approval of the national assembly. This will not be easy. The government will, therefore, need to invest its political capital in securing the cooperation of all political parties, and persuading unions and other groups to accept some sacrifices. There is a broad consensus in Costa Rica that fiscal sustainability is the key foundation for stability and growth. And the government should build on this consensus.

Making growth more inclusive

Costa Rica's potential growth has historically stayed close to 4¼ percent per year, but has been slowing in recent years. Our report highlights the key policy ingredients to ward off risks, boost potential growth, and reduce income inequality.

First, in addition to lowering the fiscal deficit to sustainable levels, a stronger policy framework is needed to mitigate risks. In particular, concluding the transition to inflation targeting will help maintain low inflation. Greater exchange rate flexibility is an important element in this transition, as this could also lower risks from unhedged operations linked to financial dollarization. In addition, stronger cross-border banking supervision is needed to deal with spillover risks related to rising financial interconnectedness within the region.

Second, structural reforms are central to boosting productivity and improving competitiveness. Actions to lower energy cost, ease red tape, and upgrade physical infrastructure will improve Costa Rica's competitive edge. Greater competition in the banking system would also help foster financial inclusion. In addition, promoting high quality education and enhanced childhood care would raise women's participation in the labor force. These actions would be essential to raise growth, lower informality, and further ease income inequality.

In the absence of a government majority in congress, the broad support of the Costa Rican society will be the main ingredient for the success of the country's policy agenda for fiscal consolidation and growth. Achieving better results will ensure that Costa Rica maintains its public debt on safe levels and continues to improve the living standards of all Costa Ricans through higher growth.

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