Diálogo a fondo
El blog del FMI sobre temas económicos de América Latina

Managing Fiscal Consolidation in Costa Rica

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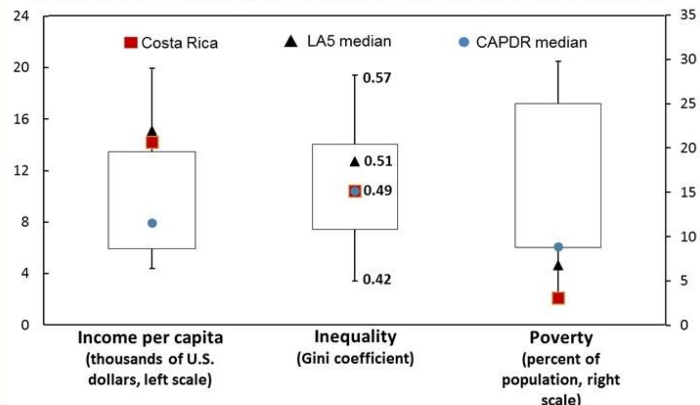
May 23, 2016

Costa Rica has made remarkable strides on the social, economic, and environmental fronts, making it a standout in Central America (see Chart 1). The outlook for the economy calls for solid growth and low inflation, thanks largely to a recovery in the United States, persistently low commodity prices, and still accommodative financial conditions abroad.

Chart 1
Costa Rica has made great strides in improving social indicators.



Sources: World Development Indicators; and Fund staff calculations.
Note: Whiskers represent the highest and the lowest country. Boxes depict the 25th to 75th percentile range. Whiskers and percentile range refers to Central America, Panama, and the Dominican Republic (CAPDR). LA5 = Brazil, Chile, Colombia, Mexico, and Peru. Income per capita converted to U.S. dollars using purchasing power parity (PPP); inequality measured by Gini coefficient (0=full equality and 1= full inequality); poverty line of $2 per day in PPP terms.

Costa Rica's economy is expected to grow at 4¼ percent per year in 2016–18 and then stabilize at 4 percent (the estimated potential growth rate) over the medium term, in line with the average for Central America. Inflation is projected to stay low, within the central bank's new and lower target range of 2–4 percent, supported by prudent monetary policy.

However, a major challenge to the economy is the worsening fiscal situation. Costa Rica's inability to reverse the countercyclical fiscal policies implemented during the 2008–09 global financial crisis has led to large fiscal deficits and a nearly doubling of the public debt-to-GDP ratio since 2008 (42 percent in 2015). Our latest report on Costa Rica warns that, without corrective measures, the debt ratio will continue to grow and reach unprecedented high levels for the country (70 percent of GDP by 2021). Such an acute fiscal deterioration will not only hurt the economy's growth prospects, but also seriously increase the risk that an abrupt shift in financial conditions could force a disorderly macroeconomic correction in the future and turn back Costa Rica's social progress.

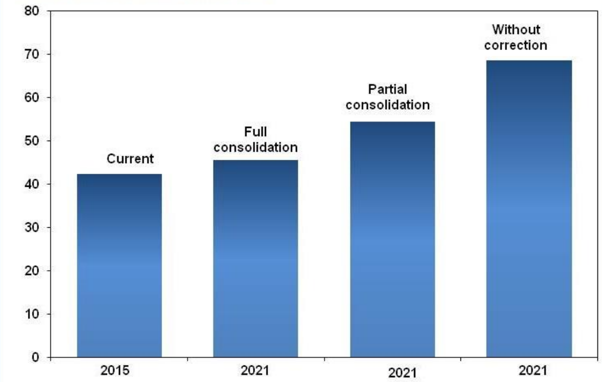
Restoring fiscal health

Taking advantage of the real income gains that Costa Rica is deriving from the favorable external tailwinds, the authorities have put together a strategy to restore fiscal soundness. The challenge is to conduct this budgetary adjustment in a manner that protects growth and job creation, and is socially friendly as well. These are crucial ingredients to gain the approval of Congress and secure the buy-in of society.

That said, at this stage, it is not clear whether the consolidation needed to prevent further increases in the public debt ratio will be politically feasible. Our report stresses that attaining this objective is absolutely necessary.

- Indeed, partial consolidation, for example even one entailing a significant fiscal correction of about 2 percent of GDP (that would result if the national assembly did not approve some of the consolidation measures proposed by the government), would unfortunately not be enough to seriously reduce macroeconomic risks (see Chart 2). While this correction would slow the pace of debt accumulation, it would still let the debt ratio escalate to "unsafe" levels in the next few years (55 percent by 2021). Country experience shows that such high levels of public debt significantly increase the risk of a macroeconomic crisis in emerging economies.

Chart 2
Only a full consolidation of about 3¾ percent of GDP would safely stabilize public debt
(central government debt, percent of GDP)



Sources: Costa Rican authorities; and IMF staff estimates.

- Only full consolidation, based on a larger correction amounting to 3¾ percent of GDP, would safely stabilize public debt. Recognizing this and listening to calls from many stakeholders, the authorities have come up with a fiscal plan that focuses on raising revenues and, sizable measures to contain spending growth that would result in its reduction as a share of GDP over time. This comprehensive effort will maintain the debt ratio at safe levels (46 percent of GDP), which, in turn, will strengthen the foundations of macroeconomic stability and create space for badly needed higher capital spending to boost growth prospects.

The composition of the authorities' consolidation strategy has been well designed. About two-thirds of the consolidation effort will come from higher revenues, which will bring Costa Rica's tax effort more in line with other emerging economies. The revenue gain will result from reforms to reduce exemptions, broaden the tax bases, and lower tax evasion. Other measures include higher rates on value-added and personal income taxes for higher incomes, while protecting lower income families. The remaining one-third of the effort will come from measures to slow the growth in current transfers, the wage bill, and pensions.

The gradual adjustment—expected to start this year—is also well calibrated. The plan envisions between half and two-thirds of the total correction to take place in 2016–17, with smaller efforts spread out over the following four years. Continuation of an accommodative monetary policy, enabled by economic activity being below its potential and low inflation, should help offset any negative impact on output and jobs from the fiscal correction in 2016–17. To secure long-term spending discipline, the authorities have proposed various steps to control expansion of public employment, introduce fiscal responsibility rules, and steadily strengthen the financial position of the pension system.

Our report also highlights that fiscal consolidation must be accompanied by other measures to make the economy more resilient to shocks and facilitate more equitable growth. They should include steps to strengthen the monetary policy framework (such as making the exchange rate more flexible), protect better the financial sector by adopting macroprudential policies, and boost the competitiveness of the economy.

The authorities have already presented most of these fiscal reforms to the national assembly. To avoid reaching unsafe debt ratios, legislators need to act today and should not dilute key ingredients of this strategy. In this regard, the next few months will be crucial for Costa Rica. Political parties, unions, and influential stakeholders need to work together to secure approval of the full consolidation strategy to decisively reduce economic risks for Costa Rica.

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