



**The World Bank**

First Fiscal and Decarbonization Management DPL (P171912)

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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROGRAM DOCUMENT FOR A

PROPOSED LOAN

IN THE AMOUNT OF US\$300 MILLION

TO

REPUBLIC OF COSTA RICA

FOR THE

FIRST FISCAL AND DECARBONIZATION MANAGEMENT

DEVELOPMENT POLICY LOAN

June 12, 2020

Macroeconomics, Trade and Investment Global Practice  
Latin America and Caribbean Region

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Republic of Costa Rica

**GOVERNMENT FISCAL YEAR**

January 1 – December 31

**CURRENCY EQUIVALENTS**

(Exchange Rate Effective as of June 2, 2020)

Currency Unit = Costa Rican Colon (CRC)

US\$1.00= CRC 571.29

**ABBREVIATIONS AND ACRONYMS**

AFD	French Development Agency ( <i>Agence Française de Développement</i> )	IMF	International Monetary Fund
ARESEP	Regulatory Authority for Public Services ( <i>Autoridad Reguladora de los Servicios Públicos</i> )	INS	National Insurance Institute ( <i>Instituto Nacional de Seguros</i> )
BCCR	Central Bank of Costa Rica ( <i>Banco Central de Costa Rica</i> )	MAG	Ministry of Agriculture and Livestock ( <i>Ministerio de Agricultura y Ganadería</i> )
CABEI	Central American Bank for Economic Integration	M&E	Monitoring and Evaluation
CAF	Development Bank of Latin America ( <i>Corporación Andina de Fomento - Banco de Desarrollo de América Latina</i> )	MIDEPLAN	Ministry of National Planning and Economic Policy ( <i>Ministerio de Planificación Nacional y Política Económica</i> )
CAPE	Coalition of Finance Ministers for Climate Action	MINAE	Ministry of Environment and Energy ( <i>Ministerio de Ambiente y Energía</i> )
CCSS	Costa Rican Social Security Administration ( <i>Caja Costarricense de Seguro Social</i> )	MOF	Ministry of Finance ( <i>Ministerio de Hacienda</i> )
CENCE	Costa Rican National Energy Dispatch Center ( <i>Centro Nacional de Control de Energía Costa Rica</i> )	MTDS	Medium-Term Debt Strategy
CG	Central Government	MTSS	Ministry of Labor and Social Security ( <i>Ministerio de Trabajo y Seguridad Social</i> )
CIT	Corporate Income Tax	NDP	National Decarbonization Plan
CNNP	Carbon Neutrality National Program	NFPS	Non-Financial Public Sector
CPF	Country Partnership Framework	NGFS	Central Bank and Supervisors Network for Greening the Financial System
CPS	Consolidated Public Sector	OECD	Organization for Economic Cooperation and Development
CRC	Costa Rica Colon	PFM	Public Financial Management
CSA	Climate-smart Agriculture	PFR	Public Finance Review
CSD	Central Securities Depository	PIT	Personal Income Tax
DPF	Development Policy Financing	RECOPE	Costa Rican Petroleum Refinery ( <i>Refinadora Costarricense de Petróleo</i> )

DSA	Debt Sustainability Analysis	SICOP	Integrated System of Public Procurement <i>(Sistema Integrado de Compras Públicas)</i>
FDI	Foreign Direct Investment	SINAMECC	National Climate Change Metrics System <i>(Sistema Nacional de Métricas de Cambio Climático)</i>
GDP	Gross Domestic Product		
GHG	Greenhouse Gas	SINIRUBE	National Information System and Unique Registry of Beneficiaries (Sistema Nacional de Información y Registro Unico de Beneficiarios del Estado)
GRS	Grievance Redress Service		
IBRD	International Bank for Reconstruction and Development		
ICE	Costa Rican Institute of Electricity <i>(Instituto Costarricense de Electricidad)</i>	SOEs	State-Owned Enterprises (financial and non-financial)
IDB	Inter-American Development Bank	UNFCCC	United Nations Framework Convention on Climate Change
IFC	International Finance Corporation	VUI	<i>Single Investment Window (Ventanilla Unica de Inversión)</i>

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**REPUBLIC OF COSTA RICA  
FIRST FISCAL AND DECARBONIZATION MANAGEMENT DPL**

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## SUMMARY OF PROPOSED FINANCING AND PROGRAM

### BASIC INFORMATION

Project ID	Programmatic	If programmatic, position in series
P171912	Yes	1st in a series of 1

### Proposed Development Objective(s)

The Program Development Objective of this DPL is to support Costa Rica's program to: (i) protect people's income and jobs from the impact of COVID-19 and foster small and medium enterprise recovery; (ii) reinforce fiscal sustainability in the aftermath of COVID-19; and (iii) lay out the foundations for a strong post-COVID-19 recovery by promoting green growth and low-carbon development.

### Organizations

Borrower: REPUBLIC OF COSTA RICA

Implementing Agency: MINISTRY OF FINANCE

### PROJECT FINANCING DATA (US\$, Millions)

#### SUMMARY

Total Financing	300.00
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#### DETAILS

International Bank for Reconstruction and Development (IBRD)	300.00
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### INSTITUTIONAL DATA

#### Climate Change and Disaster Screening

This operation has been screened for short and long-term climate change and disaster risks

#### Overall Risk Rating

Substantial



**RESULTS**

Indicator Name	Baseline	Target
- Beneficiaries of the unemployment allowance (number)	0 (2019)	600,000 (2020)
- Share of families in the lowest quintile of the income distribution covered by <i>Avancemos</i> (percent)	20 (2019)	40 (2022)
- Districts covered by <i>Estrategia Puente</i> (number)	75 districts (2019)	88 districts (2022)
- Amount of additional liquidity provided to SMEs (cumulative, starting in March 2020) (percent of GDP)	0.0 (2019)	0.5 (2022)
- Procedures to start a business (number)	10 (2019)	5 (2022)
- All business processes online (number)	22 (2019)	119 (2022)
- Revenue generated from transferring SOEs' revenues or capital (percent of GDP)	0 (2019)	0.2 (2020)
- Revenue from VAT and income taxes (percent of GDP)	10.3 (2018)	12.2 (2022)
- Annual budgets of the Central Government (CG), Social Insurance Fund (SIF) and universities in compliance with the fiscal rule (number)	0 (2018)	CG = 3 (2022) SIF = 3 (2022) Universities = 3 (2022)
- Average nominal growth rate of the public wage bill in the CG and the Non-Financial Public Sector (NFPS) (percent)	CG: 6.5 NFPS: 6.5 (average 2013-8)	CG: 3.2 NFPS: 3.2 (average 2020-22)
- Benchmark bonds outstanding in the domestic market for amounts US\$1 billion or higher (number)	0 (2019)	2 (2022)
- Reduction of non-competitive issuances, balance of direct investments and "treasury direct" as of end of the year (billions of colones)	774 (2019)	619 (2022)
- Agreements formalizing reporting to the National Climate Change Metrics System (SINAMECC) (number)	0 (2019)	4 (2022)
- Updated emission data reported to the United Nations Framework Convention on Climate Change (UNFCCC) (text)	Data as of 2012 (2019)	Data as of 2019 (2022)
- Municipalities in the Carbon Neutrality National Program (CNNP) (number)	0 (2019)	20 (2022)
- Organizations in the CNNP (number)	0 (2019)	200 (2022)
- Products in the CNNP (number)	0 (2019)	10 (2022)
- Livestock and coffee producers applying Nationally Appropriate Mitigation Actions (NAMA) model (percent of total)	3 and 13 (2019)	7 and 20 (2022)
- Farms/producers receiving environmental service incentives (number of integrated farms)	50 (2019)	100 (2022)
- Power plants registered to provide ancillary services according to the procedures established for these purposes (number)	0 (2019)	13 (2022)



## IBRD PROGRAM DOCUMENT FOR A PROPOSED LOAN TO THE REPUBLIC OF COSTA RICA

### 1. INTRODUCTION AND COUNTRY CONTEXT

1. **The proposed operation supports Costa Rica in mitigating the social and economic impacts of the coronavirus (COVID-19) pandemic and lays the foundations for sustainable fiscal recovery that also promotes green growth and low carbon development.** The proposed US\$300 million operation is the first in a programmatic Development Policy Financing (DPF) series of two in support of the Government's program to: (i) protect people's income and jobs from the impacts of COVID-19 and foster small and medium enterprise (SME) recovery; (ii) reinforce fiscal sustainability in the aftermath of COVID-19; and (iii) lay out the foundations for strong post-COVID-19 recovery by promoting green growth and low-carbon development. Supporting the Government of Costa Rica in effectively responding to the pandemic is critical to assist the population in greatest need, prevent job loss, and foster job creation, while at the same time tapping non-distortionary revenue sources to partially fund these efforts. Once the crisis moderates, the authorities plan to reinforce their fiscal and decarbonization programs, which the Government had vigorously launched prior to the pandemic. Swift and continuous implementation of fiscal and decarbonization reforms is essential to boost the country's stabilization efforts and generate new sources of sustainable growth. The last DPL for Costa Rica (P115173) was approved in April 2009.

2. **Costa Rica has been hard hit by the impact of COVID-19, but so far containment and relief efforts have been adequate to flatten the curve and reduce deaths.** As of June 2, 2020, 1,105 cases have been detected (10 deaths). The Government responded quickly by introducing strong containment measures while reallocating spending and mobilizing revenue to create headroom to fund the response and rolled out programs to support vulnerable segments of the population. Containment measures included international travel restrictions, partial lockdowns and closures of schools, national parks and most economic activities. A relatively well-developed healthcare system rapidly expanded treatment capacity (including converting a rehabilitation center into a hospital) and testing has steadily increased.

3. **While containment measures flattened the infection curve, they also have – together with the effects of the global recession – brought to a halt the recovery of late 2019 and early 2020 and resulted in a sharp contraction of the economy.** Data from the Central Bank of Costa Rica (*Banco Central de Costa Rica*, BCCR) suggests growth fell from 3.1 percent in the fourth quarter of 2019 to 0.5 percent in first quarter of 2020, after only two weeks of lockdown. This rapid decline validated predictions of a deep recession, with GDP expected to contract by 3.3 percent in 2020 and poverty expected to increase by at least 3.5 percentage points, to 13.6 percent of the population (180,200 new poor).<sup>1</sup> The total impact on annual poverty rates will depend on the duration of the crisis and the speed and extent of economic reactivation over the coming months. Importantly, asset depletion among certain households could have longer-term effects on the recovery in terms of consumption smoothing. Approximately 60 percent of all workers (1.2 million) are expected to be impacted by the shock, given either their participation in the most affected sectors (those related to tourism, construction, and commerce), their informal employment, or their employment in small firms. While the majority of the total affected are in the Central region (63 percent) given population concentrations, certain regions have a higher share of their population affected,

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<sup>1</sup> Poverty is defined using the US\$5.5 per capita per day poverty line at 2011 Purchasing Power Parity (PPP) prices.



including Brunca, Chorotega and Pacifico Central (with the last two relatively more dependent on tourism).

4. **Measures to save lives and livelihoods were swiftly implemented.** To save lives, the authorities postponed non-urgent care and rapidly invested in medical equipment and infrastructure. To safeguard livelihoods, jobs and provide liquidity to SMEs, the authorities launched a special allowance (*Bono Proteger*) targeted at those who have lost their job, including informal and independent workers earning less than US\$1,310 per month prior to the crisis,<sup>2</sup> continued to provide school meals, and deferred tax returns and payments for three months and social security contributions for the duration of the emergency. Flexible work arrangements were also introduced, along with SME credit lines via state-owned banks. Monetary policy has been eased and commercial banks are postponing debt service for those companies and individuals that request forbearance to meet immediate liquidity needs (Box 1).

5. **The authorities reprioritized Central Government (CG) spending toward health and social measures, complementing already deployed resources by the autonomous Costa Rican Social Security Administration (*Caja Costarricense de Seguridad Social, CCSS*).** Immediate health sector needs were funded out of the CCSS and the National Catastrophe Fund. The additional temporary spending measures were funded by reprogramming spending, temporarily tapping non-distortionary revenue bases and mobilized additional resources from multilateral institutions. The authorities suspended salary increases for public employees in 2020 (except for law enforcement and healthcare workers), postponed their 2020 annual bonus, and froze 4,953 public sector vacancies along with the initiation of new public investment projects. They also transferred excess capital and revenues from public insurance and fuel companies to the budget.

6. **The proposed operation is being prepared as part of an international financing package to support Costa Rica during the COVID-19 emergency.** The series is part of a coordinated effort by the international community to support Costa Rica's macroeconomic stabilization and sustainable growth program. In the context of COVID-19, this effort has been adjusted to help the crisis response. The international package includes an International Monetary Fund (IMF) Rapid Financing Instrument (RFI) for US\$504 million, which was approved on April 29, 2020 as a bridge until a full arrangement is in place. Attached to the IMF's RFI, the Inter-American Development Bank (IDB) is preparing a financing package of around US\$250 million to support the crisis response and has already approved a budget support operation together with the French Development Agency (AFD) for US\$380 million. The Development Bank of Latin America (CAF) has already disbursed a package of around US\$500 million to support the crisis response and the Central American Bank for Integration (CABEI) is providing US\$300 million in parallel co-financing to the proposed IBRD operation.

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<sup>2</sup> The allowance equals to about US\$220 per month for 6 months and has been paid to about 414,000 individuals already as of mid-May 2020.



**Box 1: Costa Rica's Economic and Social Response to COVID-19**

**Saving lives.** The authorities: (i) issued a declaration of national emergency, including the closure of all schools until further notice (school meals continuity for at least 850,000 students), cancellation of large public events and closure of bars, clubs and casinos; (ii) banned non-residents and non-nationals from entering the country and imposed a mandatory quarantine on those who have close contact with the infected and/or who enter the country from abroad; (iii) authorized flexible work hours for the private sector, including reducing working days up to 50-75 percent to support virus containment while keeping firms afloat and (iv) increased CCSS's response capacity (228 ventilators acquired, medicines delivered to patients at home, reconverted a health facility to assist exclusively COVID-19 patients), and promoted the public production of hand sanitizers.

**Preserving livelihoods.** The authorities: (i) approved a three-month moratorium on the payment of value-added taxes (VAT), business income taxes, and customs duties; (ii) made social security contributions proportional to the time worked, and deferred their payment until the end of the year; (iii) triggered a fiscal rule escape clause to allow higher spending by the Institute of Social Assistance (*Instituto Mixto de Ayuda Social*, IMAS), Ministry of Labor and Social Security (*Ministerio de Trabajo y Seguridad Social*, MTSS), police and firefighters corps; (iv) transferred CRC 33 billion (≈US\$60 million) from the Ministry of Finance (*Ministerio de Hacienda*, MOF) to CCSS to compensate for the reduced 25 percent minimum contributory base for three months; (v) launched a CRC 225 billion (≈US\$390 million) program to provide a subsidy of CRC 125,000 (≈US\$220) per month/family for three months for individuals temporarily or permanently laid off or facing reduced working hours and with a monthly income of less than CRC 750,000 (≈US\$1,310) prior to COVID-19; ; and (vi) approved a supplemental budget that: (a) included the above-mentioned social programs; (b) cancelled 4,953 public vacancies for 2020; (c) set an implicit tax on fuel sector revenue, by freezing the domestic consumer fuel price for premium gasoline as of March 4, 2020; (d) transferred to the budget about CRC 75,000 million (≈US\$130 million) of excess capital in the National Insurance Institute (*Instituto Nacional de Seguros*, INS); and (e) suspended salary increases for public employees (except for the police and health workers) for 2020 and postponed annual bonus payments (except for police and health workers).

**Providing liquidity.** The authorities: (i) reduced the Central Bank policy rate by 100 basis points (bps) to 1.25 percent; (ii) reduced interest rates of the Permanent Credit Facility and the Permanent Deposit Facility of the Integrated Liquidity Market from 2.75 and 0.75 percent to 2 and 0.01 percent, respectively; (iii) temporarily reduced the minimum accumulation of countercyclical provisions for financial entities; (iv) provided emergency funding of CRC 8 billion (≈US\$14 million) to SMEs (*Programa de Primer Impacto*); (v) established a voluntary loan moratorium for cooperatives and SMEs affected by coronavirus; (vi) authorized Central Bank to purchase government securities in the secondary market under market stress and to offer liquidity to complementary pension operators; and (ix) authorized withdrawal savings from a supplementary Labor Capitalization Fund for employees whose incomes are reduced due to lay-offs or working hour reductions.

**Preserving jobs.** The authorities: (i) extended importer licenses and created simplified procedures for phytosanitary approvals and border-crossings for food and health imports; (ii) waved all paper submission requirements and allowing for electronic payment processing; (iii) issued guidelines to government agencies to adopt practices to extend permits, licenses and concessions until January 2021; (iv) established a four-month moratorium on tourism taxes for firms in the tourism sector; and (v) announced CRC 584 billion (≈US\$ 1,000 million) in flexible credit lines to finance payroll, working capital and seed capital through state-owned banks to boost output recovery.

**Reopening of the economy.** As the infection curve has flattened and the health system has been strengthened both to prevent and treat the virus, the authorities have already announced a staggered plan to reopen the economy. Recreational activities and non-essential businesses started to re-open gradually starting May 1. Also, a four-phase re-opening plan was announced on May 11 to be implemented from June through August 2, sequencing activities along with capacity restrictions.



7. **In crafting a short- to medium-term response to the crisis, the authorities have made it clear that additional public spending is temporary and does not imply a loss of control over public finances.** Costa Rica had enacted a major fiscal reform at the end of 2018 putting the country's debt on a sustainable path. The revenue measures include replacing the sales tax with a value-added tax with a broader base, increasing personal income taxes, harmonizing the treatment of capital income across taxation regimes and introducing best practices to combat base-erosion and profit-shifting. Measures to contain the wage bill were also enacted, together with a fiscal rule that caps the nominal growth of spending by amounts that are inversely proportional to the country's public debt ratio. Building on the end-2018 fiscal reform, the authorities announced additional measures in February 2020 in response to an interest bill hike and the materialization of one-off spending that increased the overall deficit in 2019. These measures included revamping tax collection (supported by the Fiscal Management Improvement Project, P172352), replacing expensive debt, consolidating public institutions and streamlining public wage scales, and reducing debt through asset sales and tapping the financial surpluses of decentralized public entities. The February measures reassured markets of Costa Rica's commitment to fiscal discipline with spreads on both international and domestic bonds stabilizing, although still at relatively high levels, although the deep impact of the pandemic on the country led to a downgrade by Fitch from B+ to B on May 8, 2020, which aligns its rating to that of other agencies.

8. **The social and economic impact of COVID-19 has slowed down the fiscal adjustment, but only temporarily, as the fiscal response effort has been based on reversible measures, with a clear prioritization of objectives and consistent focus on contributing to expanding fiscal space.** While all measures continue to be in place, key elements have appropriately been "deactivated" during the pandemic. The moratorium on all tax filing and payments was required to ensure that individuals and companies retain liquidity to confront the reduction in income and demand, respectively. The escape clause of the fiscal rule was also invoked, although temporarily and selectively to allow an increase in health, social protection, labor and law enforcement spending. Also, given the prominent role local government's play in the fighting of the pandemic, mitigating its economic impact and fostering a recovery, subnational spending financed through own sources was exempted from the fiscal rule.

9. **Costa Rica's growth and economic diversification strategy builds on the country's key strengths, including its trademark natural resource management.** Costa Rica's development success is an anchor of stability in the region. Per capita income has doubled over the past two decades due to openness to trade and foreign investments as well as a significant investment in human capital and institutions. Costa Rica is also a worldwide leader in environmental management policies and the only tropical country in the world that has managed to reverse deforestation, receiving the "2019 Champions of the Earth" award, the United Nations' (UN) highest environmental honor for its leadership in natural resource conservation and its commitment to ambitious climate policies. On May 15, 2020, Costa Rica was invited to become the Organization for Economic Cooperation and Development's (OECD) 38<sup>th</sup> member and the fourth Latin American country. The accession process required approving and implementing structural reforms in areas that also support medium-term growth prospects (environment, fiscal, health, education, governance, labor and finance).

10. **The country's National Decarbonization Plan 2018-50 (NDP) aims to modernize and revitalize the economy through a green growth lens as much as reverse increases in greenhouse gas (GHG) emissions.** By introducing incentive schemes to accelerate and scale-up the deployment of low-carbon technologies in the agriculture sector, and by strengthening the country's green branding, Costa Rica can pioneer ways to enhance market access and export zero-emission/green products, that will bring added



value to these products along the quality and price ladders. In the energy sector, the national electric system will be strengthened to increase capacity and resilience needed to supply and manage renewable energy at competitive costs. The banking sector regulator, the Central Bank, and key financial sector players are already working to improve financial sector readiness for sponsoring carbon neutral projects in the agriculture, housing, and manufacturing sectors that are sound on environment, social and governance grounds—which the authorities view as the only sustainable manner in which to finance the majority of NDP measures when the Plan is fully deployed in 2031; the NDP’s initial phase (2018-2022) is currently under implementation, to be followed by its intermediate phase (2023-2030). At the same time, efforts are ongoing to retool public investment decisions to make them climate-neutral, including by incorporating climate change considerations in the discount rate. Costa Rica is an active member of the Central Bank and Supervisors Network for Greening the Financial System (NGFS) and the Coalition of Finance Ministers for Climate Action, entitled Climate Action Peer Exchange (CAPE).

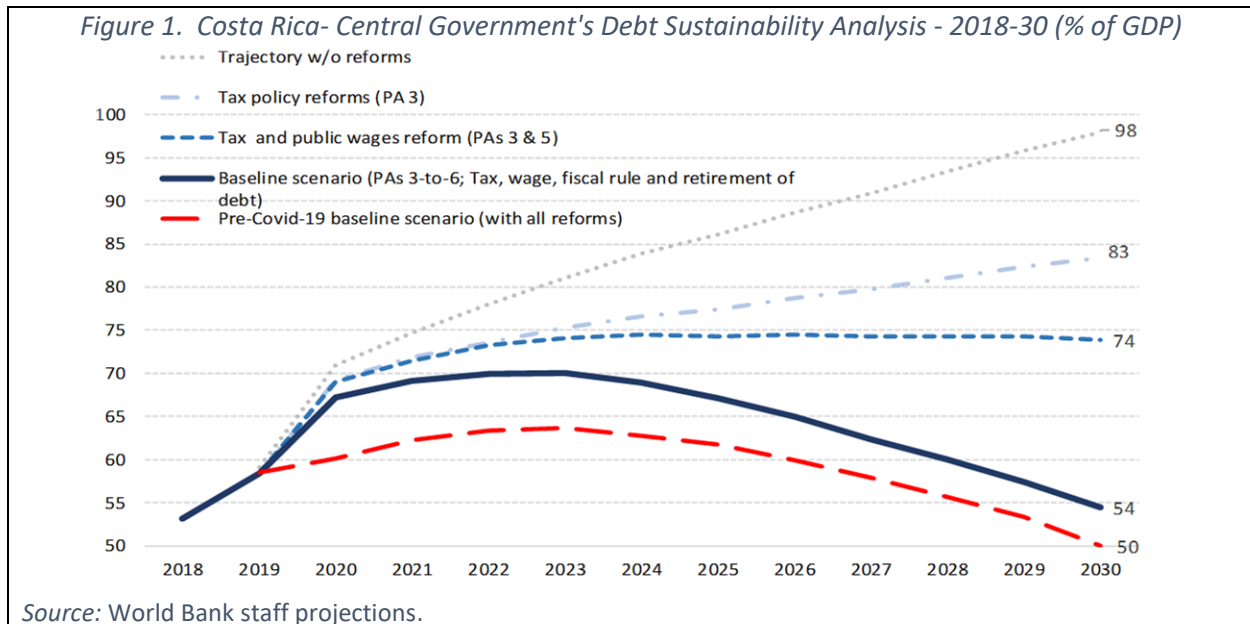
11. **The proposed DPL series is part of Costa Rica’s COVID-19 response to protect individuals and jobs, while supporting two essential elements to relaunch growth, namely the country’s fiscal consolidation and low-carbon development plans.** Pillar A supports special allowances to households in need, and measures to protect jobs and SMEs affected by COVID-19. Pillar B builds on the transitory measures to finance COVID-19 response to re-launch, once the pandemic recedes, an ambitious fiscal consolidation based on: (i) broadening bases for taxes on consumption and all sources of income; (ii) reducing the wage bill and restraining overall spending; and (iii) improving debt management. Finally, Pillar C builds on pre-COVID-19 plans to deepen the country’s already solid foundation for green growth by creating the system needed to consistently register, track and analyze carbon development initiatives and their impact on green growth. It also sharpens agricultural and environmental policy coordination to sustainably leverage natural resources for growth (e.g., land and forestry), and improves regulation to increase investments in renewable energy sources. Overall, the supported reforms are expected to be distributionally neutral or positive and environmentally friendly.

12. **Costa Rica’s macroeconomic policy framework underpinning this operation is deemed adequate, but subject to significant risks.** First, Costa Rica’s external sector strength has been enhanced by sustained trade, tourism and foreign direct investment (FDI) flows. The 2020 recession is expected to temporarily widen the current account deficit from 2.5 to 4.8 percent of GDP, but multilateral support is expected to meet the additional financing requirement and avoid the need to use international reserves for reasons other than smoothing out volatility. After 2020, external imbalances are expected to be smaller and fully funded by FDI. International reserves stood at US\$9 billion at the end of 2019 (14.5 percent of GDP and 5 months of non-free economic zone import coverage). Second, the financial sector is stable and entered the crisis with adequate capital and liquidity buffers, and overall low albeit ticking-up nonperforming assets. The sector is nonetheless exposed to currency risks since around 36 percent of its portfolio is in foreign currency to hedged and non-hedged clients – a risk expected to be mitigated by able monetary and regulatory management. Third, the monetary policy framework has been vastly improved with the introduction of the inflation-targeting regime, adopted in 2018 after over a decade of preparation, which has reduced the level and volatility of inflation and the pass-through of depreciation to inflation.

13. **Fiscal sustainability had been the weak link in the overall macroeconomic framework, but important fiscal reforms were steps in the right direction.** The framework to assess fiscal sustainability is aligned with the IMF’s RFI and is based on the following: (i) growth is projected to drop by 3.3 percent



in 2020 as a result of the pandemic, but gradually converge toward its potential level of 3.5 percent by 2024 driven by solid economic fundamentals and the implementation of structural reforms related to OECD accession and green growth; (ii) the primary balance is expected to improve by almost 6 percentage points of GDP over the next four years, from an expected 3.7 percent of GDP deficit in 2020 to a 2.2 percent of GDP surplus in 2024, driven mainly by already enacted tax, public wage and expenditure constraint reforms with pay-off expected to re-start in 2021; (iii) debt management operations are expected to focus new issuance on fewer lines with larger amounts, thus increasing liquidity in the government security secondary market and eventually reducing costs; and (iv) asset and liability management policy should allow retiring debt for about 2.1 percentage points of GDP by using the proceeds from asset sales and consolidation of government balances in the treasury account (in addition to 1.5 percentage points already retired in early 2020). Overall, these components will cumulatively contribute to stabilize the Central Government’s debt-to-GDP ratio, which is expected to peak at 70 percent in 2023 and fall thereafter to 54 percent by 2030 (Figure 1) The IMF assistance through the RFI can possibly be followed by an upper-credit-tranche program (i.e., a Stand-By or an Extended Fund Facility arrangement) as warranted.



14. **The risks associated with the proposed DPF are rated as Substantial.** While the Government is strongly committed to the reform agenda, there are significant downside risks that could delay or complicate the implementation of structural reforms. Macroeconomic risks have been assessed as high and arise from a protracted impact from COVID-19, stressing the economic, social and fiscal situation further. The baseline macroeconomic framework expects economic activity to resume in the third quarter of 2020 and economic activity to pick up very gradually after that. Risks to this scenario include an extended recession in the global economy or longer than expected domestic lockdown measures. The strength of the country’s economic and health sectors coupled with an able policy making process and the support of the international community are expected to mitigate this risk. Further, the fiscal framework might encounter liquidity or refinancing risks, which will be mitigated though additional fiscal measures, some already indicated as triggers for DPL 2, and by greater access to multilateral funding, including an arrangement with the IMF, as warranted.



## 2. MACROECONOMIC POLICY FRAMEWORK

### 2.1. RECENT ECONOMIC DEVELOPMENTS

15. **Prior to COVID-19, external shocks and a fragile fiscal situation weakened growth, but the approval and implementation of the fiscal reform boosted confidence.** After growing by an average of 4 percent per year between 2010 and 2016, growth slowed to 3.4 percent in 2017, 2.6 percent in 2018 and further to 1.2 percent in the first half of 2019 driven by a worsening fiscal situation, the crisis in Nicaragua, and demand and supply shocks depressing agricultural activities. However, the fiscal reform approval in December 2018 and its implementation starting in July 2019 dissipated uncertainties, contributing to accelerate growth to 3.1 percent during the 4th quarter of that year and resulting in overall growth of 2.1 percent. The recovery continued throughout the first two months of 2020, until the COVID-19 outbreak. Tourism activities increased by a massive 8 percent in the first two months of 2020 (y-o-y), aided by the country's positioning as a top ecotourism destination renowned for its national parks and biodiversity.

16. **While Costa Rica's external situation has been strong, thanks to robust exports from special economic zones and continued FDI inflows, it is currently being impacted by the COVID-19 shock.** In recent years, import growth has been weak given the slowdown in domestic demand, while traditional (agricultural) export growth decelerated. This was compensated by a strong dynamism in the export of medical devices and other products from special economic zones that attract the bulk of FDI and has been the key engine of growth. A slowdown in imports coupled with stable exports reduced the current account deficit from 3.3 to 2.5 percent of GDP between 2018 and 2019. FDI fully financed this gap. Net international reserves increased from 12.4 to 14.5 percent of GDP during the same period. However, the global growth slowdown and containment measures are having a sharp impact on the balance of payments. Tourism receipts, which usually represent more than 19 percent of annual exports, collapsed in March and April 2020, due to border closures and travel restrictions domestically and abroad.

17. **Inflation remains low and the Central Bank has deepened its accommodative monetary policy stance to support the economy during the COVID-19 crisis.** The Central Bank adopted an inflation-targeting regime in 2018, that had been under preparation since 2005 and, in February 2019, the Assembly increased Central Bank independence by revoking the MOF's voting powers in its Board of Directors. Altogether, these measures strengthened the credibility of the monetary policy framework to "weather the storm" when required, including reducing foreign exchange interventions and avoiding Central Bank direct financing of the deficit. As inflation was 1.5 percent during most of 2019, below the 2 percent lower bound target, the Central Bank adopted a looser stance by lowering the policy rate from 5.25 to 2.25 percent, and by decreasing minimum legal reserve requirements from 15 to 12 percent. This stance was justified given the rise in unemployment, the deflationary effects of a weakening domestic demand and the slowdown in credit to the private sector, the well-anchored inflation expectations and the reduction in rates by the United States Federal Reserve. To support the economy in light of the COVID-19 shock, in March 2020 the Central Bank deepened its accommodative monetary policy stance to continue providing liquidity to the financial system by reducing the policy rate from 2.25 to 1.25 percent and the gross interest rate on overnight deposits from 0.62 to 0.01 percent, reducing the interest rates of the Permanent Credit Facility and the Permanent Deposit Facility of the Integrated Liquidity Market from 2.75 and 0.75 percent to 2.00 and 0.01 percent, respectively.



18. **The recent accommodative monetary stance has had a limited impact on the exchange rate, which has been stable.** Before the passage of the fiscal reform at the end of 2018, the Costa Rican public sector faced liquidity difficulties leading to increases in bond spreads and depreciation pressure on the exchange rate. Government's demand for foreign exchange stressed markets, which prompted an exchange rate depreciation and required Central Bank intervention to smooth out the spike. Once the fiscal reform was approved in December 2018, markets started to calm down and, aided by short term inflows related to the embedded tax amnesty of the reform, the Costa Rican Colon (CRC) appreciated by 10 percent against the US dollar (US\$) between the peak in November 2018 (CRC 629 per US\$1) and January 2020 (CRC 565 per US\$1). The Central Bank reduced its interventions significantly, closing the year with only US\$76 million in net interventions (compared to US\$453 million in 2018). Unlike most countries in Latin America which have had a large depreciation of their currencies since the beginning of the pandemic, the CRC has not depreciated. As of May 12, 2020, the CRC registered an accumulated appreciation of 0.6 percent and significantly less volatility than in the same period of 2019. International reserves as of May 11 were US\$8.6 billion, equivalent to 14 percent of GDP, providing six months of import coverage and a reasonable buffer for the Costa Rican economy.

19. **Banks have adequate capitalization, liquidity and provisioning levels, although credit dollarization is high and non-performing loans, albeit at low levels, are growing.** As expected during an economic slow-down, asset quality has deteriorated through 2019, with non-performing loans increasing from 1.6 to 2.4 percent of total banking system loans; however, these remain fully covered by provisions. High dollarization continues to be a main source of risks for the Costa Rican financial system, since about 40 percent of private deposits are denominated in foreign currency, mostly with private domestic and foreign banks. Similarly, about 40 percent of credit to the non-financial private sector is denominated in foreign currency. Due to the Central Bank shift toward greater exchange rate flexibility since the second half of 2018, credit has shifted toward local currency-denominated loans, triggering a reduction in the high levels of bank loan dollarization. While a real exchange depreciation could affect the health of the banking sector, the IMF external balance assessment for the RFI concluded that the real exchange rate is broadly consistent with fundamentals. In response to COVID-19, the Central Bank and the financial and the financial sector regulator (*Superintendencia General de Entidades Financieras*, SUGEF) have taken actions to ease credit and liquidity conditions for households and businesses to prevent a widespread collapse. These include a temporary reduction of the minimum accumulation of counter-cyclical provisions for financial entities, a 12-month suspension of provisioning rules for entities that enter category 2 when they record losses for at least six out of the previous 12 months, a loan moratorium for cooperatives and SMEs affected by coronavirus, and authorization to the Central Bank to purchase Government securities in the secondary market under market stress and to offer liquidity to complementary pension operators. These measures are appropriate, however it is crucial that they remain temporary, to avoid moral hazard and poor credit risk management practices.

20. **In 2019, the Central Government's overall deficit reached 7 percent of GDP due to one-off spending and a higher interest bill, but the first quarter of 2020 delivered the lowest primary deficit in a decade.** In 2019, revenues started to reflect the positive impact of replacing the sales for a value added tax (VAT), which kicked-off in July 2019: tax revenues reached 14 percent of GDP, up from 13.3 percent of GDP a year before. On the spending side, while public sector wages increased minimally in nominal terms (1.2 percent), overall spending increased driven by a higher interest bill (up from 3.5 to 4.2 percent of GDP) and one-off expenditures associated with structural reforms (e.g., spending associated with the downsizing of the state-owned port and the payment of liabilities associated to the closure of a state-



owned bank in 2017), or key investments (e.g., transfers for rural roads and education, and for the membership quota in CAF). The overall deficit, thus, reached 7 percent of GDP, 0.8 percentage points of GDP higher than expected, and the highest level in several decades. However, a similar increase in spending cannot be repeated in 2020 or over the medium term until the debt-to-GDP ratio falls below 45 percent. This is because spending by the Central Government (and the entire non-financial public sector) is now subject to growth caps imposed by the fiscal rule, with any potential breach subject to heavy penalties imposed by the independent General Comptroller's Office. Furthermore, the first quarter of 2020 showed the lowest primary deficit in over a decade (0.12 percent of GDP), decreasing by 77.3 percent relative to the same period in 2019. This indicates that, prior to the COVID-19 shock, the tax reform was paying off more than expected. During the first quarter of 2020, tax collection increased 17 percent compared to the same period of the previous year (3.4 versus 3 percent of GDP), with revenues from internal value added tax increasing by 49.2 percent.

21. **The Central Government's debt-to-GDP ratio increased to 58 percent, commanding increased risk premiums (Figure 2).** Debt levels for the consolidated public sector (CPS) are only slightly higher at 61 percent of GDP, after netting out intra public sector debt holdings of about 13 percent of GDP (also in Figure 2).<sup>3</sup> Rising debt levels have commanded increased risk premiums and shorter maturities given the lack of fiscal reforms prior to 2018, increasing debt service costs and refinancing risks. In February 2020, Moody's downgraded the Government of Costa Rica's bond ratings from B1 to B2 (with stable outlook), citing high fiscal deficits and large borrowing requirements. Standard & Poor's and Fitch had downgraded their ratings in late 2018, from BB- to B+ (with negative outlook), or four notches below investment grade. On May 8, 2020, Fitch aligned its rating with Moody's by downgrading Costa Rica from B+ to B with negative outlook considering the potential impact of COVID-19 on the economy and the fiscal framework.

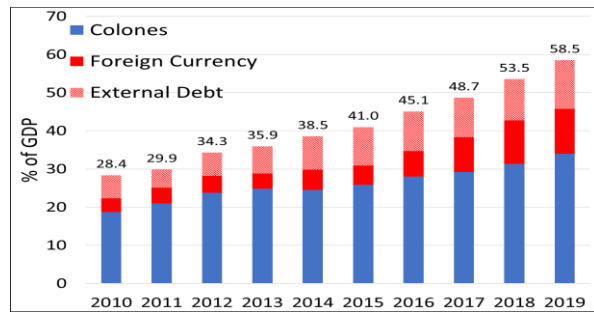
22. **The fiscal reform increased investor confidence last year, particularly in domestic markets where 87 percent of the financing has been raised in the past.** The fiscal reform resulted in a decline of around 400 basis points (bps) on average in domestic markets, across all maturities and currencies by December 2019, and these rates have not been affected by the turbulence triggered by COVID-19 (Figures 4 and 5). The National Assembly authorized some international borrowing last year, which reduced pressure on domestic markets and allowed the CG to fund its deficit equally from local and foreign markets for the first time in over a decade, while pre-financing most of its financing requirements for 2020. (Costa Rica is one of the few upper middle-income countries in the world where the National Assembly must authorize each international borrowing operation rather than an overall ceiling.) During the second half of 2019, the CG raised US\$1,850 million via: (i) a euro bond for US\$1.2 billion with an 11-year maturity and a 6.25 percent yield; (ii) reopening of a 2045 bond for an additional US\$300 million with a 26-year maturity and a 7.25 percent yield; and (iii) a US\$350 million budget support operation from the IDB. Sovereign spreads in international markets had also fallen after the approval of the fiscal reform (Figure 6), but have spiked in recent months due to the COVID-19 shock generating flight to quality (investors are leaving assets from emerging economies towards more liquid and safer assets of advanced economies like the United States).

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<sup>3</sup> The main difference between the CG and the CPS debt-to-GDP ratios is explained by Central Bank (6.6 percent of GDP) and the SOEs sector (8.2 percent of GDP), mainly the electricity conglomerate.

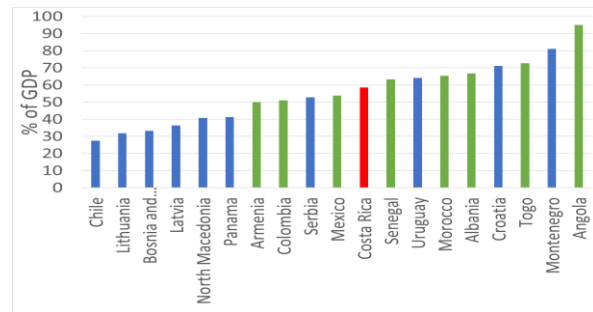


Figure 2. Evolution and composition of public debt – 2010-19 (% of GDP)



Source: Ministry of Finance.

Figure 3. Public debt vis-a-vis comparators, latest available data (% of GDP)



Source: World Economic Outlook.

Note: Gross debt does not net out intra-governmental borrowings. Foreign currency debt comprises domestic and externally issued debt. In 2018, the Central Government (and the Public Sector) have issued debt overseas amounting to only 12.8 percent of GDP.

Figure 4. Yield curve, local currency bonds, basis points

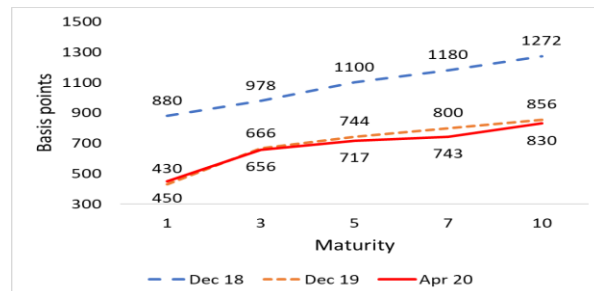
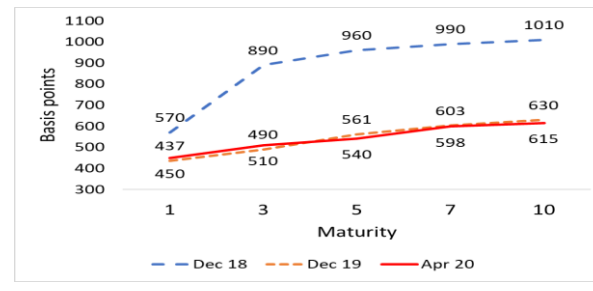
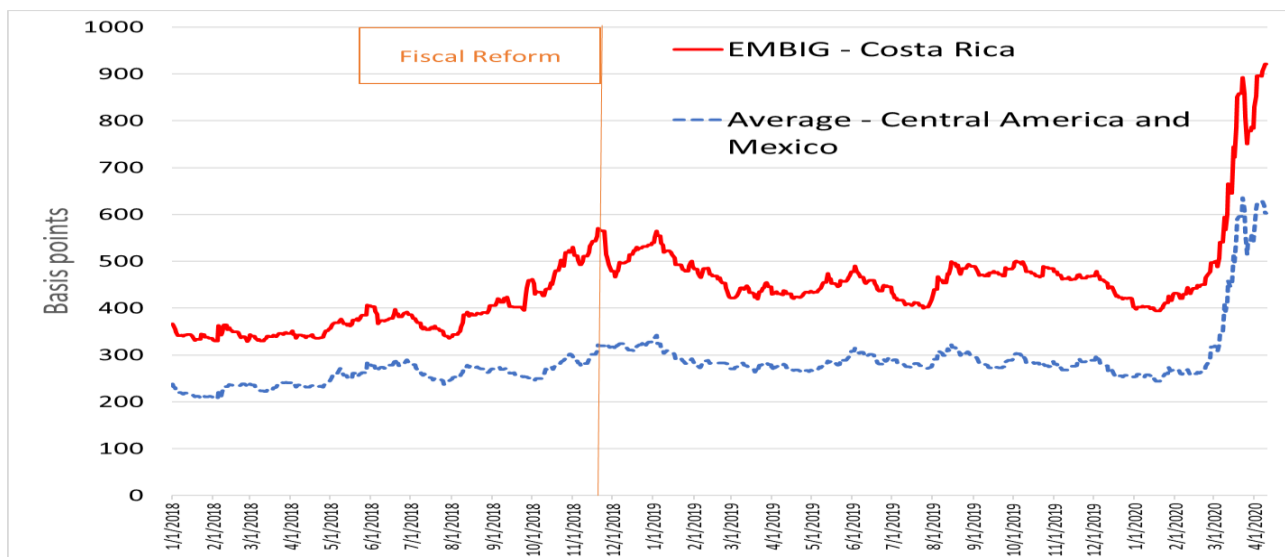


Figure 5. Yield curve, foreign currency bonds, basis points



Source: World Bank staff estimates based on MOF and Costa Rica Stock Exchange.

Figure 6. Costa Rica: EMBIG spread, basis points



Source: Bloomberg. Note: the blue line plots the simple mean of the EMBI spreads for Mexico and Central America without Costa Rica.



## 2.2. MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

23. **The economy is projected to enter a recession in 2020 due to global and domestic shocks related to COVID-19, but to gradually recover as restrictions are lifted.** On the external front, the severe decrease in growth of external demand and tightening of international financial conditions will be partially mitigated by the sharp drop in oil prices. On the domestic side, the lockdown has caused a loss of output and lower incomes for companies and households, with a negative impact on employment and aggregate demand. Due to the combined effect of these shocks, GDP is projected to contract by 3.3 percent in 2020, the largest contraction since 1982 and almost four times larger than the 2009 recession. Assuming containment measures will gradually be lifted starting mid-2020, the output fall would concentrate in the second and third quarters and would be followed by a gradual recovery leading to a 3 percent growth in 2021. Over the medium-term, growth is projected to progressively converge to its 3.5 percent potential by 2024 supported by the payoff of the structural reforms under the green growth agenda and the OECD accession process.

24. **Although all sectors will see negative growth, some will be particularly affected in 2020 and the recovery is projected to be at different speeds.** For instance, tourism will be severely impacted, dropping by more than 30 percent in 2020, and only recover slightly by 3 percent in 2021. Manufacturing, though declining, is expected to be supported by special regime companies, and lead the recovery in 2021 growing by around 5 percent. Agriculture will decline by around 2.5 percent in 2020 due to lower external demand for traditional exports, but quickly recover in 2021. Exports are projected to have the greatest contraction during 2020 (13.9 percent) due to the strong recession in the country's main trading partners. In particular, the abrupt drop in the export of services reflects the direct impact of travel restrictions on tourism, an activity that is expected to have a slower recovery after the sanitary containment measures are concluded. This effect would be partially offset by the increase in exports of business and computer services, less affected by the lockdown. Exports of goods (agricultural and manufactured) would have less impact, particularly exports of manufactured goods under the special regimes.

25. **The recession is projected to widen the current account deficit, expected to be funded largely by multilateral borrowing and FDI.** FDI is projected to decrease due to lower retained earnings of foreign companies in 2020 and 2021. Therefore, unlike in recent years, where FDI was more than enough to cover the economy's financing needs, for 2020 Costa Rica will need to complement FDI inflows with external credits for budgetary support for the public sector that allow it to finance the effects of this pandemic. This external savings (for the public and private sectors) would allow the current account gap to be addressed and maintain the position of international reserves at around 15 percent in 2020 and 14 percent a year later. As growth recovers towards 2024, so will FDI inflows. Therefore, it is projected that Costa Rica should face little difficulty in meeting its external financing requirement, and that the Government is able to continue to access global markets, which in turn depends on the Government's ability to maintain momentum and implement further fiscal reforms (Table 2).

26. **COVID-19 has hit the country's overall fiscal framework hard, but the authorities are carefully managing the impact in the broader context of the fiscal consolidation program.** The fiscal deficit is expected to increase in 2020 but the CG is expected to reach a primary balance by 2022, with a surplus thereafter. Given the recession and the fiscal cost of measures to mitigate COVID-19 impacts, revenues are expected to fall due to tax deferrals and recession and spending to rise due to a one-time increase in transfers, widening the overall fiscal deficit to 8.7 percent of GDP in 2020. Fiscal consolidation efforts are expected to accelerate in 2021, as tax revenues increase, the fiscal rule is fully reenacted, and further



spending provisions are implemented. The full implementation of the end-2018 fiscal reform is expected to yield savings of about 5 percent of GDP for the CG over 2020-23 through both revenue and spending measures. The CG's primary deficit is expected to turn into a surplus of 1.2 percent of GDP by 2023. The fiscal program has considered not just efficiency and growth effects, but also distributional impacts. For instance, the food basket consumed by the bottom 40 percent of the population, rather than all food products, has only a 1 percent VAT rate, and targeted social spending levels are protected by law or, in the case of education, by the Constitution.

27. **Given the recession triggered by the COVID-19 pandemic and the fiscal cost implied by the disaster relief, the CG's debt-to-GDP ratio is projected to continue to increase in the next few years, peaking in 2023 at 70 percent, falling thereafter to 54 percent by 2030.** The CG's gross financing requirements are also expected to increase this year and remain high for several years—sovereign financing needs are expected to require 10.3 percent of GDP in 2020, increasing to 13 percent of GDP by 2021 and 2022 due to amortizations. Debt management operations, recent and future placements in international financial markets, and loans from development banks should all result in flattening the expected debt service peaks over the next five years and should pre-finance needs of this and next year, including: (i) already issued US\$1.5 billion in Eurobonds; (ii) an additional US\$1.5 billion in loans from multilateral development banks; and (iii) the continued reopening and exchanges of domestic bonds at short maturities.

28. **The public debt sustainability analysis considers both the restricted coverage of the public sector at the Central Government level (Figure 8), and the rest of the consolidated public sector (Figure 9).** However, all the dynamics come from the debt of the CG, as the rest of the public sector has been broadly in balance in recent years, which is expected to continue. In particular: (i) the surplus of the social security system (including the pension and health funds), the local governments, and the decentralized government entities broadly offset the small Central Bank deficit (in turn caused by a legacy of old industrial policy operations, among others); and (ii) the operational balance of the public enterprises is also assumed to continue, driven by downsizing two loss making State-owned Enterprises (SOEs) and improvements in others, particularly the electricity conglomerate. The Costa Rican pension system stands out in the region for its high coverage. A recent actuarial study by the University of Costa Rica found that the pension system will have a financial surplus until 2030, but thereafter will start running deficits.<sup>4</sup> While existing reserves should be sufficient to cover the gap until 2045, it is important that the country designs and implements a comprehensive pension reform over the next five years, which should, among others, address the high replacement rate (around 85 percent) and the early retirement provisions of the current system (the statutory retirement age is 65 years, but women can opt for early retirement with full pension at age 60 and men at 62 if a minimum number of contributory years is achieved).

29. **Growth and fiscal policy assumptions for the debt sustainability assessment (DSA) are on the conservative side and in line with IMF projections.** Box 2 presents an alternative downside scenario from COVID-19 and compares it with the baselines pre- and post-COVID. All projections include the impact of implementing the indicative triggers for DPL 2 (on tax expenditures, procurement and public employment), and conservative gains coming from the Fiscal Management Improvement Project (P172352). The DSA shows that the public debt is manageable under independent standard stress scenarios (Figure 8). However, the debt would exceed the high-risk threshold under a combined shock

<sup>4</sup> *Estudio actuarial del seguro de invalidez, vejez y muerte administrado por la Caja Costarricense del Seguro Social* by Rodrigo Arias Lopez, Luis Alberto Barboza Chinchilla, Jose Alexander Ramirez González, Universidad de Costa Rica (2017).



that includes GDP growth, primary balance, exchange rate, and contingent liability shocks. Gross financing needs, on the other hand, would remain below the high-risk threshold in all standardized macro-fiscal stress tests, except for the contingent liability shock scenario.

30. **Costa Rica’s macroeconomic policy framework is deemed adequate for this operation but faces significant risks.** Costa Rica’s external position has strong underlying fundamentals, with relatively low external indebtedness ratios by the public (which mainly borrows domestically) and private sectors, relatively high reserves, and a strong export sector. Also, the country’s monetary framework is credible and existing growth fundamentals are sound, including continued attraction of FDI flows and increasing exports of sophisticated products and services. The “Achilles’ heel” of the country’s macroeconomic framework is the fiscal stance, with implications on the public debt dynamics given that growth is well below real interest rates. However, the implementation of the 2018 fiscal reform and the further measures announced in February 2020, including with support from the World Bank and the International Monetary Fund, are expected to stabilize the debt ratio by balancing the primary position of the Government in 2022, when the debt-to-GDP ratio will also start to fall.



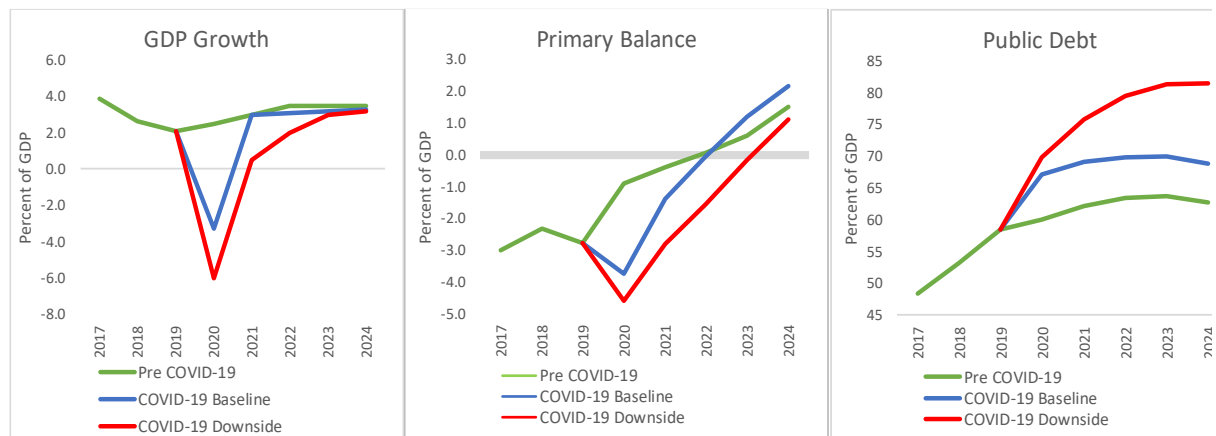
### Box 2. COVID-19 impact on macroeconomic prospects

**Costa Rica has been particularly affected by the COVID-19 pandemic, with GDP expected to contract by 3.3 percent in 2020 although projections are subject to some uncertainty.** Baseline projections assume that the epidemic peaks in the 2nd and 3rd quarters of 2020, with a gradual recovery through the 4th quarter. On this basis, GDP is projected to drop by 3.3 percent in 2020 (compared to 3 percent growth projected before COVID-19), and then grow by 3 percent in 2021 (compared to 3.5 percent growth projected before COVID-19) as the effects of the coronavirus fade and output gradually recovers. Announced and implemented policy actions incorporated in the projections will help to support incomes in the near term, particularly to affected firms and households. Consumer confidence is expected to improve as the effects of the virus outbreak and supply-side disruptions fade. The monetary policy stimulus provided by the Central Bank, through lower interest rates, helps cushion demand, although its impact is likely to be modest while the lockdown is in place. Then, the economy is projected to gradually converge to its potential level of 3.5 percent by 2024, driven mainly by solid economic fundamentals and structural reforms related to OECD accession.

**However, the recession could be larger if downside risks materialize.** Although the Government has already started to soften restrictions, there is a large uncertainty related to how long they will last, and the major downside risk is that the impact of the coronavirus proves longer lasting and stronger than assumed in the baseline scenario. If domestic and global restrictions to the movement of people remain as they are until the first quarter of 2021, the adverse effects on growth and trade will be much worse. Illustrative simulations of this downside risk scenario suggest that GDP could possibly be reduced by 6 percent in 2020, rather than by 3.3 percent as in the baseline scenario (Figure 7). This will generate a further hit to confidence and heightened uncertainty, depressing consumption and investment even more.

**A larger recession will affect macro stability, resulting in sharp increases of the fiscal deficit and public debt.** Despite fiscal consolidation efforts, a larger recession will add significant spending pressures and will also undermine revenue mobilization capacity. Despite the 2018 fiscal reform and revenue mobilization measures announced in the beginning of February 2020, the economic contraction will likely result in larger deterioration in the primary deficit and overall deficits to 5 percent of GDP in 2020 and a more gradual (than predicted in the baselines scenario) adjustment in following years. This will push the public debt significantly above the projection in the baseline scenario. Under the severe downside scenario, the overall deficit could reach 10.5 percent of GDP in 2020 and the public debt could escalate to above 80 percent of GDP by 2023.

Figure 7. Macroeconomic prospects before and after COVID-19



Source: Central Bank of Costa Rica, Ministry of Finance of Costa Rica, and World Bank staff projections.



Table 1. Key macroeconomic indicators

	2016	2017	2018	2019 <sup>e</sup>	2020 <sup>p</sup>	2021 <sup>p</sup>	2022 <sup>p</sup>	2023 <sup>p</sup>	2024 <sup>p</sup>
<b>Real Economy</b>									
	<b>Annual percentage change, unless otherwise indicated</b>								
Nominal GDP in local currency	6.3	6.6	5.3	3.8	-2.1	5.6	5.9	6.2	6.3
Real GDP	4.2	3.9	2.7	2.1	-3.3	3.0	3.1	3.2	3.3
Per Capita GNI (US\$ Atlas Method) <sup>1</sup>	10,770	11,090	11,520	11,700	..	..	..	..	..
<b>Contributions:</b>									
Consumption	3.0	2.9	1.3	1.8	-1.1	1.0	1.2	1.7	2.1
Private	2.6	2.3	1.2	1.0	-1.2	1.9	2.1	..	..
Public	0.4	0.5	0.1	0.8	0.1	-0.9	-0.9	..	..
Investment	1.2	0.9	-0.2	-0.6	-0.8	0.6	1.2	1.3	1.1
Private	1.0	0.6	-0.3	-1.4	-0.3	-0.4	0.9	..	..
Public	0.3	0.3	0.0	0.8	-0.5	1.0	0.3	..	..
Net Exports	0.1	0.1	1.5	0.8	-1.4	1.4	0.6	0.2	0.1
Imports	8.9	3.7	0.1	0.2	-9.7	5.5	3.8	4.1	4.2
Exports	9.4	4.0	4.7	2.7	-13.9	10.5	5.8	4.7	4.5
Unemployment rate <sup>2</sup>	9.5	9.3	12.0	12.4	15.9	14.2	12.4	10.9	10.5
CPI (eop)	0.8	2.6	2.0	1.5	1.5	2.0	2.5	3.0	3.0
<b>Fiscal Accounts</b>									
	<b>Percent of GDP</b>								
<b>Central Government (CG)</b>									
Expenditures	19.9	20.4	20.0	21.7	23.3	23.3	22.2	21.3	20.3
Revenues	14.7	14.3	14.3	14.7	14.6	16.5	17.0	17.3	17.6
Primary Balance	-2.4	-3.0	-2.2	-2.8	-3.7	-1.4	0.0	1.2	2.2
Overall Balance	-5.2	-6.1	-5.7	-7.0	-8.7	-6.7	-5.2	-4.0	-2.8
<b>Non-Financial Public Sector (NFPS)</b>									
Expenditures	30.6	30.7	30.8	32.4	33.8	34.3	33.9	33.2	33.0
Revenues	26.5	25.8	26.1	26.4	25.8	27.0	27.6	27.8	28.2
Primary Balance	-1.2	-1.7	-1.1	-1.7	-3.0	-1.8	-1.0	-0.2	0.4
Overall Balance	-4.1	-4.9	-4.7	-6.0	-8.1	-7.3	-6.3	-5.4	-4.7
<b>Central Government Debt</b>	45.1	48.4	53.2	58.5	67.2	69.1	69.9	70.0	68.8
<b>Consolidated Public Sector Debt (CPS)</b>	49.8	50.5	55.5	58.9	66.8	67.9	67.9	67.1	65.2
<b>Selected Monetary and Financial Indicators</b>									
	<b>Annual percentage change, unless otherwise indicated</b>								
Base Money	6.4	10.8	2.3	-3.8	..	..	..	..	..
Credit to the Private Sector	12.8	8.5	6.3	-1.5	..	..	..	..	..
Interest (key policy interest rate, eop)	1.8	4.8	5.3	2.8	..	..	..	..	..
Return on equity (ROE) (in percent) <sup>3</sup>	8.8	6.4	6.5	6.7	..	..	..	..	..
Nonperforming loans to total loans (in percent) <sup>3</sup>	1.5	2.0	2.1	2.4	..	..	..	..	..
Liquid assets to short-term liabilities (in percent) <sup>3</sup>	95.9	102.7	98.6	96.8	..	..	..	..	..
Credit to the Private Sector (as percent of GDP) <sup>4</sup>									
Banking Sector	46.9	47.2	47.3	44.1	..	..	..	..	..
Financial Sector	59.1	60.1	60.7	57.5	..	..	..	..	..
Credit in foreign current (share of total credit, eop)	41.0	39.2	39.1	36.3	..	..	..	..	..
<b>Balance of Payments</b>									
	<b>Percent of GDP</b>								
Current Account Balance	-2.2	-3.3	-3.3	-2.5	-4.8	-2.9	-3.0	-3.1	-3.2
Imports	31.0	32.4	32.7	32.1	28.9	29.0	29.1	29.4	29.8
Exports	32.2	33.1	34.0	34.6	28.5	30.7	30.8	30.9	31.0
Foreign Direct Investment	3.7	-4.4	-3.6	-3.9	-2.3	-3.3	-3.4	-3.6	-3.8
Gross Reserves (in billion US\$, eop) <sup>5</sup>	7.6	7.2	7.5	9.0	7.0	8.0	8.8	8.7	9.4
As % of GDP	13.3	12.3	12.5	14.5	11.3	12.3	12.8	12.0	12.3
In months of next year non-maquila imports	4.9	4.4	4.7	6.1	4.5	4.9	5.1	4.7	4.8
As % of Short-term external debt	165.1	136.6	120.3	123.5	129.2	144.2	139.2	135.6	144.9
External debt	44.2	46.1	47.7	49.4	48.0	49.4	49.5	47.8	46.7
Terms of Trade	118.0	115.5	112.0	111.9	118.6	118.6	118.6	118.8	119.1
Exchange rate (average)	551.1	572.2	580.2	590.4	..	..	..	..	..
Exchange rate (eop)	561.1	572.6	611.8	576.5	..	..	..	..	..
Real exchange rate index (eop, up = depreciation)	79.8	84.1	87.4	82.9	..	..	..	..	..

Source: Ministerio de Hacienda, Banco Central de Costa Rica and WBG staff calculations, except for BoP which is World Economic Outlook (IMF).

<sup>1</sup> Costa Rica is classified as an upper middle income country for the purpose of IBRD lending classification.

<sup>2</sup> WBG staff calculations 2020, 2021 and 2022. ILO projections from 2023 onwards.

<sup>3</sup> Financial Soundness Indicators, IMF.

<sup>4</sup> Credit includes BCCR and domestic commercial banks. Financial sector includes additionally as credit unions and other financial institutions.

<sup>5</sup> Data from BCCR through 2019 and IMF WEO projections thereafter.



*Table 2. BOP financing requirements and sources (US\$ millions)*

	2018	2019 <sup>e</sup>	2020 <sup>p</sup>	2021 <sup>p</sup>	2022 <sup>p</sup>	2023 <sup>p</sup>	2024 <sup>p</sup>
Financing requirements	5,554	5,649	7,760	6,260	6,574	8,353	7,452
Current account deficit	1,999	1,545	2,976	1,913	2,068	2,237	2,433
MLT debt amortizations, public and private	3,555	4,104	4,784	4,347	4,506	6,116	5,019
<i>of which:</i>							
Private sector	2,268	2,417	2,642	2,909	3,187	3,192	3,476
Public Sector	1,287	1,687	2,143	1,438	1,319	2,924	1,543
Financing Sources	5,852	6,867	4,255	7,260	7,374	8,253	8,152
Short term capital inflows	31	32	34	37	40	42	44
Foreing Direct Investment, net	2,183	2,418	1,434	2,152	2,349	2,588	2,871
Other Private Sector flows	1,664	1,717	2,056	1,985	2,420	2,593	3,005
Public Sector flows	1,974	2,700	732	3,086	2,565	3,030	2,232
<i>of which:</i>							
Eurobonds		1,500	0	1,500	1,500	1,500	..
Multilaterals		350	1,280	380	750	..	..
BCIE					250	..	..
CAF			1,050			..	..
IDB		350	230	380	200	..	..
IBRD					300	..	..
Bilaterals			150		100	..	..
AFD			150		100	..	..
Net errors and omissions	59	236	0	0	0	0	0
Change in reserves (+ increase)	357	1,455	-1,946	1,000	800	-100	700
Financing Gap	0	0	-1,559	0	0	0	0
<i>of which:</i>							
IBRD			300				
IMF			504				
IDB			250				
BCIE			300				

Source: IMF's World Economic Outlook and WBG staff calculations.



Table 3. Fiscal indicators (% of GDP)

	2016	2017	2018	2019 <sup>e</sup>	2020 <sup>p</sup>	2021 <sup>p</sup>	2022 <sup>p</sup>	2023 <sup>p</sup>	2024 <sup>p</sup>
<b>1. Central Government (CG)<sup>1</sup></b>	<b>Percent of GDP</b>								
<b>Total Revenues (and grants)</b>	<b>14.7</b>	<b>14.3</b>	<b>14.3</b>	<b>14.7</b>	<b>14.6</b>	<b>16.5</b>	<b>17.0</b>	<b>17.3</b>	<b>17.6</b>
Tax revenues	13.9	13.4	13.4	13.7	13.9	15.1	15.5	15.9	16.2
Taxes on goods and services	5.4	5.1	4.9	5.1	5.3	5.6	6.0	6.2	6.4
Direct Taxes	5.1	5.3	5.4	5.7	5.8	6.0	6.2	6.3	6.4
Social insurance contributions	0.5	0.2	0.2	0.2	0.2	0.8	0.8	0.8	0.8
Taxes on international trade	0.6	0.6	0.5	0.5	0.3	0.5	0.5	0.5	0.5
Other taxes	2.3	2.3	2.3	2.3	2.3	2.2	2.1	2.1	2.1
Non-tax revenues	0.8	0.9	0.9	1.0	0.7	1.4	1.4	1.4	1.4
<b>Expenditures</b>	<b>19.9</b>	<b>20.4</b>	<b>20.0</b>	<b>21.7</b>	<b>23.3</b>	<b>23.3</b>	<b>22.2</b>	<b>21.3</b>	<b>20.3</b>
Current expenditures	18.1	18.4	18.6	19.7	21.4	21.3	20.2	19.3	18.3
Wages and compensation	7.0	6.9	6.8	6.8	7.0	7.3	6.8	6.4	6.2
Goods and services	0.6	0.7	0.6	0.6	1.2	0.9	0.7	0.7	0.7
Interest payments	2.8	3.1	3.5	4.2	5.0	5.4	5.2	5.1	5.0
Current transfers	7.6	7.8	7.6	8.0	8.3	7.8	7.4	7.0	6.5
Capital expenditures	1.9	2.0	1.4	2.1	1.9	2.0	2.0	2.0	2.0
Capital investments	0.2	0.2	0.1	0.2	0.1	0.1	0.2	0.2	0.2
Capital transfers	1.6	1.8	1.3	1.9	1.8	1.8	1.8	1.8	1.8
<b>Overall Balance</b>	<b>-5.2</b>	<b>-6.1</b>	<b>-5.7</b>	<b>-7.0</b>	<b>-8.7</b>	<b>-6.7</b>	<b>-5.2</b>	<b>-4.0</b>	<b>-2.8</b>
<i>of which: Primary balance</i>	-2.4	-3.0	-2.2	-2.8	-3.7	-1.4	0.0	1.2	2.2
<b>Central Government Financing</b>	<b>5.2</b>	<b>6.1</b>	<b>5.7</b>	<b>7.0</b>	<b>8.7</b>	<b>6.7</b>	<b>5.2</b>	<b>4.0</b>	<b>2.8</b>
External (net)	0.5	0.2	0.4	3.6	4.0	3.5	2.6	0.3	1.6
Domestic (net)	4.7	5.9	5.4	3.4	2.2	3.2	2.7	3.6	1.3
<i>of which: Deposits and Asset sales</i>	0.0	0.0	0.0	0.0	1.5	1.3	0.8	0.0	0.0
Other debt (multilateral financing)	0.0	0.0	0.0	0.0	2.5	0.0	0.0	0.0	0.0
<b>2. Non-Financial Public Sector (NFPS)<sup>2</sup></b>	<b>Percent of GDP</b>								
<b>Total Revenues</b>	<b>26.5</b>	<b>25.8</b>	<b>26.1</b>	<b>26.4</b>	<b>25.8</b>	<b>27.0</b>	<b>27.6</b>	<b>27.8</b>	<b>28.2</b>
Tax revenues	22.1	21.7	21.9	22.1	21.4	22.7	23.3	23.5	23.9
<i>of which: Social insurance contributions</i>	7.5	7.3	7.5	7.5	6.7	7.5	7.5	7.5	7.5
Non-tax revenues	2.3	2.2	2.8	2.8	2.8	2.8	2.8	2.8	2.8
Operating balance of public enterprises	2.1	1.8	1.4	1.5	1.5	1.5	1.5	1.5	1.5
<b>Expenditures</b>	<b>30.6</b>	<b>30.7</b>	<b>30.8</b>	<b>32.4</b>	<b>33.8</b>	<b>34.3</b>	<b>33.9</b>	<b>33.2</b>	<b>33.0</b>
Current expenditures	25.9	26.0	26.8	27.8	29.4	29.8	29.3	28.7	28.4
<i>of which: Wages and compensation</i>	11.3	11.1	11.2	11.2	11.3	11.6	11.2	10.8	10.5
Capital expenditures	4.6	4.6	3.9	4.6	4.4	4.5	4.6	4.5	4.6
<b>Overall balance</b>	<b>-4.1</b>	<b>-4.9</b>	<b>-4.7</b>	<b>-6.0</b>	<b>-8.1</b>	<b>-7.3</b>	<b>-6.3</b>	<b>-5.4</b>	<b>-4.7</b>
Central government	-5.3	-6.0	-5.8	-7.0	-8.7	-6.7	-5.2	-4.0	-2.8
<i>of which: Local governments</i>	-0.1	-0.2	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3
Decentralized government entities	0.9	0.9	1.0	1.0	0.6	-0.5	-1.1	-1.4	-2.0
<i>of which: Primary balance</i>	-1.2	-1.7	-1.1	-1.7	-3.0	-1.8	-1.0	-0.2	0.4
Central government	-2.5	-2.9	-2.3	-2.8	-3.7	-1.4	0.0	1.2	2.2
Decentralized government entities	0.9	1.0	1.1	1.1	0.7	-0.4	-0.9	-1.3	-1.8
<b>Non-Financial Public Sector Financing</b>	<b>4.4</b>	<b>5.1</b>	<b>4.8</b>	<b>6.0</b>	<b>8.1</b>	<b>7.3</b>	<b>6.3</b>	<b>5.4</b>	<b>4.7</b>
External (net)	0.6	0.4	0.3	3.6	4.0	3.5	2.6	0.3	1.6
Domestic (net)	3.8	4.7	4.5	2.3	1.6	3.8	3.7	5.1	3.1
Other debt (multilateral financing)	0.0	0.0	0.0	0.0	2.5	0.0	0.0	0.0	0.0
<b>3. Consolidated Public Sector (CPS)<sup>3</sup></b>	<b>Percent of GDP</b>								
<b>Public Sector Consolidated Balance</b>	<b>-4.7</b>	<b>-5.3</b>	<b>-5.1</b>	<b>-6.3</b>	<b>-8.3</b>	<b>-7.4</b>	<b>-6.3</b>	<b>-5.3</b>	<b>-4.5</b>
<i>of which: Central Bank operating Balance</i>	-0.6	-0.4	-0.4	-0.3	-0.2	-0.1	0.0	0.1	0.2
<b>4. Consolidated Public Sector Debt<sup>4</sup></b>	<b>49.8</b>	<b>50.5</b>	<b>55.5</b>	<b>58.9</b>	<b>66.8</b>	<b>67.9</b>	<b>67.9</b>	<b>67.1</b>	<b>65.2</b>
Central Government	36.4	39.0	41.0	46.7	54.1	54.1	53.8	53.4	51.8
Non-financial Public Sector	7.7	7.2	8.7	7.0	7.6	8.8	9.3	9.0	8.7
<i>of which: State owned enterprises</i>	7.1	6.5	8.0	6.2	..	..	..	..	..
Central Bank	5.6	4.3	5.8	5.1	5.0	4.9	4.8	4.7	4.6
Debt service Consolidated Public Sector	7.7	7.5	9.1	9.8	8.6	11.3	11.1	11.5	10.5
Interest Payments	2.9	3.1	3.6	4.3	5.1	5.4	5.3	5.2	5.1
Debt Amortization	4.8	4.3	5.5	5.5	3.5	5.8	5.8	6.3	5.4
Debt service (Percent of total revenue)	29.5	29.1	35.0	37.0	33.4	41.7	40.2	41.4	37.3
Average Maturity of Central Govt Debt	8.7	8.2	7.6	8.0	..	..	..	..	..
<b>5. Memorandum items</b>	<b>Percent of GDP</b>								
<b>Gross Public Sector Debt</b>	<b>60.7</b>	<b>61.7</b>	<b>69.3</b>	<b>72.1</b>	<b>81.3</b>	<b>84.3</b>	<b>85.4</b>	<b>85.1</b>	<b>83.6</b>
Central Government	45.1	48.4	53.2	58.5	67.2	69.1	69.9	70.0	68.8
Non-financial Public Sector	7.7	7.2	8.7	7.0	7.6	8.8	9.3	9.0	8.7
Central Bank	7.9	6.1	7.5	6.6	6.5	6.4	6.3	6.2	6.1
Intra Public Sector debt holdings	10.9	11.2	13.8	13.2	14.5	16.4	17.5	18.0	18.4

Source: Ministerio de Hacienda, Banco Central de Costa Rica and WBG staff calculations

<sup>1</sup> Central Government currently only comprises core central administration; from 2021 deconcentrated entities are included in the Central Government accounts. Excludes contributions to Social Insurance Fund.

<sup>2</sup> Includes CG, Local Governments, Social Insurance Funds, Decentralized entities and SOEs, but excludes Instituto Costarricense de Electricidad (ICE).

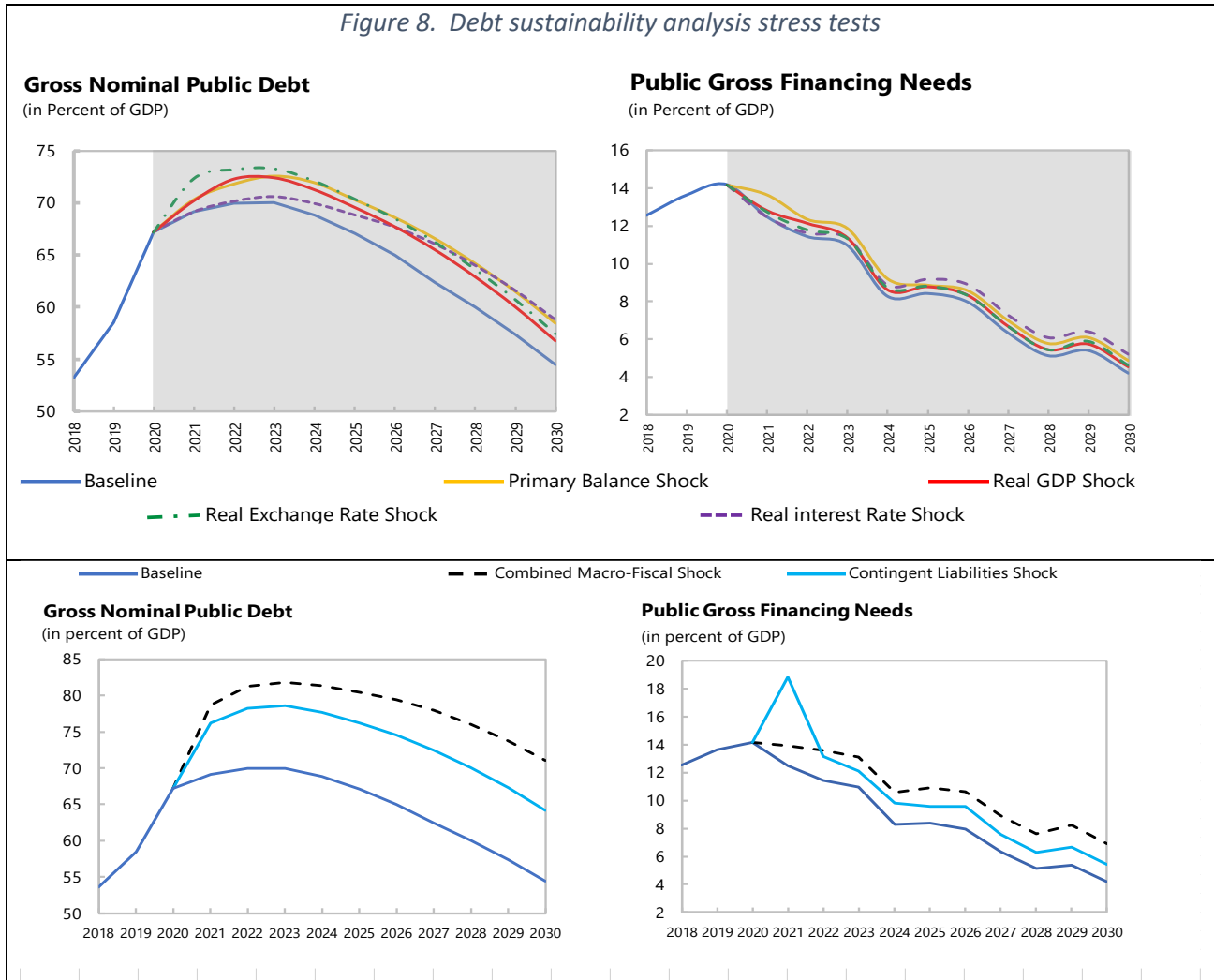
<sup>3</sup> Includes NFSP and the Central Bank.

<sup>4</sup> Consolidated Public Sector Debt is net of intra-public sector debt holdings

<sup>5</sup> Does not include Public Sector debt holding of Non-financial Public Enterprises and Decentralized Public Sector Institutions

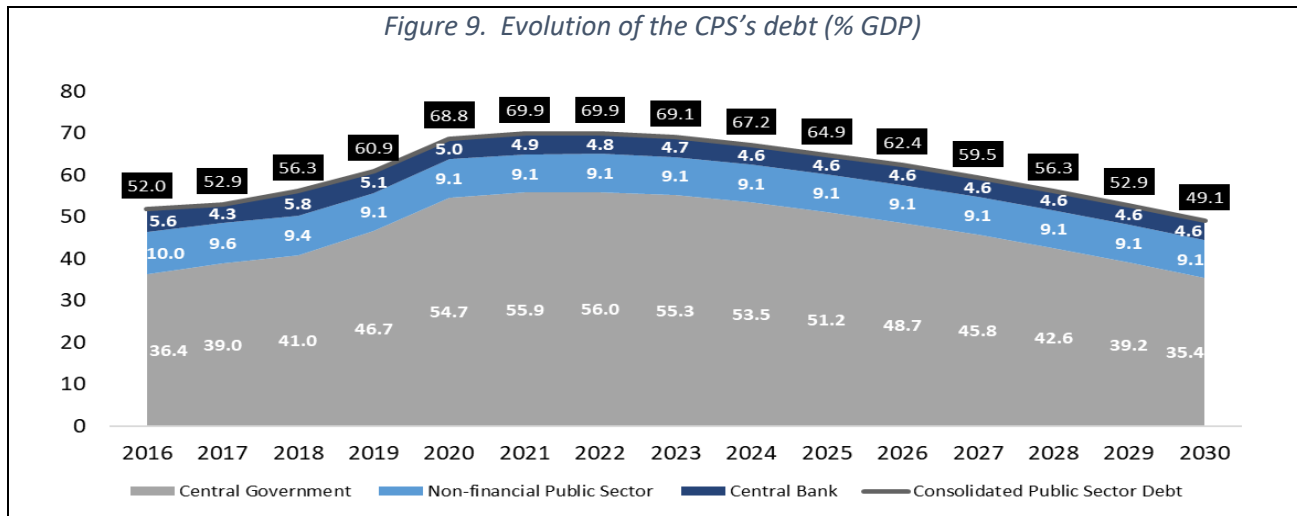


Figure 8. Debt sustainability analysis stress tests



Source: World Bank staff *Debt Sustainability Analysis* based on MOF and Central Bank information and in consultation with IMF staff.

Note: The assumptions for shocks relative to baseline are: (i) half the primary balance adjustment; (ii) growth reduced by 1st or 1 percentage point for two years; (iii) interest rate increases by 200 bps over a five-year period; and (iv) the real exchange rate depreciates by 23 percent. The combined macro-fiscal shock assumes the baseline is impacted by all former shocks. Contingent Liabilities shock assumes that in addition to a growth shock, primary expenditure increases by 6.2 percent of GDP due to materialized contingent liabilities.



Source: World Bank staff *Debt Sustainability Analysis* based on MOF and Central Bank information and in consultation with IMF staff.

### 2.3. IMF RELATIONS

31. **The IMF Executive Board has recently approved Costa Rica’s request for emergency financial assistance of about US\$504 million to help the country meet the urgent needs stemming from the COVID-19 pandemic.** The IMF considers that the Costa Rican authorities have taken important measures to contain the spread of the virus and to mitigate its economic impact. The funds will provide timely resources to support essential health expenditures and relief measures for vulnerable populations, and to meet the urgent balance of payment needs stemming from the pandemic. The IMF assistance through the RFI can possibly be followed by an upper-credit-tranche program (i.e., a Stand-By or an Extended Fund Facility arrangement) as warranted. The Government of Costa Rica intends to continue maintaining a close policy dialogue with the IMF on external and public debt sustainability policies.

## 3. GOVERNMENT PROGRAM

32. **Prior to the COVID-19 pandemic, fiscal and environmental sustainability were the main priorities of the current administration, together with reforms associated with the completed OECD accession process.** Upon taking office in May 2018, the administration’s priorities were to stabilize public finances, decarbonize the economy, and accelerate the implementation of reforms needed by the country and linked to the OECD accession process. The administration’s overall vision calls for laying further foundations for a green and low-carbon development and various program identified short-, medium-, and long-term sectoral reforms.

33. **Implementation of these priorities had already begun in earnest, but the COVID-19 outbreak made crisis response the most immediate priority.** The COVID-19 pandemic postponed but not derailed these priorities. As presented in Box 1 above, many of the containment and response measures have been carefully executed to ensure that the country’s fiscal framework is not over stretched, while the re-opening of the economy is prioritized along with the implementation of green growth measures.



34. **The Government’s plan continues to highlight the need for strong and orderly fiscal adjustment.**

Costa Rica was on a path of fiscal consolidation to keep public debt on a sustainable path and although the fiscal deficit will increase in the short term due to necessary spending in response to the COVID-19 crisis, reinforcing it once the impact of the pandemic recedes is of utmost priority to the authorities. While both tax and spending measures have been partially relaxed due to the impact of COVID-19, the full framework of the fiscal reform remains in place and will be reinforced once the National Emergency Declaration is lifted. The Government is committed to resuming the fiscal consolidation path with a strict implementation of the fiscal rule and revenue-enhancing measures once the crisis moderates. An important pillar in this strategy is decreasing the interest rate bill, which rapidly increased in recent years, reaching more than 4 percent of GDP at the end of 2019. To this end, the Government is trying to reduce the number of benchmark securities. Also, since January 2019 the calendar of quarterly auctions is published, and debt management plans are now presented to markets twice per year.

35. **The Government also enacted in early 2019 a National Decarbonization Plan (NDP), aiming at decarbonizing the country by 2050 through green growth and low-carbon initiatives to be undertaken by the public and private sectors.**

The Plan includes concrete short-, medium-, and long-term goals in strategic sectors such as transport, energy, and agriculture. The Plan has divided these goals into three phases: an initial phase (2018-2022), inflection (2023-2030), and mass deployment (2031-2050). The Plan, which sets the country on a green growth and low carbon trajectory, also fosters reforms that will help reactivate the economy following the COVID-19 pandemic. It includes ambitious goals in sectors, such as:

- (i) **Transport.** This sector is the largest and fastest growing source of greenhouse gas (GHG) emissions and, thus, the NDP promotes the use of both public and private electric transportation (Figure 10).
- (ii) **Agriculture.** Agriculture is the second-largest contributor to GHG emissions in Costa Rica. The NDP promotes the establishment of technical and financial programs to help rural communities and small enterprises better manage land resources and access to finance, so that they improve their ability to address a range of agricultural and land management challenges
- (iii) **Energy.** The NDP fosters electrification of the energy system, as it is an efficient way to decarbonize the economy and reduce exposure to potential fuel supply shortages that might arise from health or other crises. It aims at increasing the flexibility and “intelligence” of energy infrastructure, allowing for the integration of distributed generation and demand management strategies along with new business models enabled by new technologies.

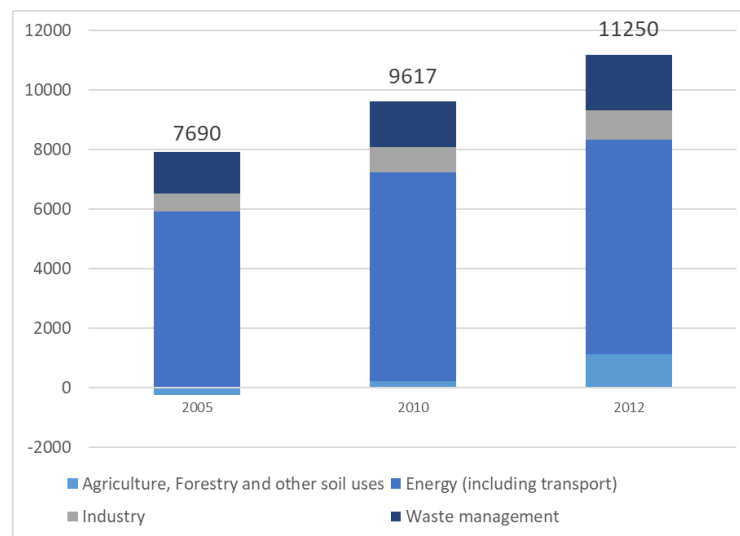
36. **Considering the impact of COVID-19 on the economy, the authorities view the promotion of green and low carbon technologies as a key ingredient in restarting growth and ensuring its sustainability.** Costa Rica has reaped the benefits of its track record in environmental management in terms of growth, with a leading tourist industry built mainly on the principles of environmental and biodiversity sustainability. The country is also steadily making inroads into niche markets not only for organic products, but also for carbon-neutral agricultural products.

37. **Carbon neutrality and fiscal consolidation efforts are prioritized by virtue of the country’s overall fiscal rule and public investment management framework.** When the country’s debt-to-GDP ratio surpasses 60 percent, as will be the case this year, fiscal rule constraints will be enacted for all types of spending, including capital and recurrent. This, in turn, means that low-carbon products must fit within



the overall budget envelop, which creates a constraint. At the same time, the country’s public investment system, while robust, is being retooled to ensure investment decisions are climate-neutral, including by incorporating climate change considerations in the discount rate. Costa Rica however is making efforts to ensure its decarbonization program attracts both private and blended capital into the country and, in this regard, the country has become an active member of the NGFS. The Central Bank and key financial sector players are already working to improve financial sector readiness by sponsoring carbon neutral projects in the agriculture, housing, and manufacturing sectors that are sound on environment, social and governance (ESG)<sup>5</sup> grounds—which the authorities view as the only sustainable manner in which to finance the majority of NDP measures when the Plan is fully deployed starting in 2031. In this respect, the Government is ready to promote green finance via green bonds and other forms of sustainable finance, once country risks start to fall, and mandating that financial firms better disclose climate risks in their lending and investment portfolios. The country is also an active member of the CAPE, where it is learning best practices in greening budget financial management systems with World Bank support.

Figure 10. Annual GHG emissions (in metric tons / CO2 equivalent) by sector



Source: Costa Rica Emissions Reports to UNFCCC, 2005, 2010, 2012

38. **While the NDP (and this DPL Series) focuses on decarbonization actions that support low emissions development and accessing growing markets for green products, Costa Rica is also taking solid steps to adapt to climate change impacts.** Costa Rica recognizes that adaptation efforts are needed to address the country’s extreme climate events and natural hazards, given that 77 percent of the population and 80 percent of the country's GDP reside in areas at high risk of multiple hazards, including floods and landslides, cyclones, storm surge, and sea level rise. In addition, since 1960, temperatures have increased between 0.2°C and 0.3°C per decade with a prolonged and hotter dry season, as has extreme precipitation with more intense rains occurring during shorter periods of time that produce greater average precipitation per episode. These trends are expected to continue in the future. Costa Rica has a strong plan for adaptation (National Adaptation Policy, 2018 -2030), which the Bank is supporting across several activities. Costa Rica has benefited from the Bank’s first Catastrophe Deferred Drawdown Option

<sup>5</sup> Environmental, Social and Governance (ESG) criteria are used by investors and shareholders to screen investments and assess the sustainability and societal impact of an investment in a company or business.



operation (P111926, 2008-2017), which has become an example for other countries. In addition, the Sustainable Fisheries Development Project (P168475), recently approved by the Bank's Board, is providing adaptation support.

## 4. PROPOSED OPERATION

### 4.1. LINK TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION

39. **The proposed operation supports Costa Rica's efforts to mitigate the social and economic impacts of the COVID-19 crisis and achieve a sustainable fiscal and growth path.** The proposed US\$300 million operation is the first in a programmatic Development Policy Financing (DPF) series of two. Supporting the Government's effective response to the pandemic is critical, particularly to assist the population in greatest need and prevent job loss and foster job creation – while tapping non-distortionary revenue sources to partially fund these efforts. Once the crisis moderates, the authorities plan to reinforce their fiscal and decarbonization programs, which they had vigorously launched prior to the pandemic. Swift implementation of the fiscal and decarbonization reforms is essential to boost the country's stabilization efforts and generate new sources of sustainable growth.

40. **The proposed operation combines crisis-response measures with structural reforms that will help strengthen Costa Rica's economic position to navigate the COVID-19 crisis and its aftermath.** The three proposed pillars are interlinked and mutually reinforcing. Measures under Pillar A support the COVID-19 crisis response, helping maintain the livelihoods of vulnerable segments of the population through cash transfers to those who become unemployed or underemployed due to the pandemic. Measures also help maintain formal jobs in the private sector, creating fiscal space for crisis response. Pillar B aims at increasing structural tax revenues and containing spending growth, while ensuring sustainability of public finance in the aftermath of the COVID-19 crisis. Finally, Pillar C promotes green growth and low-carbon development measures, laying the basis for post-crisis recovery.

### 4.2. PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS

#### Pillar A: Protecting people's income and jobs from the impact of COVID-19 and fostering SME recovery

41. **Pillar A seeks to support the authorities' efforts to mitigate the social and economic impacts of COVID-19 and lay the basis for post-outbreak recovery by:** (i) protecting the vulnerable against the short and medium-term impacts of the COVID-19 crisis (Prior Action 1); (ii) protecting jobs and supporting SMEs, both over the short and medium term (Prior Action 2); and (iii) mobilizing non-distortionary sources of financing to help offset the crisis-related fiscal outlays (Prior Action 3).

42. **There is a need to expand safety nets for those losing income and jobs during the lockdown, with special attention to vulnerable groups.** Costa Rica's social policy is grounded in a strong social compact, with close to universal access to health and education services. Prior to the COVID-19 outbreak, the population's risk of falling into poverty was increasing as evidenced by the high unemployment rate (12.4 percent of the population, the highest in 10 years). While this was partly due to a steep increase in labor force participation, it also reflected weak overall growth and the transition costs of the country's economic transformation -- as jobs had been moving out of agriculture and traditional industries toward services and high-tech industries. Unemployment affected particularly the youth, those with incomplete



secondary education, and women. These segments of the population, along with those working in the informal sector who often live on day-to-day income generation are the groups expected to be most affected by the COVID-19 crisis. The pandemic is expected to increase not only unemployment and informality rates, but also poverty rates – the latter by at least 3.5 percentage points in 2020, or more than 180,200 people, under the assumption that GDP would fall by 3.3. percent.<sup>6</sup> As the fiscal situation is very tight, mobilizing new sources to at least partially fund any transfer to citizens is very important, especially from untapped and non-distortionary sources that can become permanent over the medium-term.

43. **At the same time, jobs need to be preserved and conditions for SMEs to stay in business need to be put in-place to protect livelihoods.** Measures already taken in this regard include postponing tax returns and payments to partially ease liquidity constraints on SMEs, together with the postponement of social security contributions as well. Flexible working hours have also been introduced for the first time into the country’s labor code, and financing mechanisms, including establishing credit lines, included in the country’s second tier development banks. Monetary policy has been eased and commercial banks are postponing debt service to those companies and individuals that request forbearance to meet immediate liquidity needs.

44. **As these measures imply a large fiscal cost at an already tight fiscal environment, the Government has followed a three-pronged fiscal strategy.** First, it swiftly moved to reallocate resources by freezing wages and hires, refraining from starting new capital projects (but protecting operation and maintenance of existing infrastructure), fine-tuning high-level pensions, and curtailing transfers (in small amounts) to many decentralized institutions, such as museums. However, respecting the principle that it is most efficient for the sovereign to borrow to smooth out the impact of the pandemic, the reduction in transfers has not affected subnational authorities. Second, it tapped excess profits in SOEs created either by a temporary wedge between domestic and international prices of fuel, or the overcapitalization of the state-owned insurance. While one-offs, the authorities are already working with the OECD and the World Bank in developing a proper dividend policy for all SOEs aligned with OECD best practices. Third, the Government looked to multilateral institutions for additional sources of deficit financing, including an IMF Rapid Financing Instrument. Some of these measures were reflected in the first supplementary budget for 2020 that the National Assembly approved on April 24, 2020.

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<sup>6</sup> Poverty is defined using the US\$5.5 per capita per day at 2011 Purchasing Power Parity (PPP) prices.



Table 4. Fiscal impact of COVID-19 in 2020 budget (% of GDP)

Text Table. Spending and revenue measures to address COVID-19 in 2020 1/  
(Billions of colones)

	Billions of Colones	Percent of GDP
<b>Total spending measures 1/</b>	<b>277</b>	<b>0.78</b>
Subsidies to households (including Bono Proteger)	275	0.77
Additional budget to Ministry of Health	2	0.01
<b>Financing Source</b>	<b>277</b>	<b>0.78</b>
Transfers from National Insurance Institution (INS)	75	0.21
Transfer from RECOPE (Fuel price differential)	30	0.09
Suspension of 2020 salary increase	19	0.05
Freezing 4953 job openings in public sector	15	0.04
Elimination of 2020 annual bonus (anualidades)	11	0.03
Other cuts in remuneration associated with the three previous points	17	0.05
Transfers to Public Institutions *	13	0.04
Cuts in operating expenses	9	0.02
Loan from CAF	88	0.24
<b>Total Revenue measures</b>	<b>63</b>	<b>0.18</b>
3-month tax moratorium 2/	25	0.07
VAT	13	0.04
Customs	3	0.01
Corporate Income Taxes	10	0.03
Social security contribution reduction	38	0.11

1/ World Bank staff projections.

2/ World Bank staff estimates assuming all taxpayers benefit from the moratorium.

**Prior Action 1** – The Borrower has created a temporary unemployment subsidy (Bono Proteger) to contribute to the social protection of households affected by the change in their working or income conditions due to the national emergency caused by the COVID-19.

**Evidence:** Decree No. 42305-MTSS–MDHIS dated April 17, 2020 and published in the Borrower’s Official Gazette on April 17, 2020 as amended by Decree No. 42329-MTSS-MDHIS dated April 29, 2020 and published in the Borrower’s Official Gazette on April 29, 2020; and Law No. 9840 dated April 22, 2020 and published in the Borrower’s Official Gazette on April 22, 2020.

**Indicative Trigger 1** – The Borrower has improved the targeting of existing social programs on poorest households by (a) better identifying families in extreme poverty, based on the poverty-targeted methodology of the National Information System and Unique Registry of Beneficiaries (SINIRUBE), and frequently updating the database of SINIRUBE to maintain its relevance in addressing the needs of the poor; and (b) using savings to expand the district-level coverage of the national Bridge Strategy (Estrategia Puente) to deliver a package of benefits to families in extreme poverty.

45. **Rationale.** The health measures needed to contain the effects of COVID-19 are affecting the working conditions, income, and assets of many people, particularly low-income households. Workers and businesses in sectors such as hotels, restaurants, and transport (which employ 277,000 people, 61 percent unskilled and 11 percent of the poor) are being directly affected. At least 80 percent of workers in this sector are projected to suffer from temporary suspension or termination of their contracts. This is



putting additional pressures on an already slack labor market. As previously mentioned, the unemployment rate has risen in recent years, reaching 12.4 percent in 2019, the highest level in ten years. Unlike other OECD countries, Costa Rica does not have unemployment insurance to compensate for job losses, or while transitioning or searching for a new one. The World Bank estimates that a loss of just 14 days of monthly labor income among the informal self-employed and small businesses could push 310,000 people into poverty during the quarantine period (US\$5.5/day PPP), and at least 180,200 people by the end of 2020.

46. **Substance of the Prior Action.** The *Bono Proteger* aims to provide beneficiaries with a basic allowance to temporarily (6 months) meet basic needs and is targeted to those most impacted by the National Emergency and associated lockdown due to COVID-19. Beneficiaries include Costa Rican citizens or foreigners in a regular migratory condition aged 15 years and older who have lost their job, had their working days reduced, employment contract suspended, or income reduced as a result of COVID-19. The amount to be paid through *Bono Proteger* will depend on the condition of those affected and will be related to the average cost of the Basic Food Basket (*Canasta Básica*, CBA), which is CRC 125,000 per month. Workers who have lost their job will receive 100 percent of this amount, while those with a working day reduction of 50 percent or less will receive half of this amount. The resources will be assigned to the National Employment Program of the Ministry of Labor and Social Security (MTSS) and to the Program of Promotion and Social Protection of the Institute of Social Aid (IMAS). It is IMAS's responsibility to grant the *Bono Proteger*. Public sector workers or beneficiaries of state with money transfers equal to or greater than CRC 50,000 per month may not benefit from this subsidy. Therefore, it is key that IMAS strengthens its monitoring and targeting of the different social programs to avoid duplication of payments.

47. **Indicative Trigger 1.** The trigger reflects the Government's policy to improve the targeting, coverage and adequacy of its traditionally means-tested social assistance program. Despite increasing over time, social assistance programs have low coverage and are not necessarily reaching the target populations. Institutional fragmentation and lack of coordination have created inefficiencies and duplications of targeted social programs, reducing their impact. About 22 percent of individuals in the lowest quintile were not covered by any social assistance program and none of the programs cover more than 30 percent of the poorest 20 percent of the income distribution. The National Scholarship Fund (*Fondo Nacional de Becas*, FONABE) and *Avancemos*<sup>7</sup> had about 60 percent of their beneficiaries not belonging to the lowest quintile of the income distribution. Costa Rica's Public Financial Review (PFR) estimations suggest that improving targeting accuracy alone could reduce extreme poverty by 0.5 percentage points; this could be done just by transferring resources from non-eligible beneficiaries toward eligible extreme poor who are currently not covered by the program. To this end, the authorities are developing a reform to: (i) better identify families in extreme poverty by improving the targeting methodology and the National Information System and Unique Registry of Beneficiaries (*Sistema Nacional de Información y Registro Unico de Beneficiarios del Estado*, SINIRUBE) and frequently updating the database of SINIRUBE; and (ii) expand the district-level coverage of the *Estrategia Puente*<sup>8</sup> to deliver a package of benefits to families in extreme poverty. Given that an improvement in targeting will gradually exclude current non-poor beneficiaries, the roll out of the programs under the improved poverty-targeted

<sup>7</sup> The *Avancemos* is a conditional cash transfer program established in 2008 with the objective of promoting "retention and reintegration into the formal education system for adolescents and youth from families who are struggling to keep their children in the education system due to economic reasons."

<sup>8</sup> The *Estrategia Puente* is a safety net program launched in 2015 focused on the 75 poorest districts of Costa Rica based on the National Statistics and Census Institute's (INEC) poverty map.



methodology should aim at mitigating social risks, potentially considering a transition period or rule for those that will be no longer eligible and, as needed, assessing and facilitating access to other programs (those not extreme-poverty-targeted) that can promote productive inclusion in the labor market and increase their capacity to generate market income.

48. **Expected Results and Indicators.** The impact of Prior Action 1 will be measured by the number of beneficiaries that receive the special unemployment subsidy in 2020 against a 2019 baseline of zero (target of 600,000). The trigger is expected to use the lessons and tools used in *Bono Proteger* to increase the targeting of *Avancemos* from 20 to 40 percent of the lowest quintile (of the income distribution) and the coverage of *Estrategia Puente* from 75 to 88 districts.

**Prior Action 2** – *The Borrower has taken measures to protect jobs and support SMEs affected by the COVID-19 pandemic by: (a) granting a moratorium on the payment of VAT, business income taxes, and customs duties; (b) approving a temporary reduction of social security contributions; (c) allowing temporary suspension of work shifts; and (d) urging state-owned commercial banks to provide financial mechanisms to individuals and firms affected by COVID-19 who need access to credit for working and investment capital.*

**Evidence:** (i) Law No. 9830 dated March 19, 2020 and published in the Borrower’s Official Gazette on March 20, 2020; (ii) CCSS Communication SJD-0494-2020 on the Resolution of the Board of Directors dated March 20, 2020; (iii) Law No. 9832 dated March 21, 2020 and published in the Borrower’s Official Gazette on March 23, 2020; and (iv) Guideline 083-H-MIDEPLAN from May 8, 2020 and published in the Borrower’s Official Gazette on May 9, 2020.

**Indicative Trigger 2** – *The Borrower has introduced measures to support economic recovery and job creation by: (a) improving and, if appropriate, expanding development bank financing to help SMEs and producers in tourism and other sectors in their post-COVID-19 recovery; (b) approving legislation to modernize the National Institute of Learning (Instituto Nacional de Aprendizaje, INA); and (c) reducing the number of procedures to open a business and increase the number of them that are processed through the Single Investment Window (Ventanilla Unica de Inversión, VUI).*

49. **Rationale.** The supply and demand shocks associated with COVID-19 have reduced revenues and can jeopardize the economic viability of otherwise healthy firms. Economic disruptions associated with the COVID-19 crisis have led to a collapse in firms’ cash flow, particularly in sectors most affected by the lockdown. These shocks are placing liquidity pressures on firms, particularly SMEs, and in the case of Costa Rica, these pressures come from:

- (i) **Tax obligations.** In the context of liquidity constraints generated by COVID-19, complying with tax obligations could force companies to lay off workers or cut payment responsibilities to their workers.
- (ii) **Large Payments of Social Security Contributions.** The social security contribution rate represents 36.5 percent of gross salary, with 26.3 percentage points levied on the employer and 9.3 percentage points on employees. The portion payable by employers is higher in Costa Rica than in most Latin American and OECD countries. Since during the COVID-19 pandemic many firms have been forced to shut down, the financial burden on employers and independent workers



making these contributions becomes extremely high, putting at risk the continuity of business activities even after the pandemic.<sup>9</sup>

- (iii) *Limited access to credit.* In the current context, access to capital and investment credit mechanisms is a determining factor for sustaining business activity. This is relevant for Costa Rica, where banks may be reluctant to engage in new lending given heightened (perceived) credit and liquidity risks. This is in addition to a pre-crisis context characterized by limited credit supply and overall costly credit intermediation for and SMEs account for 29 percent of national employment in Costa Rica, and many of them are not registered in the national registry and do not have official accounting records. Therefore, SMEs face difficulties in having access to formal finance as they operate under high informality. In this context, credit lines provided by government-owned banks are a useful complement to credit guarantees to address the liquidity needs of firms that cannot access bank financing directly.

50. **Substance of the Prior Action.** Prior Action 2 comprises four components, covering tax deferrals, social security contributions, labor market regulations, and access to finance components.

- (i) *Tax deferrals.* The National Assembly approved a law that establishes a three-month moratorium on the filing and payment of various taxes in order to mitigate the economic effects of COVID-19. This moratorium applies to partial payments of income tax, payment of VAT and custom taxes, in the months of April, May and June 2020.
- (ii) *Temporary reduction in social security contributions.* The Government introduced labor and social security measures to mitigate the effects of COVID-19 in the workplace by temporarily alleviating the financial burden on employers and independent workers and ensuring the continuity of business activities. First, the CCSS approved reducing the Minimum Tax Base in health and pension insurance for employer contributions and independent workers for the months of March, April and May 2020. The reductions are from CRC 294,619 to CRC 73,654 (approximately US\$520 to US\$130, respectively), for Health Insurance and from CRC 275,759 to CRC 68,639 (US\$285 to US\$120) for pension insurance. Also, the collection of late payments and related fees has been postponed until June 30, 2020, while interest rates are reduced for payment arrangements and agreements that are in force or new ones to be signed, whose measures will last until August 31, 2020.
- (iii) *Access to credit.* Through the state-owned banks in partnership with the System of Development Banks, the Government has created financing mechanisms in favor of individuals and firms affected by COVID-19, which require access to credit for working capital, payroll and investment, including:
  - (i) elimination of the practice of minimum levels of active interest rates, both for existing credits and for new credit operations;
  - (ii) temporary flexibility in the risk assessment of credit operations;
  - (iii) elimination of the practice of applying penalties or commissions for advance or extraordinary payments; and
  - (iv) additional lines of credits and partial credit risks guarantee for SMEs. State-owned banks have mobilized about US\$1 billion equivalent for this purpose, as follows: (a) *Banco*

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<sup>9</sup> In this context, measures to increase the flexibility of labor regulations were also submitted to The National Assembly to minimize job losses and ease firm's response to COVID-19 (these not part of the legal prior action). Costa Rica's labor regulations include rigidities such as high minimum wages and inflexible working hours or contracts. These arrangements discourage firms from opening formal positions and forces firms to fire workers, rather than modify compensation or hours of work, to comply with the COVID-19 containment measures. The proposed changes to labor regulation, thus, include the possibility that employers reduce the number of working hours of their employees by 50 percent for reasons directly related to the declaration of the National Emergency (to avoid misuse, changes will need to be reviewed by the Ministry of Labor and Social Security).



*Nacional* will offer US\$500 million equivalent in a new credit line to support business continuity for all enterprises; (b) *Banco de Costa Rica* announced three credit lines for an amount of US\$200 million equivalent for Large, SMEs and micro enterprises respectively; and (c) *Banco Popular* will provide US\$300 million equivalent to businesses impacted by COVID-19 under improved credit conditions.

51. **Indicative Trigger 2.** The authorities have announced their intention to build on the above measures to support economic recovery and job creation, including by: (i) improving and, if appropriate, expanding development bank financing to help SMEs and producers in tourism and other sectors in their post-COVID-19 recovery; (ii) approving legislation to modernize INA; and (iii) reducing the number of procedures to open a business and increase the number of them that are processed through VUI.

52. **Expected Results and Indicators.** These measures are projected to: (i) increase the liquidity provided to support SMEs during the COVID-19 pandemic to around 0.5 percent of GDP by 2022 (starting in 2020), and (ii) reduce the number of procedures to start a business from 10 to 5,<sup>10</sup> as well as increase the number of procedures (to start a business, register a property, register a patent, Single Tax Registry, etc.) that can be carried out through a VUI by 2022 from 22 to 119.

**Prior Action 3** – *The Borrower has mobilized resources to address COVID-19 mitigation efforts including: (a) transferring revenues from RECOPE to the Borrower central government’s budget that were generated by creating a temporary price gap between domestic and international prices for petroleum products; and (b) transferring excess capital from INS to the Borrower’s central government’s budget.*

**Evidence:** (i) Law No. 9840 dated April 22, 2020 and published in the Borrower’s Official Gazette on April 22, 2020; and (ii) Law No. 9847 dated May 18, 2020 and published in the Borrower’s Official Gazette on May 19, 2020.

**Indicative Trigger 3** – *The Borrower has enacted a dividend policy for SOEs, including transfers to the budget when appropriate.*

53. **Rationale.** In order to partially offset the extraordinary fiscal spending required to mitigate the impact of COVID-19, the Government has identified temporary funding sources from windfall profits and surplus capital from SOEs.

(i) *Costa Rican Petroleum Refinery’s (Refinadora Costarricense de Petróleo, RECOPE)* revenue. Costa Rica does not subsidize the consumption of fossil fuels, but the authorities have used the opportunity of falling international prices for oil and fuels to create a wedge between domestic and international prices by fixing the former at the March 24, 2020 levels during the duration of the National Emergency, or, until international prices increase back to this level, whichever occurs first. As the wedge will generate a revenue windfall in RECOPE, the authorities have been authorized to transfer it to the budget.

<sup>10</sup> According to the World Bank’s Doing Business 2020, in 2019 10 procedures were required to start a business, higher than the averages for Latin American and the Caribbean (8.1) and OECD (4.9).



(ii) *National Institute of Insurance*<sup>11</sup> (*Instituto Nacional de Seguros, INS*) *excess capital*. The INS has accumulated excess capital that has not been transferred to the Central Government since 2008 when the sector was opened for competition. While the INS Law establishes that INS must retain 75 percent of annual profits after taxes, it suggests that the remaining 25 percent must be transferred to the CG as dividends. However, when the insurance market was opened to competition (with the state maintaining the ownership of INS), the INS was authorized to retain 100 percent of the profits for five years in order to strengthen it against new entrants. Profits retention since 2008 led to an accrued Capital Sufficiency Index (Indice de Suficiencia de Capital, ISC) of 2.56, far exceeding the minimum of 1.3 required by law. Thus, INS currently has excess capital that can be legally transferred to the CG without affecting its solvency.

54. **Substance of the Prior Action.** Prior Action 3 comprises two components, whereby revenues from RECOPE and excess capital from INS are transferred to the CG's budget.

(i) *Transferring RECOPE's revenues*. The Borrower has enacted legislation that authorizes it to transfer the windfall profits of RECOPE generated by freezing domestic fuel prices for gasoline with 91 and 95 octanes during the duration of the National Emergency (or until the international price reaches these levels again, whichever occurs first). The prices will be CRC 606 for high octane gasoline and CRC 583 for regular gasoline (both slightly above US\$1).

(ii) *Transferring INS excess capital*. The National Assembly has also approved legislation to allow the INS to transfer part of its excess capital to the budget, for an amount of CRC 75 billion. This transfer would represent, approximately, a decrease of 0.30 in the ISC, which is a ratio of capital to risks-weighted assets, which will remain at 2.16, still much higher than the minimum of 1.3 required by Law. Therefore, this transfer does not technically affect the regulatory or competitiveness conditions necessary for the operation of the National Insurance Institute.

55. **Indicative Trigger 3.** The authorities are designing a dividend policy for SOEs, compatible with OECD best practices. This will create a regular, non-discretionary source of non-tax revenue for the country.

56. **Expected Results and Indicators.** This measure is projected to raise about CRC 105,000 million (around 0.3 percent of GDP) in extra revenues for the CG.

## Pillar B: Reinforcing fiscal sustainability in the aftermath of COVID-19

57. **Costa Rica had launched a robust fiscal consolidation program prior to the pandemic, which the authorities plan to resume once the crisis moderates.** Fiscal sustainability had been the weak link in the overall macroeconomic framework—the external sector's strength has been anchored to sustained trade, tourism and FDI flows mainly with the US. By end of 2018, the Executive and Legislative branches forged a historic consensus to address fiscal problems with the enactment of a fiscal package expected to deliver 4.1 percentage points of GDP in savings. Implementation started in earnest in mid-2019 with good gross results—although a higher than expected interest bill and one-off spending derailed the adjustment in 2019. This derailment in fiscal consolidation generated a new fiscal reform impetus, as new measures were announced in February 2020 adding to an additional 2.3 percentage points of GDP—for an expected overall consolidation of 6.3 percentage points of GDP (Table 5).

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<sup>11</sup> The INS is a state-owned insurance provider company created in 1924 as a monopoly.



58. **As previously stated, the COVID-19 pandemic has delayed but not derailed the fiscal consolidation plans.** In crafting a medium-term response to the crisis, the authorities have made it clear that fiscal measures are temporary and do not imply losing control over public finances. As also shown in Table 5, the authorities have not abandoned their plans to achieve a fiscal consolidation effort of 6.3 percentage points of GDP. They realize that an adjustment of this magnitude will not fully lead to the debt-to-GDP levels targeted before the COVID-19 pandemic but see it as feasible to still compress the same consolidation effort during the 2021-24 period.

59. **This pillar supports already enacted tax enhancing and expenditure reducing measures, together with wage bill and debt management improvements.** Tax measures include broadening of bases and increases in rates for all major taxes (Prior Action 4), while expenditure measures focus on wage bill reductions (Prior Action 5), and the imposition of caps to the growth of current (if the debt-to-GDP ratios is below 60 percent) or total expenditure (if bigger than 60 percent) (Prior Action 6). Debt management measures (Prior Action 7) complement the previous measures by aiming to increase liquidity around key government bond benchmarks, among others. The proposed triggers include additional improvements in tax policy and administration, and wage bill and debt management, which are supported by the Fiscal management Improvement Project (P172352) approved by the World Bank Board of Executive Directors on March 26, 2020.

60. **The authorities deem fiscal consolidation as an essential ingredient to restore growth post COVID-19.** Growth in Costa Rica has solid underpinnings, given the country’s track record in attracting FDI into sophisticated export-oriented manufacturing and service industries. However, before the end of 2018 fiscal reforms, private investment, and consumption had nearly stalled due to the uncertainty regarding the country’s fiscal solvency. It is thus imperative to retake and reinforce the fiscal stabilization path to ensure investor and consumer confidence is fully restored.

Table 5. Fiscal savings emerging from 2018 fiscal reform (% of GDP)

Concept	Pre COVID-19							Post COVID-19					
	2019	2020	2021	2022	2023	2024	Accumulated	2020	2021	2022	2023	2024	Accumulated
<b>Revenue measures</b>	<b>1.05</b>	<b>1.10</b>	<b>0.31</b>	<b>0.37</b>	<b>0.25</b>	<b>0.25</b>	<b>3.33</b>	<b>-0.11</b>	<b>1.00</b>	<b>0.55</b>	<b>0.39</b>	<b>0.45</b>	<b>3.33</b>
Amnesty (actual, one-off)	0.38						0.38						0.38
VAT reform (PA 4)	0.33	0.37	0.05	0.03	0.00		0.78	0.10	0.21	0.15	0.00		0.78
Elimination of Tax Expenditures (Trigger 4)		0.20					0.20		0.20				0.20
Income taxes (PA 4)	0.34	0.33	0.01	0.00	0.00		0.68	-0.20	0.39	0.11	0.04		0.68
Additional Impact from lower tax evasion (Trigger 4)			0.25	0.25	0.25	0.25	1.00			0.20	0.35	0.45	1.00
Global BEPS <sup>1</sup> (PA 4)	0.00	0.20	0.00	0.09	0.00		0.29	0.00	0.20	0.09	0.00	0.00	0.29
<b>Expenditure measures</b>	<b>0.01</b>	<b>1.09</b>	<b>0.43</b>	<b>0.55</b>	<b>0.66</b>	<b>0.20</b>	<b>2.94</b>	<b>-0.59</b>	<b>1.31</b>	<b>0.79</b>	<b>0.82</b>	<b>0.60</b>	<b>2.94</b>
Goods and services (PA 5: Fiscal rule)	0.01	0.00	0.02	0.05	0.06		0.14	-0.52	0.30	0.20	0.15		0.14
Additional impact Public Procurement (Trigger 5)			0.10	0.10	0.10	0.10	0.40		0.10	0.10	0.10	0.10	0.40
Current transfers (PA 5: Fiscal rule)	-0.07	0.61	0.09	0.10	0.15		0.88	-0.10	0.43	0.19	0.22	0.17	0.84
Capital spending (PA 5: Fiscal Rule)				0.10	0.15		0.25			0.10	0.15	0.15	0.40
Public wages (PA 6)	0.07	0.28	0.12	0.10	0.10		0.67	0.03	0.28	0.10	0.10	0.08	0.66
Additional impact Public Employment Reform (Trigger 6)		0.20	0.10	0.10	0.10	0.10	0.60	0.00	0.20	0.10	0.10	0.10	0.50
<b>Total</b>	<b>1.06</b>	<b>2.19</b>	<b>0.74</b>	<b>0.92</b>	<b>0.91</b>	<b>0.45</b>	<b>6.27</b>	<b>-0.69</b>	<b>2.31</b>	<b>1.34</b>	<b>1.21</b>	<b>1.05</b>	<b>6.27</b>

<sup>1</sup> Base-erosion and profit shifting measures

Source: World Bank and IMF staff projections based on information provided by the Ministry of Finance of Costa Rica.



**Prior Action 4** – *The Borrower has approved a tax reform that: (a) converted the sales tax into a value added tax (VAT); (b) regulated the VAT base to reduce exemptions and established a reduced rate for the basic consumption basket; (c) broadened basis and harmonized rates for capital earnings between the personal income tax (PIT) and the corporate income tax (CIT) and adopted best international practices on capital income taxation and Base Erosion and Profit Shifting (BEPS); and (d) added two top brackets to the PIT (20 and 25 percent for incomes above US\$3,400 and US\$7,200 equivalent per month, respectively).*<sup>12</sup>

**Evidence:** (i) Titles I and II of Law No.9635 dated December 3, 2018 and published in the Borrower's Official Gazette on December 4, 2018; (ii) Decree No. 41779 dated June 7, 2019 and published in the Borrower's Official Gazette on June 11, 2019; (iii) Decree No. 41615 MEIC-H dated March 13, 2019 and published in the Borrower's Official Gazette on March 18, 2019, and (iv) Executive Decree No. 41818-H dated June 17, 2019 and published in the Borrower's Official Gazette on June 26, 2019.

**Indicative Trigger 4** – *The Borrower has enacted measures to (a) curtail key tax exemptions and require periodic impact evaluations and sunset clauses for the remaining exemptions, and (b) introduce a Risk Matrix and associated implementation mechanisms for all tax audits.*

61. **Rationale.** First, Costa Rica needed to introduce a proper VAT. The sales tax is the largest source of revenue, raising about 4.4 percent of GDP in 2017; or 35 percent of total tax revenue. But the tax efficiency was low relative to comparable taxes in most OECD and Latin American countries. While the sales tax rate was high at 13 percent, its base was very narrow given large exemptions, including: (i) goods in the basic consumption basket (more than 250), (ii) essential goods for education, (iii) medicines, (iv) agricultural inputs, (v) several cultural goods, (vi) kerosene, and (vii) basic consumption of electricity up to 250 kW/h per month. Also, the sales tax was generally not levied on services, except for those that were explicitly included in the law, such as restaurants and hotels. In addition to reducing tax efficiency and neutrality, this narrow tax base generated revenue losses. Taxing goods but not services also created challenges in relation to sales whose price includes both goods and services components. The sales tax was also somewhat regressive due to various exemptions that primarily benefitted richer households. Second, Costa Rica also needed to improve the income and corporate taxation regimes. Prior to the reform, the income tax was by income category, taxing income from different sources at different rates. This caused a loss of efficiency and equity of the tax, by allowing income that comes from a different source to receive a different treatment, even though they are of the same magnitude (a problem of horizontal equity). There were numerous differential rates and exemptions that generated holes, allowing for evasion and producing inequities. There was a need to complete tax design by standardizing tax on capital income and increasing progressivity in personal income tax.

62. **Substance of the Prior Action.** The transformation of the sales tax into a VAT brings several advantages to Costa Rica: (i) the VAT does not punish adding value to a particular commodity, since the base is not its total value but only the "value-added;" (ii) the reform broadened significantly the tax base, most notably to all services; and consequently, (iii) it will help increase tax revenues. The approved resolution for the VAT implementation comes with additional advantages, such as a narrowly defined food basket (only for the minimum caloric intake basket used to calculate extreme poverty), which was not

<sup>12</sup> See Prior Action 2 on the postponement of tax returns and payments to help preserve jobs and provide liquidity to the SME sector.



exempted (a move that would break the chain affecting producers) but taxed at a 1 percent rate. Private health centers were rated at 4 percent, while pharmaceuticals at 2 percent.

63. On income taxes, a series of reforms to the Income Tax Law were enacted:

- (i) **Introducing a global tax of 15 percent on all sources of capital income:** dividends, interest, royalties, rental of real estate and capital gains. For capital rents, a deduction of expenses is allowed, with a maximum and automatic of 15 percent (20 percent for real estate investment funds);
- (ii) **Introducing marginal rates for SMEs** (or companies that sell less than CRC 106 million), with the following scale: (a) 5 percent up to CRC 5 million net income; (b) 10 percent on the excess of CRC 5 million up to CRC 7.5 million; (c) 15 percent on the excess of CRC 7.5 million up to CRC 10 million; (d) 20 percent on the excess of CRC 10 million; and (e) above CRC 106 million of sales applies a rate of 30 percent to the total of the net rent (not to the excess); and
- (iii) **introducing two new top brackets of 20 and 25 percent to the tax on salaries, pensions and other labor-related income.** The new scale is as follows: (a) exempt up to CRC 1.2 million; (b) 15 percent from CRC 1.2 to CRC 2.1 million; (c) 20 percent from CRC 2.1 to CRC 4.2 million; and (d) 25 percent when it exceeds CRC 4.2 million.

64. The reforms also provided for key measures to combat Base-Erosion and Profit Shifting, such as:

- (i) **Incorporation of the arm's length principle in the country's primary legislation** (Art. 2 of Law 9635/18, Section 17, pursuant to which new Art.81 bis is added to the Income Tax Act). Following the adoption of the arm's length principle, Costa Rica issued regulations for the application of the transfer pricing regime, providing for the definition of related parties, the transfer pricing methods, the use of comparables, documentation requirements, the possibility of entering into advanced pricing agreements (APAs), among others. (Art. 2 of Decree 41818-H/19, pursuant to which Arts. 64-75 are added to the Income Tax Regulations).
- (ii) **Enactment of a provision preventing resident taxpayers from deducting payments made to related parties abroad.** This is done when, as a result of a hybrid mismatch, such payments result in non-taxable income or exempt income to the related party abroad, or when such payments may be deducted by the related party abroad (Art.2 of Law 9635/18, Section 9, pursuant to which paragraph m) is added to Art.9 of the Income Tax Act).
- (iii) **Enactment of a thin-capitalization rule,** pursuant to which resident taxpayers are not allowed to deduct interest payments made to non-financial institutions exceeding 20 percent of their Earnings Before Interest and Taxes. The rule also provides for a definition of financial institutions, additional details on the way to calculate the deductible interest-payments under the provision, and exceptions applicable to interest-payments made by financial institutions and to interest-payments made in connection with locally financed infrastructure projects, among others. (Art. 2 of Law 9635/18, Section 10, pursuant to which Art. 9bis is added to the Income Tax Act).
- (iv) **Enactment of a provision disallowing the deduction of expenses incurred by resident taxpayers corresponding to transactions involving, directly or indirectly, persons who are residents of "non-cooperative jurisdictions," and of payments made through residents in such jurisdictions.** The provision further provides for the criteria to be applied by the Tax Administration for issuing



the list of "non-cooperative jurisdictions," which needs to be updated regularly. (Art.2 of Law 9635/18, Section 9, pursuant to which paragraph k is added to Art.9 of the Income Tax Act).

- (v) **Enactment of VAT applicable to digital services provided to customers in Costa Rica.** (Art.1 of Law 9635/18, pursuant to which Art.1, numeral 2, Literal c) (ii) was introduced to the VAT Act.

65. **Indicative Trigger 4** deepens efforts to increase the tax base by reducing tax expenditures. In a period of fiscal consolidation, where public expenditure programs are under scrutiny, it is also important to review tax expenditures, and Trigger 1 has this express purpose. Tax expenditures in Costa Rica are far above the regional average. Personal Income Tax (PIT) expenditures are estimated at 1.2 percent of GDP, the second highest level in the region, and Corporate Income Tax (CIT) expenditures are estimated at 0.8 percent of GDP, of which 0.49 is due to foregone revenues in special economic zones and are around the regional average. The introduction of the VAT sharply reduced VAT expenditures by broadening the base and especially by taxing services, but there is still 1.6 percent of GDP in foregone revenue due to exemptions on goods, some of which is being reviewed. A Risk Matrix and associated implementation mechanisms for tax audits of the PIT and CIT will deepen these efforts to increase revenue collection from income taxes, which is in part due to poor compliance rates. The Costa Rican General Directorate of Taxation (*Dirección General de Tributación*) estimates that tax evasion and avoidance represent around 8 percent of GDP. Tax evasion is especially prevalent among liberal professions and corporations. The OECD estimates that, in 2014, a quarter of corporations and almost one-fifth of self-employed professionals did not fill out their income taxes. The OECD also estimates that over 55 percent of persons who have profitable professional service activities declare zero income tax. In this regard, developing a risk matrix as the basis for all audit processes in the Tax Administration could help to significantly reduce evasion of income taxes—which is part of a broader modernization and digitalization efforts in the tax administration. These efforts are further supported under the Fiscal Management Improvement Project (P172352), which includes measures to revamp tax collection.

66. **Expected Results and Indicators.** Drawing on the analysis carried out under the PFR, the creation of the VAT is projected to increase tax revenues from 4.9 to 6.0 percent of GDP between 2018 and 2022. Also, per the analysis in the PFR, the income tax reform is projected to increase tax revenues by from 5.4 to 6.2 percent of GDP between 2018 and 2022.

**Prior Action 5** – *The Borrower has established a fiscal responsibility framework by: (a) limiting the growth of the non-financial public sector (NFPS) expenditure to that of the average nominal growth of GDP—or less, when the debt-to-GDP ratio crosses the 30, 45 or the 60 percent thresholds; (b) establishing the necessary procedures to comply with the rule – including the basis for the activation of the escape clause – and communicating them to NFPS institutions for the formulation of the 2020 budget; (c) establishing an autonomous Fiscal Council to issue its opinion on the results of the monitoring of adherence to the fiscal responsibility rule; and (d) clarifying that compliance with the fiscal rule for the pertinent year under consideration will be verified based on budget outturn.*<sup>13</sup>

**Evidence:** (i) Title IV of Law No. 9635 dated December 3, 2018 and published in the Borrower's Official Gazette on December 4, 2018; (ii) Decree No. 41641-H dated April 9, 2019 and published in the Borrower's

<sup>13</sup> The escape clause was properly and selectively activated for the budgets of the 4 institutions in the frontline of the fight against COVID-19, by the National Emergency declared in Executive Decree 42227-MP-S.



*Official Gazette on April 25, 2019 and DM-0466-2019 of the Ministry of Finance; (iii) Decree No. 41937-H dated August 1, 2019 and published in the Borrower's Official Gazette on August 28, 2019; and (iv) Decree N° 42218-H dated February 26, 2020 and published in the Borrower's Official Gazette on March 4, 2020.*

**Indicative Trigger 5** – *The Borrower has improved key budget process by: (a) issuing procedures to incorporate the national level decentralized agencies (about 50) into the CG budget and the single treasury account; (b) creating a macroeconomic analysis unit in the MOF tasked to centralize the preparation of the Medium Term Fiscal Framework for the entire NFPS; and (c) improve procurement processes by, among others, requiring all procuring entities to use the electronic platform (Sistema Integrado de Compras Públicas, SICOP) and introducing a sound regulatory and institutional framework for managing and implementing umbrella contracts for goods and services.*

67. **Rationale.** Aggregate public spending in Costa Rica has not been subject to limits, beyond financing constraints, facilitating a rapid expansion in recent years. Since most current expenditures are rigid (on payroll, goods and maintenance), adjustments during times of revenue shortfall have been difficult. The rigidity is reinforced by various pro-cyclical spending mandates (e.g. education) which are defined as a share of GDP. As a result, the current expenditure of the NFPS increased from 20.1 percent to 26.8 percent of GDP between 2008 and 2018, with the public wage bill of the NFPS increasing from 9 to 11.2 percent of GDP between 2008 and 2018. The creation of the fiscal rule, the issuance of clear procedures, and the establishment of an independent fiscal council provide a basic institutional framework to strengthen the sustainability of public finances in Costa Rica.

68. **Substance of the Prior Action.** The approved fiscal rule places constraints on recurrent expenditures by the NFPS (except spending financed from local governments' own resources) as follows:

- (i) Annual growth of *current* spending must not exceed the average nominal GDP growth of the past four years *if* the debt-to-GDP ratio (at the end of the previous fiscal year) is below 30 percent or the current expenditure-to-GDP ratio is below 17 percent.
- (ii) Annual growth of *current* spending must not exceed 85 percent of the average nominal GDP growth in the past four years *if* the debt-to-GDP ratio (at the end of the previous fiscal year) is between 30 and 45 percent.
- (iii) Annual growth of *current* spending must not exceed 75 percent of the average nominal GDP growth in the past four years *if* the debt-to-GDP ratio (at the end of the previous fiscal year) is between 45 and 60 percent.
- (iv) The annual growth of *total* spending must not exceed 65 percent of the average nominal GDP growth in the past four years *if* the debt-to-GDP ratio at the end of the previous fiscal year is above 60 percent.

69. **Item (iii) above has been used to prepare the 2020 budget for the CG (including the judiciary), the decentralized national agencies, the Social Insurance Fund (SIF), universities and SOEs.** Although some institutions requested exclusion (e.g., the SIF, the judiciary), the General Comptroller's Office (*Contraloría General de la República*) ratified the stance that the rule covered the entire NFPS. Currently, the rule only constrains current spending, hence sparing public investment from consolidation efforts, but this will not be the case once public debt surpasses the 60 percent of GDP threshold, which is likely to be



the case for the 2021 budget. The fiscal rule does not constrain spending financed from local governments' own resources. This does not affect the substance of the prior action, as spending by municipalities represent less than 5 percent of the NFPS budget and transfers from the central government to municipalities are still subject to the fiscal rule.

70. **Indicative Trigger 5** deepens these efforts to ensure implementation of the fiscal rule with three significant measures. First, the incorporation of all extra budgetary agencies of the CG, about 54, into the CG budget and the single treasury account which eliminates rigidities in budget and treasury management and improves overall transparency. Second, a macroeconomic analysis unit will be created under the Cabinet of the MOF tasked with the implementation of the rules and the preparation of the medium-term framework for the entire NFPS. Finally, reforms to the procurement code will take into consideration many of the findings from the PFR in that they: (i) tighten the conditions for use of "special regimen," which the PFR analysis found to result in higher prices; (ii) enable the National Procurement System to monitor and fight monopolies and oligopolies in public procurement at the buyer level; (iii) add a pre-bidding stage to help improve planning; and (iv) remove awards based on raffles and direct selections, among others. The analysis developed by the PFR suggests that there are opportunities to allocate resources more efficiently by promoting savings in the purchase of goods and services.

71. **Expected Results and Indicators.** Given the disputes about fiscal rules coverage, the results would be measured in terms of the budgets prepared by the CG, the SIF, and universities that fully comply with the rules. If full compliance is assumed, this reform is expected to contain growth of public spending and contribute to reduce the fiscal deficit of the CG by one percentage point of GDP by 2022 (and 1.3 percentage points by 2023; see Table 5).

**Prior Action 6** – *The Borrower has: (a) frozen basic public sector wages of the central government in 2020, (b) closed public sector vacancies pending to be filled; (c) proposed the elimination of the annual bonus for 2020 for the public sector (except for the police and personnel of the Borrower's Ministry of Health and of the CCSS) and the redirection of all savings towards the National Commission of Risk Prevention and Emergency Attention; and (d) simplified the remuneration policy of public servants, capping bonuses and extraordinary compensations (in levels), and establishing new rules for performance evaluation.*

**Evidence:** (i) Decree No. 42286-MTSS-H-MIDEPLAN dated April 4, 2020 and published in the Borrower's Official Gazette on April 6, 2020; (ii) Draft Bill No. 21,917 published in the Borrower's Official Gazette on April 9, 2020; (iii) Law No. 9841 dated April 24, 2020 and published in the Borrower's Official Gazette on April 25, 2020; (iv) Title III of Law No. 9635 dated December 3, 2018 and published in the Borrower's Official Gazette on December 4, 2018; and (v) Decree No. 42087-MP-PLAN dated December 4, 2019 and published in the Borrower's Official Gazette on December 10, 2019.

**Indicative Trigger 6** – *The Borrower has enacted a New Public Employment Law introducing a single remuneration arrangement and a post-management system for civil service.*

72. **Rationale.** At around 11 percent of GDP on average between 2014 and 2017, the public sector wage bill in Costa Rica is among the highest in Latin America (only behind Argentina with 12 percent, and significantly above the Latin American average of 8 percent) and slightly above the aspirational peers from



the OECD countries (10 percent). In contrast, public employment only represents 12.2 percent of total employment in Costa Rica, below the OECD (20.2 percent) and Latin American (12.5 percent) averages. Public salaries, however, were found to be almost 50 percent higher than those in the private sector, after controlling for employees' characteristics.<sup>14</sup> Rapidly growing public salaries have contributed to fiscal imbalances, especially in the early years after the global financial crisis, limiting fiscal space for social and capital spending, and raising concerns about fiscal sustainability. Furthermore, public employment and the remuneration framework have displayed certain weaknesses with regards to efficiency and equity. The lack of performance incentives and large discrepancies within compensation levels for employees performing similar tasks affect staff motivation and morale leading to weaker overall quality of service delivery. In addition, the disconnect between the private and public-sector wage developments contribute to increasing inequalities.

73. **Substance of the Prior Action.** The Government has adopted the following measures:

- (i) Suspended the general increase to the base salary of CG staff for 2020.
- (ii) Enacted a hiring freeze by closing public sector vacancies pending to be filled.
- (iii) Proposed the elimination of the annual bonus for 2020 for the public sector (except for the police and personnel of the Ministry of Health and of the CCSS).
- (iv) Simplified the remuneration policy of public servants by capping the growth of individual salaries to inflation rate, strictly enforcing the statutory retirement age, establishing eligibility rules for annual bonuses (*Anualidades*), terminating the Exclusive Dedication Bonus, and increasing the number of effective hours of work.

74. **These measures are all aimed at containing the growth of the wage bill and are consistent with international experience** showing that short-term fiscal containment measures, such as salary or employment freezes, can help alleviate fiscal pressures and provide additional time to design comprehensive public employment reforms that address the underlying causes of elevated wage bill as well as efficiency and equity concerns.

75. **Indicative Trigger 6** deepens these efforts by reforming the Law of Public Employment, seeking to standardize the different sub-regimes of labor relations and wages across the Government and the decentralized public sector (including autonomous institutions and public companies). The goal is to evolve towards a more transparent and sustainable performance-based compensation system including non-monetary incentives (high public sector remuneration comes largely from a highly fragmented compensation scheme in the civil service). The new Law of Public Employment, a draft of which is already in The National Assembly, will simplify the current compensation system by initiating a gradual transition to a "single spine" salary system, that is, an amalgamation of the base salary and bonuses and remuneration. Any additional payment on the base salary must be universal and made in the most transparent and simple way possible. The Public Employment chapter of the PFR estimated that a reform such as this one could help generate additional savings of around 0.5 percent of GDP by 2024.

76. **Expected Results and Indicators.** These measures allow for moderating wage bill growth in the short- and medium-term, significantly supporting a fiscal consolidation of about 0.64 percentage points of

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<sup>14</sup> World Bank PFR, 2019.



GDP by 2022. Results will be measured as the nominal growth of the wage bill of the CG, which should fall from 6.5 to 3.2 percent, the average of the 2013-18 period vis-a-vis the 2019-22 period. Because the reforms cover the entire NFPS, the growth of the wage bill for this broader definition of the state is also expected to slow-down from 6.5 to 3.2 percent over the same two periods.

**Prior Action 7** – *The Borrower has adopted measures to increase debt management transparency and efficiency, by enacting a public policy for the NFPS that enshrines the principle of debt sustainability, the requirement to register and track contingent liabilities and international good practices on transparency and accountability.*

**Evidence:** *Decree No. 41935-H dated August 16, 2019 and published in the Borrower’s Official Gazette on August 26, 2019.*

**Indicative Trigger 7** — *The Borrower has further improved public debt management and transparency by: (a) publishing a strengthened Medium-Term Debt Strategy (MTDS) and the associated Borrowing Plan for the first semester of 2021; (b) enacting a road map to broaden the investors’ base and improve liquidity in the Government securities secondary market; (c) further advancing in the implementation of benchmark policy issuances; and (d) improving coordination mechanism between the Treasury and the Debt Management Office, whereby: (i) the Debt Management Office is responsible for the MTDS, the instruments and the borrowing plan; and (ii) the Treasury is responsible for cash management.*

77. **Rationale.** Costa Rica’s public debt market has been challenged in recent years, as rising government financing needs have taken priority over the principles of sound medium term debt management. Pressures to finance the fiscal deficit have led to the adoption of multiple methods of contracting debt, with non-competitive methods accounting for the bulk of issuance. The fragmentation and frequency of issuance in the primary market hamper the development of a secondary debt market. On top of the rather scattered supply of government securities, the demand arises mainly from a public pension fund and commercial banks with little incentive to trade with each other. The combination of the scattered supply and the buy and hold investors result in a market with highly illiquid instruments that tend to elevate government funding costs, in the absence of a more diversified investor base and reasonable price discovery. Recent improvements of centralized debt management function have contributed to enhance transparency of public accounts and certainties regarding debt burden of decentralized public entities. Further coordination of debt management will contribute to strengthen accountability and promote transparency regarding the use and sources of external resources.

78. **Substance of the Prior Action.** There has been significant progress in 2019 toward the consolidation of the debt stock into fewer lines, but much remains to be done. The formal approval of a Public Debt Policy tasks the MOF with the further consolidation of government securities around a few key benchmarks, which will provide the basis for more active trading and for the creation of a representative yield curve, which the private sector needs as reference. It also imposes the responsibility of formulating and complying with annual borrowing plans by all public sector borrowing entities (non-financial) that are anchored in the Public Debt Policy. Finally, such a policy tasks the MOF with improving the organization and functioning of both primary and secondary markets and broadening the base of investors –including attracting foreign investors via a well-established international central securities depository (ICSD). Further, the new regulation emphasizes improving transparency on the information trail to foster accountability on public debt by mandating public institutions to publish the investment project financed with external credits as well as their quarterly execution. In addition, it requires the CG



and decentralized entities to present clear plans and accountability reports of debt issuance and disclosure information on contingent liabilities, which is particularly important for the country's SOEs. Additionally, the MOF will be responsible for creating and maintaining communication channels with investors and credit agencies to promote transparency and information exchange. Finally, the Policy enshrined the principle of debt sustainability, defining as a "natural" upper bound of the debt-to-GDP ratio 60 percent, above which measures should be triggered to reduce it, notwithstanding that it is expected for the debt ratio to be much lower than 60 percent during most periods.

79. **Indicative Trigger 7** builds on the recent efforts to improve debt management, particularly by revamping the country's MTDS, which could be improved in many aspects, including listing a set of carefully crafted risk indicators to provide better guidance to domestic and foreign investors. The MTDS should be complemented by the publication of an annual borrowing plan, which is mandatory but has been suspended for the last several years, notwithstanding the recent publication of a semi-annual borrowing plan for the first semester of 2020. Equally important would be the preparation of a road map of reforms to broaden the investors' base attracting non-resident investors through the improvement of the market infrastructure such as the link to an International CSD and exploring the feasibility of a potential global bond in local currency. Finally, a sharper formalization of the roles and responsibilities of the Treasury and Debt Management Offices within the MOF is also needed, for the latter to be fully responsible for designing and implementing the MTDS, the borrowing plan, and the issuance of government securities, while the former focuses on cash management.

80. **Expected Results and Indicators.** There will be at least two benchmark bonds in local currency with an individual size of at least US\$1 billion equivalent, thus paving the way to participating in key local currency indexes, such as that of JP Morgan. The creation of liquid benchmark bonds and reliable price references will enable the improvement of the liquidity in the secondary market. Also, in accordance with this goal, under the strengthened MTDS and annual borrowing plan, the share of government securities issued under non-competitive (direct) process will be reduced by 20 percent by the end of 2022 to about CRC 619 billion.

### **Pillar C: Laying the foundations for a strong post-COVID-19 recovery by promoting green growth and low-carbon development.**

81. **In February 2019 Costa Rica launched an ambitious economy-wide plan (NDP) to promote green growth and decarbonize the country by 2050, with short-, medium-, and long-term measures; the DPL series supports the implementation of green growth and low-carbon development reforms included in the Plan's first phase (2018-22).** This first phase recognizes the need for an adequate enabling environment to place the country on solid footing to become an emission-free and green economy. Considering the economic and social impacts of the COVID-19 pandemic, this first phase is also important for economic reactivation, by supporting key markets (coffee, fruit, and tourism) that rely on green branding in accessing markets, as well as the resilience of the national energy system. Specifically, this pillar of the DPL supports: (i) transversal reforms such as the establishment of a metrics and monitoring system to track sectoral emissions and decarbonization efforts and to provide evidence for the design of low-carbon development policies (Prior Action 8); (ii) accelerating deployment of transformative low-carbon technologies at national and municipal levels, via voluntary carbon neutrality commitments in the energy, industry, agriculture, waste, and forestry sectors, thus enhancing productivity and economic



gains<sup>15</sup> (Prior Action 9); and (iii) introducing a level-playing field for investments in energy renewables and their integration into the national electrical system (Prior Action 10).

**Prior Action 8** — *The Borrower, through MINAE, has required directorates and offices ascribed to MINAE and its Vice-Ministries of Environmental Management, Energy, Natural Resources and Water and Oceans to include and provide in a timely manner information to enable the National Climate Change Metrics System (SINAMECC) to collect, monitor, and report on climate change data within its areas of competence.*

*Evidence: Guideline No. 001-2019 dated May 17, 2019.*

**Indicative Trigger 8** — *The Borrower, through the Ministry of Environment and Energy (Ministerio de Ambiente y Energía, MINAE), has expanded interagency reporting to SINAMECC and availability of climate change data, through the signing of two ministerial agreements, fostering greater oversight of green growth and low carbon development policies.*

82. **Rationale.** To enable the evidence-based formulation of Costa Rica’s green growth and low carbon policies, a system is required to collect, monitor and report on climate change data at multiple levels (national, territorial, and sectoral). This system, the SINAMECC platform, was launched at the Pre-2019 United Nations Climate Change Conference (COP25) in October 2019, requiring agencies to systematically report on emissions, reductions, and removals in accordance with Intergovernmental Panel on Climate Change (IPCC) guidance. SINAMECC, led by MINAE’s Climate Change Directorate, in coordination with the National Statistics and Census Institute (*Instituto Nacional de Estadística y Censos*, INEC), the National Meteorological Institute (*Instituto Meteorológico Nacional*, IMN) and the National Center for Geo-Environmental Information (*Centro Nacional de Información Geoambiental*, CENIGA), provides the primary metrics to support the implementation of the NDP and evaluate its impacts. This data platform facilitates transparency, uniform accounting, participation, and knowledge on climate change, along with international reporting requirements. For example, diverse audiences, including civil society and the general public, will have direct access to the emissions inventory and its results, and be able to monitor progress in achieving climate goals; the information system will also inform on policy progress and policy impact on emissions and absorptions in all economic sectors. In the medium term, SINAMECC is expected to be expanded to also include information on adaptation and climate finance. Having publicly available climate change data at these different levels will facilitate decision making, accountability, and monitoring of progress in the implementation of climate-related policies. The system also supports OECD requirements for a national information system and environmental indicators.

83. **Substance of the Prior Action.** The Government has developed under the Bank-supported Partnership for Market Readiness (P158795) a SINAMECC platform that establishes a public registry to track GHG, reductions, and removals in a number of sectors (e.g., energy, industry, transport, agriculture, health, planning, governance, among others). The SINAMECC platform helps better visualize climate change data, providing improved information on where emissions are being generated and the

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<sup>15</sup> The Carbon Neutrality National Program (CNNP), which encompasses a subset of the NDP’s actions, has been established to provide incentives for municipalities and private and public organizations to reduce their emissions and take advantage of green and low carbon opportunities to growth. Sectoral priorities target those sectors with the largest emissions (energy, which includes transport, and agriculture) and that will bring economic gains in COVID-19 recovery efforts.



effectiveness of mitigation programs, allowing for the development of science-driven policies to reduce these emissions, and implementing mitigation actions more effectively. In particular, transparency in climate risk will be essential for future policy and investment decisions and to ensure that investments are targeted toward economic recovery.

84. **Indicative Trigger 8** expands the sectoral reach of this open data platform. MINAE will sign two agreements with the Ministry of Agriculture and Livestock (*Ministerio de Agricultura y Ganadería, MAG*) and the Ministry of Public Works and Transport (*Ministerio de Obras Públicas y Desarrollo Territorial, MOPDT*), requiring the agencies to report to SINAMECC their greenhouse gas emissions, removals, and reductions in a timely manner.

85. **Expected Results and Indicators.** The implementation of the SINAMECC platform will inform the development of climate-smart sectoral policies, programs, and projects that target low carbon development efforts and economic recovery. It will also provide close monitoring of progress made in implementing the NDP, as well as NDC commitments. Results will be measured by at least five public agencies formalizing their agreements with MINAE. These agencies will report on their greenhouse gas emission data, updating the data housed in and reported by SINAMECC, including in the Biannual Update Reports to the UNFCCC. This will enable reporting of emissions data from a baseline of 2012 up to the year 2019. Results are expected to inform and strengthen future sectoral climate policies and programs and be integrated in economic response packages for COVID-19 and other crises.

**Prior Action 9** -- *Under the Carbon Neutrality National Program (CNNP), the Borrower, through MINAE, has provided one-year term certifications for a municipality and public and private organizations for which a verification was conducted to confirm compliance with the commitment to low carbon development in key productive sectors and production processes.*

**Evidence:** *Letter from MINAE DM-0359-2020 dated March 20, 2020.*

**Indicative Trigger 9** — *The Borrower has fostered green markets and leveraging of natural resources for growth, by (a) issuing, via MINAE, a Decree, expanding the CNNP to products, such as coffee, medical devices, fruit, tourism, among others; and (b) issuing, via the MAG and MINAE, a full-fledged governance, planning, and implementation framework through a Joint High-level Commission Directive, to strengthen and streamline the economic and financial instruments utilized by both ministries and development banks to incentivize farmers' and producers' adoption of low-carbon emission technologies and climate resilient measures to meet GHG reduction commitments for the agricultural and forestry sectors.*

86. **Rationale.** MINAE, through Executive Decree No. 41122 of May 2018, established the CNNP as an important element of the overarching NDP, aiming at (i) sensitizing municipalities and local organizations to the challenges of climate change and decarbonization of the economy and of green growth investments and opportunities; (ii) promoting climate action at the local level through the management of GHG emissions and prioritization of efforts to report on and reduce emissions and promote green and low-carbon growth (see Box 3); and (iii) producing verifiable emission reports at the local level.



87. **MINAE initiated a pilot in six municipalities in December 2018 to recognize and incentivize mitigation management measures to reduce GHG emissions of local government and private organizations.** This pilot was followed by the inclusion of the CNNP as a key measure within the NDP in February 2019, which established the goals of increasing the number of municipalities and organizations participating in the Carbon Neutrality Program, as well as developing strategies and mitigation pilots in key municipal sectors such as transport, industry, and waste management. The CNNP was formally launched at the Pre-COP25, where municipalities and private and public organizations who meet requirements of adequately demonstrating emissions management, formally agreed to report their emission inventories and work toward carbon neutrality, by reducing emissions in key sectors and improving productions processes. These commitments will be verified periodically by independent Validation and Verification Organizations (*Organismos de Validación y Verificación, OVVs*) and participating local agencies and organizations will be able to utilize the CNNP logo, demonstrating their commitment to and achievement of low-carbon production and processes.

88. **The CNNP provides a platform for establishing a national voluntary carbon market.** It also contributes to develop Costa Rica’s decarbonization branding, which recognizes low-carbon production practices and allows producers and enterprises to take advantage of a more sophisticated demand for green attributes in global value chains. These actions will support economic reactivation post COVID-19, by monitoring the effectiveness of climate policy critical to recovery, as well as helping producers increase market access, generating employment, increasing food security, among others.

**Box 2: Low-Carbon Coffee -- A win-win for the environment and coffee producers**

In recent years, consumers have become increasingly conscious of the environmental impact of their consumption patterns. Climate labels are helping to respond with the offer of low-emission products that can reduce a consumer’s carbon footprint. Labels are now differentiating between a product’s carbon footprint, emission reductions in the production process, as well as those products that require emissions compensation to reach carbon neutrality.

Studies (e.g., from New York University and University of Ghent) find that consumers are willing to pay more for coffee with a sustainability attribute. In fact, these studies show that the willingness to pay for a conventional cup of coffee is Euros 2.04, while the willingness to pay for sustainable coffee is Euros 2.54. In other words, the coffee drinker indicates s/he is willing to pay an additional 24.5 percent for sustainable coffee.

The CNNP aims to support Costa Rica in capturing this growing economic opportunity. By providing products with a carbon neutral branding, the country will be able to enhance these products market access and increase exports, while at the same time continue to grow its “green branding.”

89. **Substance of the Prior Action.** Following the 2018 establishment of a platform and guidelines for municipalities and organizations to voluntarily commit to emission reductions, local government and private sector agencies are committing to report their emissions and work toward carbon neutrality, by implementing low carbon investments in the energy, industry, agriculture, waste management, and forestry sectors that support economic reactivation post COVID-19. From 2019 to present, 138 firms and organizations, and one municipality have committed to carbon neutrality, representing a reduction of 407,000 tons of CO2 equivalent. Organizations and municipalities, recognized by MINAE with a certificate to formally be a part of the CNNP, not only make commitments to register their emission reductions and



become carbon neutral, but many are also making additional commitments to support other organizations to also participate, economically, with training, and other means.<sup>16</sup> This formal recognition by MINAE provides organizations with a number of benefits, including acknowledgement of adequate emissions management, training in preparing an emissions inventory, technical support in identifying local mitigation actions (particularly in improved solid waste and transport management), information exchanges with other organizations, support in developing emission-reduction action plans, and identification of financing mechanisms for climate actions. In addition, these organizations' emission reductions could potentially be traded or sold in the future. The CNNP has the potential to further increase private sector involvement, as well as the demand for carbon offsets, further supporting economic recovery following the COVID-19 pandemic.

90. **Indicative Trigger 9** recognizes that consumer demand for lower-carbon products is growing and that consumers are prepared to change their purchasing habits to minimize the carbon footprint associated with their purchases. As such, there is a growing demand for carbon-labeled goods. Taking this into account, MINAE is expanding the CNNP to export-oriented products, such as coffee, tourism, fruit, and medical devices, providing these products with a carbon neutral branding that readies producers to access markets, offering them the opportunity to take advantage of a more sophisticated demand for greener attributes in global value chains and increase exports, thereby strengthening local carbon neutrality and increasing revenue. In addition, MINAE and MAG recognize that direct support to farmers and producers, via economic and financial instruments, is needed to incentivize them to adopt low-carbon emission technologies and climate smart agriculture techniques, which in turn would enable them to take advantage of green branding and markets. The trigger, therefore, also recognizes a Joint High-level Directive among both ministries to foster financing mechanisms suited to the needs and conditions of farmers and producers to support them in their recovery post COVID-19, through the implementation of low-carbon investments that contribute to sustainable ecosystem management, food security, and income generation, and more broadly support the country in achieving its GHG reduction commitments.

91. **Expected Results and Indicators.** Between 2019 and 2020, municipal adherence to the CNNP is expected to triple, with 38 percent national coverage. By 2022, 20 municipalities and 200 public and private organizations are expected to be registered in the CNNP, with at least 10 products expected to be reporting their emissions as well as utilizing the Program's branding. In addition, a joint environment-agriculture agenda is expected to advance decarbonization goals by promoting low-carbon and efficient agricultural food systems and an eco-competitive livestock model by increasing the number of farms applying sustainable landscape management practices, including climate-smart agriculture (CSA) techniques and practices (from approximately 3 to 7 percent of livestock farms, and from 13 to 20 percent of coffee producers by 2022). In addition, the number of farms receiving environmental service payments in recognition of their sustainable landscape management practices is expected to increase from 50 to 100 by 2022. Sustainably leveraging natural capital for growth and fostering inter-institutional collaboration for low-carbon development are expected to result in several socio-economic benefits, including increased food security, improved income generation, and restoration of productive natural resources more generally.

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<sup>16</sup> Municipalities/organizations decide the level of commitment they would like to make (e.g., the program has different categories of reporting and commitment ranging from an organization or municipality reporting its emissions inventory to committing to zero net emissions). Commitments are verified by a third-party verifier.



**Prior Action 10** — *ARESEP has issued a technical regulation to establish in a clear manner the technical and operational framework for the provision of ancillary services in the national electrical system, considering their planning, operation, allocation, supervision, evaluation and management.*

**Evidence:** *Resolution No. RE-0140-JD-2019 published in the Borrower’s Official Gazette on December 13, 2019.*

**Indicative Trigger 10** — *The Borrower has strengthened the power system’s governance and transparency by (a) issuing a normative defining the dispatch center’s (Centro Nacional de Control Energía, CENCE) governance structure and operational relationship with other agents at the Costa Rican Institute of Electricity (Instituto Costarricense de Electricidad, ICE) that operate in the power system; (b) Regulatory Authority for Public Services (Autoridad Reguladora de los Servicios Públicos, ARESEP) approval of procedures for CENCE to operate the power system and to transparently report the results of the system’s operation, together with a stakeholder grievance and a supervision mechanism for CENCE by ARESEP; and (c) ARESEP’s approval of a payment mechanism to CENCE for system operation services, separated from ICE’s transmission operation costs.*

92. **Rationale.** Focus Area 4 of the NDP highlights the need for consolidating and strengthening the national electric system with the capacity, flexibility, intelligence, and resilience necessary to supply and manage renewable energy at a competitive cost. Ancillary services, such as frequency and voltage control, and short-term balancing, are essential for keeping the dynamic demand-supply balance, stabilizing both transmission and distribution systems and maintaining predefined power supply quality and security standards. To address the variability and uncertainty of increasing variable renewable energy in the grid, ancillary services need to be adapted to increase system flexibility, incentivize fast response and ramping ability, and remunerate each of the services accordingly. In addition to being served by conventional generation units, ancillary services should be open to new participants, such as large-scale renewable generators, demand aggregators and large consumers, and to providers of Distributed Energy Resources (DERs). Further, by diversifying companies and generation units providing ancillary services, system resilience will be increased against potential emergencies that might impact the operation of different generation units.

93. **Substance of the Prior Action.** The regulation of ancillary services will contribute to optimizing the national electric system and reduce the overall system’s balancing costs, reducing transmission requirements and increasing overall system efficiencies and resilience in the use of existing infrastructure. Specifically, the digitalization of the electricity network combined with the deployment of smart grids will enable the system operator and power distribution companies to implement strategies to integrate new technologies and business models like peer-to-peer energy exchanges. A more decentralized management model of the electricity infrastructure will allow local demand-supply balances, reduce transmission requirements and increase overall system efficiency in the use of existing infrastructure, deferring the need for investments in additional power infrastructure. Adequate ancillary services regulation contributes to managing the variability of renewable energy with optimized reserves. These policies will contribute to adding more renewable energy to the system, maintaining the quality of supply at a competitive cost.

94. **Indicative Trigger 10.** The Costa Rican Institute of Electricity (*Instituto Costarricense de Electricidad*, ICE) is the vertically integrated power utility in Costa Rica, which has led the country’s electric



system development since the 1940s. While ICE is responsible for the transmission system, the distribution of electricity is provided by eight different cooperatives/municipalities –including ICE and the National Power and Lighting Company (*Compañía Nacional de Fuerza y Luz*, CNFL), a branch of ICE–, in charge of distributing electricity in their relevant regional divisions. In terms of electricity generation, these distribution utilities can opt to purchase and/or generate electricity themselves to supply their clients or to buy electricity from ICE. In addition, private Independent Power Producers (IPPs) can sell their electricity to ICE. ARESEP is the Regulatory Authority which oversees and regulates public services in Costa Rica –including the energy sector– and sets the Regulatory Framework, the tariff-setting mechanism and approves the electricity tariff, following the policies approved by the governing institution, the MINAE. Finally, CENCE is the power system’s operator, in charge of the dispatch of energy and system management, currently embedded in ICE’s corporate structure under the transmission company. While it is essential that CENCE introduce transparent modern methodologies to operate the power system, it is equally important that CENCE be perceived by the energy market as an impartial, unbiased player. Strengthening the power system’s governance and transparency has become essential. As such, the planned normative will define the governance structure of CENCE vis-à-vis other electricity agents, paving the way to increase private sector participation in generation over the medium-term, which is expected to reduce energy prices over time as well as strengthen system resilience against potential crises that might impact operation.

95. **Expected Results and Indicators.** Currently, only ICE has the responsibility to provide ancillary services to the system, reducing the efficiency of the system and the transparency in the cost assignment. The regulation of Ancillary Services will open the system to other players to provide these services with the expected result of more than one firm providing ancillary services. The proposed indicator is the number of power plants registered to provide ancillary services increases from 0 to 13 between 2019 and 2022. These 13 power plants are anticipated to be owned operated by three different firms.

### Analytical Underpinnings

96. **The proposed operation is supported by analytical and technical work under a range of instruments, as detailed in Table 6.** The operation benefitted from the Costa Rica Public Finance Review, including analysis on fiscal sustainability, public sector wage bill, public procurement and tax revenues. The operation further benefitted from technical assistance provided under the World Bank-supported Partnership for Market Readiness, which has helped develop and strengthen decarbonization pathway modeling capacity, as well as World Bank and IFC-supported technical assistance supporting an integrated demand analysis for the metropolitan area of San Jose to provide support in building a sustainable, multi-modal public transport network. Finally, the operation has benefitted from Bank technical support provided to ARESEP to develop the new regulation for ancillary services, incorporating best international practices and experience, as well as to inform the development of tariff methodologies to incentivize the electrification of transport.



**Table 6. DPL Prior Actions and Analytical Underpinnings**

Prior Actions	Analytical Underpinnings
<b>Pillar A: Protecting people’s income and jobs from the impact of COVID-19 and fostering SME recovery</b>	
Prior Action 1 – Special allowance	- <i>Costa Rica Public Finance Review</i> (World Bank, 2018) (P162556), specifically chapter on social spending.
Prior Action 2 – Protecting jobs, SMEs	- Several recent analytical notes prepared by the World Bank’s Global Practices on how best to protect jobs, ensure the stability of the financial sector and promote SME resurgence, which has been shared with the authorities during March and April 2020.
Prior Action 3 – Tapping non-distortionary sources of financing	- OECD and WB ongoing technical assistance (TA) to the management of SOEs.
<b>Pillar B: Reinforcing fiscal sustainability in the aftermath of COVID-19</b>	
Prior Action 4 – VAT and income tax reform	- <i>Costa Rica Public Finance Review</i> (World Bank, 2018) (P162556), specifically chapter on tax revenues.
Prior Action 5 – Fiscal responsibility framework	- <i>Costa Rica Public Finance Review</i> (World Bank, 2018) (P162556). - World Bank TA on fiscal rules (2016) (P151829).
Prior Action 6 – Public sector wages	- <i>Costa Rica Public Finance Review</i> (World Bank, 2018) (P162556), specifically chapter on public sector wages. IDB’s TA on single spine.
Prior Action 7 – Debt management	- IMF TA, OECD TA, World Bank (Capital Markets/Treasury) ongoing TA.
<b>Operation Pillar C: Laying the foundations for a strong post-COVID-19 recovery by promoting green growth and low-carbon development</b>	
Prior Action 8 – Climate measurement and monitoring	- World Bank TA provided during program preparation, via the Partnership for Market Readiness, supporting the review & enhancement of Costa Rica’s Climate Change Metrics System (2017 to present).
Prior Action 9 – Municipal-level voluntary emission reductions and climate mainstreaming in the agriculture sector	- World Bank TA provided during program preparation, via the Partnership for Market Readiness, supporting the development of a voluntary local-level emission reduction program (2018 to present). - <i>Assessment on reducing emissions and achieving social and environmental benefits in the livestock sub-sector</i> (UNEP, 2018). - <i>Bridging Costa Rica’s green growth gap: how to support further transformation toward a green economy</i> , Research reports and studies, November 2015, Ilmi Granoff; Monica Araya; Philipp Ulbrich; Sam Pickard; Caroline Haywood. - <i>Diagnostic to identify opportunities for strategic investments to support agro-value chains that are inclusive, competitive, sustainable and resilient in priority landscapes of Costa Rica</i> . Prepared for the World Bank by: Cátedra Latinoamericana en Decisiones Ambientales para el Cambio Global (CLADA) del CATIE, June, 2017.
Prior Action 10- Making greater use of renewable energy sources in the power system	- World Bank TA to support a sound energy transition in Costa Rica (2019 to present) (P169052)



#### 4.3. LINK TO CPF, OTHER BANK OPERATIONS AND THE WBG STRATEGY

97. **The proposed DPL series is aligned with the FY16-20 Country Partnership Framework (CPF) discussed by the Board of Executive Directors on May 26, 2015, and extended through FY22 under Performance and Learning Review (PLR) discussed by the Board on January 13, 2020; it is also fully consistent with IBRD's policies for Upper Middle-Income Economies.** Specifically, the operation is consistent with efforts to strengthen fiscal management capacity to enhance sustainability and efficiency (Objective 4). Continuing policy dialogue and support to enhance the regulatory and institutional framework of the country's fiscal management took place through various Advisory Services and Analytics (ASA), including: (i) *FY17 Fiscal Management in Central America* (P151829) providing analytical and advisory support to Costa Rica in the introduction of fiscal rules while also sponsoring randomized trials to better understand tax compliance in this country; (ii) *FY17 Central America Social Sector Expenditure and Institutional Review* (P146907) that used a lifecycle approach to examine ways to improve the impact of social spending on the poor in Costa Rica and other Central American Countries; and (iii) *Costa Rica Public Finance Review* (P162556) that provided a framework to analyze the country's various fiscal sustainability and efficiency challenges. The DPL 1 complements and is complemented by the Fiscal Management Improvement Project (P172352) that provides financial and technical support to Costa Rica's program to modernize the Ministry of Finance, including all key functions related to revenue collection and expenditure management

98. **The proposed operation is also well aligned with the CPF objective to expand capacity to promote climate-smart and environmentally sustainable development (Objective 6).** The DPL will complement past efforts to increase resilience to disasters, such as the completed DPL with a Catastrophe Deferred Draw Down Option (P111926). The DPL series also complements current World Bank support to: (i) the Reducing Emissions from Deforestation and Forest Degradation+ (REDD+) strategy to reduce greenhouse gas emissions from deforestation and forest degradation through enhanced forest management; and (ii) Costa Rica's proposed Forest Carbon Partnership Facility Emissions Reduction Program (P160368), with funding up to US\$63 million from the Carbon Fund.

99. **The DPL series also adheres to the principles for IBRD engagement in Costa Rica, whose income is above the Graduation Discussion Income (GDI).** In particular, the operation directly supports enhancing Costa Rica's access to external capital markets on reasonable terms and progress in establishing key institutions for economic development. On the latter, the Government has launched a process to modernize key institutions and has requested support from the WBG and other development partners, such as the OECD, IMF, IDB, BCIE, CAF and AFD. The DPL series also significantly contributes to Costa Rica's decarbonization agenda, which is a key global public good.

#### 4.4. CONSULTATIONS AND COLLABORATION WITH DEVELOPMENT PARTNERS

100. **Collaboration with other Development Partners has been critical in the design of this operation.** The series builds on strong policy dialogue and close collaboration with other multilateral banks, including the IDB, CABI, CAF, and AFD. CABI will fully leverage the Policy Matrix of DPL 1 on a parallel financing fashion, and teams from the two institutions have conducted joint missions to reduce transaction costs to the authorities, provide coordinated assessments, and coordinate technical assistance. All multilaterals



expect to continue supporting Costa Rica’s fiscal consolidation and decarbonization efforts in 2021. The authorities are also cooperating closely with the IMF on their macroeconomic framework, public debt sustainability analysis, and on the design of tax and expenditure policy measures.

101. **While there is overlap in some of the supported measures in the operation, the authorities have exploited the comparative advantages of each institution.** For instance, on Prior Action 7 on debt management policies, the IMF and the OECD have provided strong technical assistance, with the World Bank expected to lead on the investor’s diversification area and the improvement of the domestic capital markets. On Prior Actions 5 and 6, on the fiscal rule and improving human resource management, reforms have built on advice from the World Bank, but also on coordinated technical assistance with important additionalities from the IDB (e.g., the establishment of the fiscal council). There are, thus, many complementarities in selected areas deriving from coordinated technical assistance activities.

102. **Close cooperation with the OECD has also been important.** Costa Rica has been invited to join the OECD in mid-May 2020 and, in the context of the adhesion process, the World Bank has also participated actively in the dialogue conducive to institutional improvements in the country. In particular, the Government and the OECD welcomed World Bank’s TA on topics like competition and financial sector. The World Bank and CABI will also provide support to Costa Rica, in close coordination with the OECD, to the plan to address the recommendations of the OECD Working Party on State Ownership and Privatization Practices (WPSOPP) prior to a new revision in 2021.

103. **Internal consultations were also held with all key stakeholders during project preparation.** These included meetings with selected commissions in The National Assembly, key think tanks and opinion makers, academics and the private sector. The World Bank’s team also participated in the wide range of consultations sponsored by the Fiscal Management Improvement Project (P172352), including with key public workers and indigenous populations.

## 5. OTHER DESIGN AND APPRAISAL ISSUES

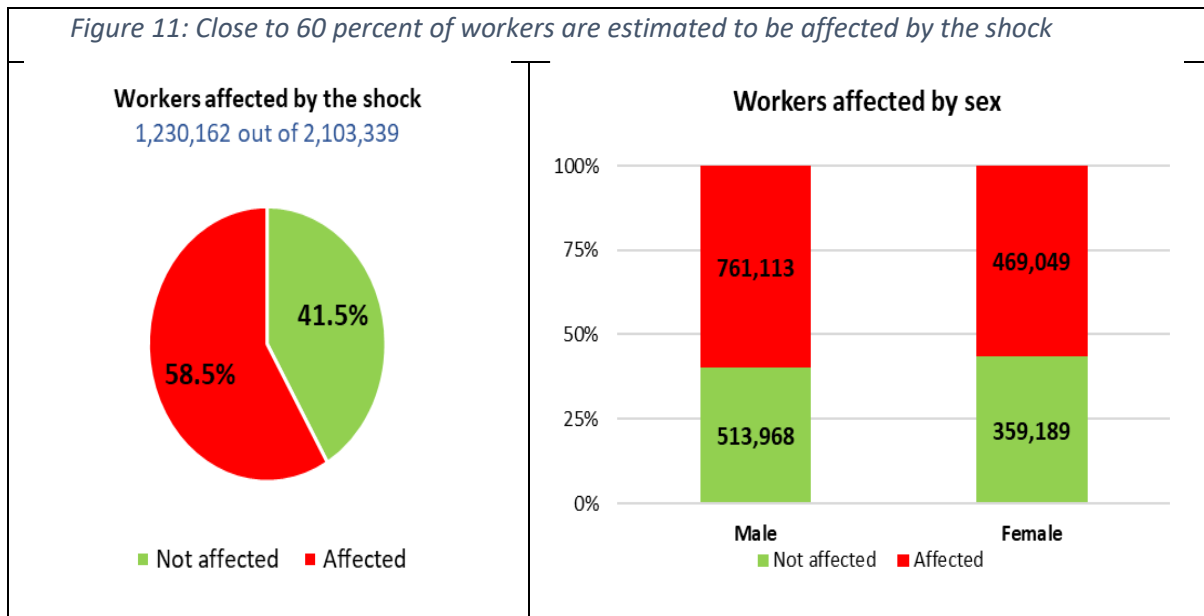
### 5.1. POVERTY AND SOCIAL IMPACT

104. **This DPL supports actions that are expected to have direct effects on poverty in the short term and a positive redistributive impact, including by supporting the COVID-19 response efforts; however, the Government will have to carefully monitor the impact of their overall fiscal adjustment program on the poor over the medium-term, given the size of both, the adjustment and the enlarger poverty and vulnerability pool.** To monitor medium-term impacts, the World Bank is providing TA to the Ministry of Finance to assess the distributional impact of fiscal policies, accompanied by a microsimulation tool. The short-term effects are documented below and further elaborated in Annex 4. Recognizing the difficulties of quantifying a counterfactual scenario, the timing and scope of measures in Pillar B reduce risks of larger fiscal adjustments which could have entailed more drastic implications on poverty and inequality outcomes. From a medium- and long-term view, the measures in this operation increase fiscal and environmental sustainability, also preserving the fiscal space necessary to sustain Costa Rica’s social compact.

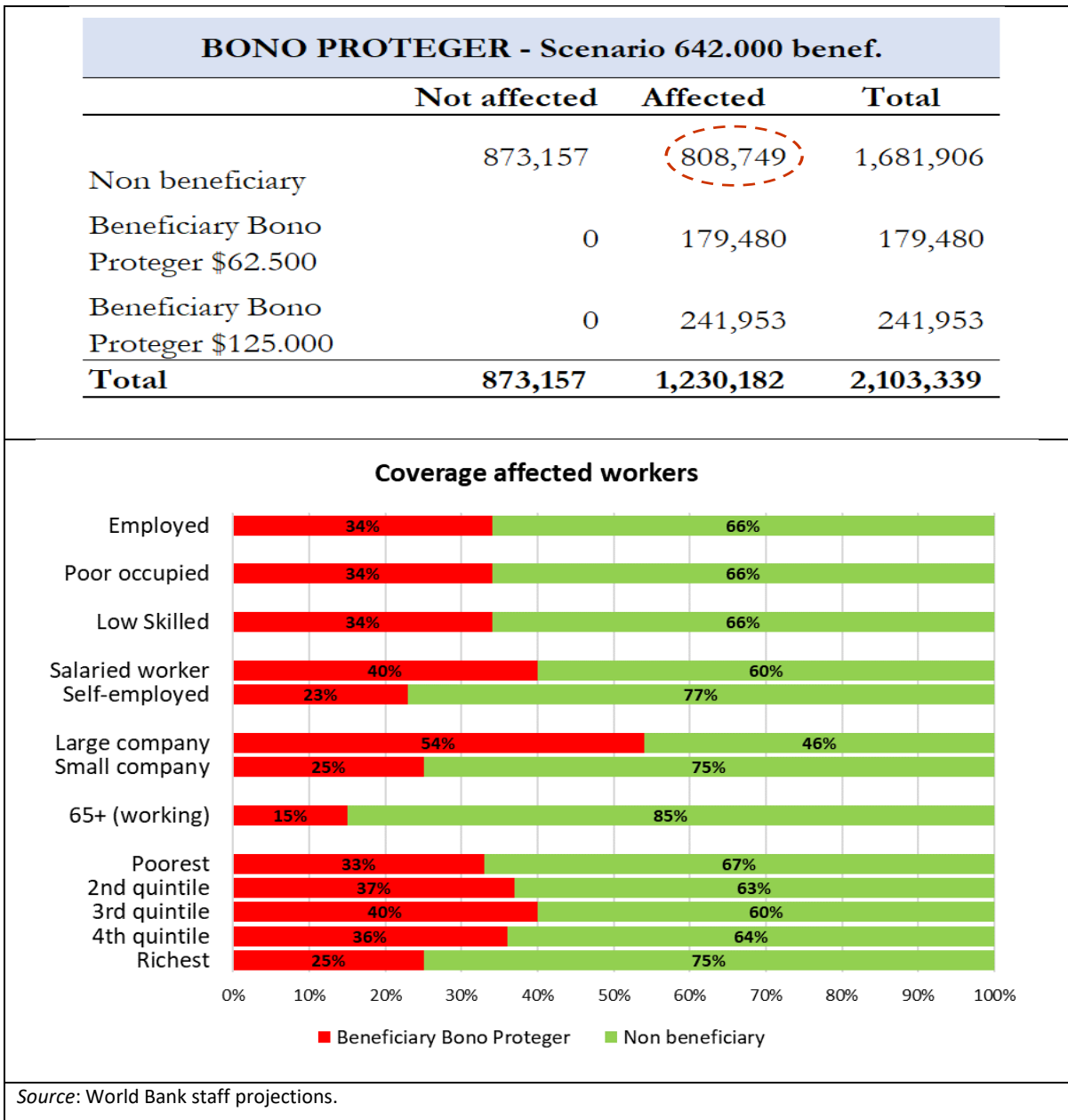


105. Considering the COVID-19 crisis, the measures supported under Pillar A are expected to contribute to reducing upward pressures on poverty and inequality, through mitigation of the negative labor market effects on vulnerable workers. Prior Action 1, the introduction of a temporary social transfer (*Bono Proteger*) to households affected by a change in their working conditions and/or labor income, is estimated to reduce the number of affected households (those with incomes falling below the poverty line, US\$5.5/day PPP) during the quarantine period. The measure is also expected to reduce pressures on rising inequality – pandemics usually push inequality upwards<sup>17</sup> - as it focuses on mitigating impacts on the most vulnerable with fewer coping mechanisms. The magnitude of the positive impact depends on the coverage that the *Bono Proteger* achieves as it is rolled out with some estimates illustrated in Figure 11. Assuming the *Bono Proteger* is paid to 642,000 beneficiaries:

- (i) About 31 percent of total workers could potentially be covered by the *Bono Proteger*, and about 52 percent of the affected workers if there is no leakage in the program towards non-affected workers.
- (ii) The coverage of the affected workers in the bottom 60 percent of the income distribution could be around 40 percent, with funds spilling into other quintiles due to the relatively generous income threshold (approximately US\$1,310/month during the months prior to COVID-19).
- (iii) The program could benefit mainly those receiving a salary (40 percent of the total salary workers affected by COVID-19) more than the self-employed (23 percent of the total affected self-employed).



<sup>17</sup> Furceri, Davide; Prakash Loungani, Jonathan D. Ostry and Pietro Pizzuto (2020) "Will COVID-19 affect inequality? Evidence from past pandemics." COVID Economics Issue 12, CEPR Press.



106. **Measures aimed at improving fiscal sustainability through reforms on the revenue side are expected to have small effects on poverty and are, in combination, progressive.**<sup>18</sup> Prior Action 4, with the introduction of the VAT, is expected by design to have a limited impact on poverty: simulations using a model of taxes of the MOF estimate that the poverty rate marginally increases from 20 to 20.3 percent (in particular because the poor consume very little of the previously exempted services and the ones they

<sup>18</sup> Cordero Peña, Jose Antonio; Luis Ángel Oviedo Carballo and Rudolf Lücke Bolaños (2018). “Situación fiscal - Ley de Fortalecimiento de las Finanzas Públicas: Nuevo estudio con base en texto sustitutivo aprobado en primer debate en la Asamblea Legislativa”. IICE, Universidad de Costa Rica.



do consume maintain lifelines, e.g., electricity, to protect poorest households). The reform is also estimated to reduce the regressivity of indirect taxes.<sup>19</sup> In turn, the reform to the income tax law in Prior Action 4 is not expected to have an impact on the poorest segments of the population. The measure largely affects high-income households, thus making it progressive and contributing to reducing inequality.

107. **The fiscal responsibility framework on public expenditures and the reforms to public employees' remuneration are expected to have neutral effects on poverty and could contribute to reducing inequality.** Measures in Prior Actions 5 and 6 will contribute to fiscal consolidation and can affect, over time, wages of employees or programs supporting the bottom forty percent of the income distribution.

108. **The implementation of the fiscal rule for the first time for the formulation of the 2020 year (Prior Action 5) did not affect social expenditures funded by the CG's budget.** It should be mentioned that the rule provides flexibility to the executive to transfer budget to guarantee the financing of institutions and programs for social and economic development (Art. 22 of the Law 20.580), in case there is a need for across-the-board cuts in the future. Equally important is the fact that most key social expenditures in Costa Rica are protected via earmarking (e.g., social security contributions for health) rather than funded from general resources of the CG. Finally, according to the implementation guidelines, ministries responsible for managing key social programs should subject to the fiscal rule in their "administrative spending," rather than funding for service provision (e.g., required health treatments) or the level of pensions. As for education spending, there is a constitutional floor.

109. **Prior Action 6, on public employees' remuneration, is expected to have neutral direct effects on poverty and positive redistributive effects.** The measure does not reduce wages but limits earnings' growth for public employees; this, in a context where public sector wages earn significantly and increasingly more than private sector workers. Moreover, the reform is expected to have little effect on poor households: among public workers, only one percent belonged to the bottom quintile of the income distribution in 2019, while 83 percent belonged to the top two quintiles. The gender impact of this measure is expected to be limited as both men and women are equally represented in the public workforce (48 vs 52 percent, respectively) and the unadjusted gender wage gap is very small (3 percent, compared to 28 percent in the private sector).<sup>20</sup> There might nonetheless be residual effects that the authorities and the World Bank will be monitoring carefully.

110. **In addition to the above-mentioned expected impacts of Prior Actions 4, 5, and 6 of Pillar B, Prior Action 7, on debt management, is expected to have neutral effects on poverty and inequality.** In the short-term, this policy measure focuses on strengthening the monitoring mechanisms towards debt sustainability.

111. **Reforms supported by Pillar C, focused on priority climate actions, are expected to have limited direct effects on poverty and no redistributive effects in the short-term.** Prior Actions 8, 9 and 10 are expected to have neutral effects on poverty and inequality, while strengthening the monitoring mechanisms for evidence-based decision-making and creating enabling conditions for emission reductions.

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<sup>19</sup> Cordero Peña, Jose Antonio; Luis Ángel Oviedo Carballo and Rudolf Lücke Bolaños (2018).

<sup>20</sup> See *Encuesta Continua de Empleo* for the 3<sup>rd</sup> quarter of 2019.



112. **Policies supported by the program are expected to have small and positive gender impacts indirectly, but no direct gender actions are part of the program.** The main mechanism of transmission of the crisis to households' income is through disruption in labor markets, where women in Costa Rica are underrepresented (with a gender gap in labor force participation of around 25 percentage points, as well as higher unemployment, as of February 2020, the unemployment rate was 9.6 percent among men and 16.7 percent among women). The COVID-19 crisis has negatively impacted labor markets in general, but it is affecting more vulnerable workers, particularly the self-employed/informal workers and small businesses, as well as sectors in which women are slightly overrepresented, such as hotels and restaurants, commerce and domestic services. Therefore, Prior Actions under Pillar A supporting people affected by the crisis, could likely benefit more women than men. For instance, as of June 1st, 52.1 percent of workers receiving *Bono Proteger* (Prior Action 1) were women. Also, since women are overrepresented in the inactive population in Costa Rica, they are likely to benefit the most from flexible employment schemes that might encourage them to work. Measures under Pillar B are not expected to have any gender specific impact. In particular, the public sector wage bill reforms (Prior Action No. 6) are not expected to have gender impacts as both men and women are equally represented in the public workforce (48 and 52 percent, respectively) and the unadjusted gender wage gap in the public sector is very small (3 percent, compared to 28 percent in the private sector). Finally, reforms supported by Pillar C are not expected to have a direct gender impact given the nature of the supported measures. Importantly, monitoring gender impacts as the crisis continues to evolve is critical, to assess the evolution of gaps across all relevant dimensions (including issues such as gender-based violence) to inform policy responses.

Table 7. Summary of Poverty and Social Impact Assessments

Prior Actions	Groups likely to be most affected	Likely Poverty / Distribution / Fiscal or environmental sustainability effects
<b>Pillar A - Protecting people's income and jobs from the impact of COVID-19 and fostering SME recovery</b>		
<b>Prior Action 1</b> – The Borrower has created a temporary unemployment subsidy ( <i>Bono Proteger</i> ) to contribute to the social protection of households affected by the change in their working or income conditions due to the national emergency caused by the COVID-19.	Beneficiary workers and households	Positive / positive
<b>Prior Action 2</b> – The Borrower has taken measures to protect jobs and support SMEs affected by the COVID-19 pandemic by: (a) granting a moratorium on the payment of VAT, business income taxes, and customs duties; (b) approving a temporary reduction of social security contributions; (c) allowing temporary suspension of work shifts; and (d) urging state-owned commercial banks to provide financial mechanisms to individuals and firms affected by COVID-19 who need access to credit for working and investment capital.	Employees in the formal sectors, including those working in SMEs.	Positive/ positive
<b>Prior Action 3</b> – The Borrower has mobilized resources to address COVID-19 mitigation efforts including: (a) transferring revenues from RECOPE to the Borrower central government's budget that were generated by creating a temporary price gap between domestic and international prices for petroleum products; and (b) transferring excess capital from INS to the Borrower's central government's budget.	Fossil fuel users	Neutral/ neutral/ positive
<b>Pillar B – Reinforcing fiscal sustainability in the aftermath of COVID-19</b>		
<b>Prior Action 4</b> – The Borrower has approved a tax reform that: (a) converted the sales tax into a value added tax (VAT); (b) regulated the VAT base to reduce exemptions and established a reduced rate for the basic consumption basket; (c) broadened basis and	(i) All households (ii) Higher income	(i) Slightly negative/positive /positive



<p>harmonized rates for capital earnings between the personal income tax (PIT) and the corporate income tax (CIT) and adopted best international practices on capital income taxation and Base Erosion and Profit Shifting (BEPS); and (d) added two top brackets to the PIT (20 and 25 percent for incomes above US\$3,400 and US\$7,200 equivalent per month, respectively).<sup>21</sup></p>	<p>Individuals</p>	<p>(ii) Neutral/positive/positive</p>
<p><b>Prior Action 5</b> – The Borrower has established a fiscal responsibility framework by: (a) limiting the growth of the non-financial public sector (NFPS) expenditure to that of the average nominal growth of GDP—or less, when the debt-to-GDP ratio crosses the 30, 45 or the 60 percent thresholds; (b) establishing the necessary procedures to comply with the rule – including the basis for the activation of the escape clause – and communicating them to NFPS institutions for the formulation of the 2020 budget; (c) establishing an autonomous Fiscal Council to issue its opinion on the results of the monitoring of adherence to the fiscal responsibility rule; and (d) clarifying that compliance with the fiscal rule for the pertinent year under consideration will be verified based on budget outturn.<sup>22</sup></p>		<p>Neutral/neutral/positive</p>
<p><b>Prior Action 6</b> – The Borrower has: (a) frozen basic public sector wages of the central government in 2020, (b) closed public sector vacancies pending to be filled; (c) proposed the elimination of the annual bonus for 2020 for the public sector (except for the police and personnel of the Borrower’s Ministry of Health and of the CCSS) and the redirection of all savings towards the National Commission of Risk Prevention and Emergency Attention; and (d) simplified the remuneration policy of public servants, capping bonuses and extraordinary compensations (in levels), and establishing new rules for performance evaluation.</p>	<p>Public employees</p>	<p>Neutral/positive/positive</p>
<p><b>Prior Action 7</b> – The Borrower has adopted measures to increase debt management transparency and efficiency, by enacting a public policy for the NFPS that enshrines the principle of debt sustainability, the requirement to register and track contingent liabilities and international good practices on transparency and accountability.</p>		<p>Neutral/neutral/positive</p>
<p><b>Pillar C - Laying the foundations for a strong post-COVID-19 recovery by promoting green growth and low-carbon development</b></p>		
<p><b>Prior Action 8</b> – The Borrower, through MINAE, has required directorates and offices ascribed to MINAE and its Vice-Ministries of Environmental Management, Energy, Natural Resources and Water and Oceans to include and provide in a timely manner information to enable the National Climate Change Metrics System (SINAMECC) to collect, monitor, and report on climate change data within its areas of competence.</p>		<p>Neutral/neutral/positive</p>
<p><b>Prior Action 9</b> – Under the Carbon Neutrality National Program (CNNP), the Borrower, through MINAE, has provided one-year term certifications for a municipality and public and private organizations for which a verification was conducted to confirm compliance with the commitment to low carbon development in key productive sectors and production processes.</p>	<p>Households in Municipality</p>	<p>Neutral/neutral/positive</p>
<p><b>Prior Action 10</b> – ARESEP has issued a technical regulation to establish in a clear manner the technical and operational framework for the provision of ancillary services in the national electrical system, considering their planning, operation, allocation, supervision, evaluation and management.</p>		<p>Neutral/neutral/positive</p>

<sup>21</sup> See Prior Action 2 on the postponement of tax returns and payments to preserve jobs and provide liquidity to the SME sector.

<sup>22</sup> The escape clause was properly and selectively activated for the budgets of the 4 institutions in the frontline of the fight against COVID-19, by the National Emergency declared in Executive Decree 42227-MP-S.



## 5.2. ENVIRONMENTAL, FORESTS, AND OTHER NATURAL RESOURCE ASPECTS

113. **Costa Rica’s environmental legislation is well structured, including in aspects related to environmental licensing.** The legal framework, policies and procedures are materially consistent with the requirements of World Bank Policies. Costa Rica is highly regarded for its environmental conservation policies, which serve as a model worldwide. Costa’s environmental offer also makes it one of the world’s top ecotourism destinations. In addition, almost all (around 98 percent) of Costa Rica’s electricity currently comes from renewable sources, with 80 percent coming from hydropower.<sup>23</sup>

114. **The policies supported by the DPL are not likely to cause any negative effect on the environment, forests, or other natural resources.** The policies supported under the first and second pillar of this DPL on COVID-19 response and fiscal management are unlikely to have significant effects on the environment. The fiscal responsibility framework (Prior Action 5) is institutional in nature and thus, does not have direct effects on the environment. Prior actions on salary (Prior Action 6) are also not expected to have an impact on the environment. Specifically, they are not expected to result in reduced staffing for agencies responsible for environmental protection. Further, policy actions in the areas of tax administration are not likely to have either significant positive or negative environmental impacts.

115. **The policies under Pillar C are designed to improve low-carbon development and environmental management and thus, will have significant positive effects.** Prior actions supporting the development of climate management tools (Prior Action 8 and Prior Action 9) provide support in climate impact assessment and knowledge management, with a view to fostering climate-related decision making and policies. Further, Prior Action 9 fosters carbon neutrality commitments by municipalities and public and private organizations, in the agriculture, waste management, transport, and forestry sectors, that will have an impact on greening their production processes and reducing their greenhouse gas emissions. The prior action displacing polluting energy sources with a greater use of renewable energy (Prior Action 10) will have a direct impact on reducing GHG. Similarly, efficiency gains under Prior Action 10, promoting greater utilization of renewable energy sources instead of more polluting fuels, will improve air quality by reducing energy-related emissions.

## 5.3. PFM, DISBURSEMENT AND AUDITING ASPECTS

116. **The latest Public Expenditure and Financial Accountability (PEFA) Assessment (completed in 2016) concludes that, in general terms, the PFM system in Costa Rica is reasonably aligned with international good practices.** The major strengths from the PFM system identified in the assessment are shown in the pillars of budget reliability and transparency of the public finances. However, the remaining pillars have mixed results and show aspects in need of further strengthening, mainly related with the internal controls for the budget execution and Government accounting processes. Some aspects that are mentioned in the assessment are: (i) the absence of a medium-term expenditure framework, which allows for an allocation of resources to the policy priorities defined over multi-year horizon; (ii) limited supervision of the fiscal risks of the entities comprising the public sector; (iii) the absence of a public strategy for the management of liabilities; (iv) the identification of contingent liabilities; and (v) the lack of a single, harmonized and cost-determining sectoral planning. The NFPS’s budget is made publicly

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<sup>23</sup> Other sources include geothermal, biomass, solar, and wind power.



available in the MOF's external website within an adequate framework. On public procurement, the creation of the integrated system of public procurement in 2015 (SICOP) as a mandatory technological platform to be used by the Central Administration for the implementation of all their Procurement processes has been a major step. This system includes several functionalities for the diverse stages of procurement processes (such as advertisement of contract opportunities, reception of electronic bids, among others) but it is not yet being used by all government institutions.

117. **The MOF has committed to further strengthen its public finances; its plan includes strengthening the efficiency and accountability in public expenditure management, tax and customs administration.** As part of these efforts, it has attracted a new cadre of technically sound high- and mid-level managers to lead this modernization. Additionally, since 2019 the Government is preparing a new procurement law that will consolidate all laws and regulations of the country related to public procurement (see Indicative Trigger 4-(iii)) to ensure transparency, efficiency and include best practices in procurement for government spending.

118. **The foreign exchange (FOREX) control environment of the Central Bank is adequate for this operation and it has recently strengthened safeguards in the area of Central Bank independency.** The latest available IMF Safeguards Assessment Report for Costa Rica was from 2009, thus, alternative due diligence procedures were carried out. The World Bank reviewed the published audited financial statements of the Central Bank for 2016, 2017 and 2018, which received unmodified opinions from the external auditors and did not reveal any significant issues related to the internal control environment. These financial statements were prepared in accordance with International Financial Reporting Standards (IFRS) and the audit was carried out in accordance with International Auditing Standards (IAS). In addition, World Bank's experience with designated accounts in Costa Rica indicates that the banking control environment into which the loan proceeds will flow is adequate.

119. **Based on the analysis of Costa Rica's PFM system and the FOREX control environment, the overall integrated fiduciary risk for this operation is assessed as Moderate.** On this basis, no audit will be required for the deposit account, and no additional fiduciary arrangements are considered necessary at this time.

120. **The World Bank will disburse the loan proceeds into a designated account that forms part of Costa Rica's official foreign exchange reserves at the Central Bank, denominated in US dollars.** After the deposit of loan proceeds, the Central Bank will credit the disbursed amount to the MOF Treasury Single Account (*Cuenta Unica de Tesorería*), thus becoming available to finance budgeted expenditures. The Government will provide the World Bank with a written confirmation within 30 days of the disbursement date that confirms: (i) the amount disbursed is deposited in the designated account; (ii) the details of the account to which an equivalent amount in US dollars and/or Costa Rica Colones will be credited; and (ii) the record that this amount has been accounted for in the budget management system. If the proceeds of the loan or any part thereof are used for ineligible purposes, as set forth in the General Conditions which are part of the Loan Agreement, the World Bank will require the Borrower to promptly return such amount to the World Bank. The amount refunded shall be cancelled from the Loan.



#### 5.4. MONITORING, EVALUATION AND ACCOUNTABILITY

121. **The MOF will be the main coordinating agency for monitoring and evaluation among the other participant ministries.** The Prior Actions in DPL 1 are the prime responsibility of several ministries, among which are: Ministry of Finance, Ministry of Environment and Energy, Ministry of National Planning and Economic Policy (MIDEPLAN), Ministry of Transport, Ministry of Agriculture, and ARESEP. The MOF will coordinate with other ministries and agencies on monitoring of the results indicators, which are based on publicly available information. The World Bank will monitor implementation of the DPL through its regular supervision missions and the preparation of DPL 2.

122. **The program outcomes will be monitored through the measurement of progress toward the achievement of results indicators included in the policy and results matrix** (Annex 1). This measurement seeks to assess progress toward the implementation of the policy and institutional measures supported by the proposed DPL series and will be evaluated following the disbursement of the first DPL. The MOF will have the responsibility of presenting the information related to the reform implementation and progress made toward results on time upon request, and in a format satisfactory to the World Bank.

123. **Grievance Redress.** Communities and individuals who believe that they are adversely affected by specific country policies supported as prior actions or tranche release conditions under a World Bank Development Policy Operation may submit complaints to the responsible country authorities, appropriate local/national grievance redress mechanisms, or the World Bank's Grievance Redress Service (GRS). The GRS ensures that complaints received are promptly reviewed to address pertinent concerns

#### 6. SUMMARY OF RISKS AND MITIGATION

124. **The overall risk rating for this operation is Substantial.** The reforms supported by the operation are a high priority for the state and, thus, benefit from their strong ownership – in fact, the National Assembly has become an important accountability player to ensure that the Executive fully responds to the COVID-19 pandemic, but promptly retakes the implementation of the 2018 fiscal package. They, and other stakeholders like the private sector and the unemployed have voiced their desire of further financing the response to the COVID-19 impact by further downsizing the state, including the public sector's wage bill. Taking into consideration the support offered by the DPL series, the most relevant residual, downside risks are related to uncertain external and internal shocks (macroeconomic), institutional capacity for implementation, and stakeholders (the latter part of the political and social risks). The DPL series, nonetheless, plays an important role in lowering these risks.

125. **Political and governance risks are assessed as Substantial.** Despite the strong commitment by both the Executive and the Legislative branches of government to implement the fiscal and decarbonization reforms, the risks of legislative gridlock in the future is not negligible. The collegial and supportive relationship between the National Assembly and the Executive is the first mitigating factor against this risk. Three other factors mitigate against this risk. First, the implementation of the operation's measures is significantly back loaded, factoring in the political feasibility of their implementation, and as such, many of the main fiscal policies will start delivering results in coming years. Second, the authorities have anchored reforms to the OECD accession process, which commands broad support in the Assembly.



Finally, the authorities are carrying out broad consultations and undertaking a carefully designed communication strategy to secure the necessary strong and broad consensus in society.

126. **Macroeconomic risks are assessed as High.** They stem from a protracted impact from COVID-19, stressing the economic, social and fiscal situation further. The baseline projections in the macroeconomic framework expects economic activity to resume in the 3<sup>rd</sup> quarter of 2020 and economic activity to pick up very gradually after that. Risks to this scenario include an extended recession in the global economy or longer than expected domestic lockdown measures. Costa Rica's economic and health sector strengths coupled with an able policy making process and the support of the international community are all expected to mitigate this risk. Further, the fiscal framework might encounter liquidity or refinancing risks, which will be mitigated through additional fiscal measures, some already indicated as indicative triggers for DPL 2, and by greater access to multilateral funding, including an arrangement with the IMF, as warranted.

127. **While risks associated to the technical design of the Program are considered low, the risks associated with the institutional capacity for its implementation and sustainability are assessed as Substantial.** Under Pillar A, the health sector response has been effective and Costa Rica is also well prepared for a new phase where testing and focused lockdowns might be feasible, allowing the possibility of resuming economic activities selectively to reach all sectors by end of the year. The risk of a re-emergence is still there, which is mitigated by the phased-approach the authorities are following. For the fiscal program under Pillar B, these risks are already being mitigated by the comprehensive modernization processes in the MOF, with World Bank support. This risk is also mitigated by the efforts in the MOF to attract a fresh cadre of highly skilled high- and mid- level managers that are tasked with implementation. For the decarbonization program under Pillar C, there can be potential constraints in the capacity to mobilize inter-ministerial coordination and financing, including MINAE's capacity to ensure adequate coordination with other line agencies, that could slow down implementation of the decarbonization program. Mitigation measures include the establishment of climate change offices and focal points within line ministries. A high-level commission will also be formed to provide oversight, operating from the President's Office, which will be comprised of representatives from the President's Office, MIDEPLAN, Finance, and MINAE. The Government is also examining ways to attract public and private finance, including the establishment of new climate finance funding mechanisms, to support the Decarbonization Plan's implementation.

128. **Stakeholder risks are also assessed as Substantial.** A diverse set of stakeholders could be affected by the supported reforms, including government's own agencies, public sector unions, private sector, and households. Some governments agencies have argued to be excluded from complying with the fiscal rule limits – particularly the SIF, the Judiciary and Universities-- a risk mitigated by the strong stance against any exclusion taken by the General Comptroller's Office, and by ongoing efforts to formally consolidate large extra budgetary central agencies into the CG. COVID-19 has increased this tension since the Executive has discretion over who should be exempted and has opted for a very narrow stance on this – with strong complaints coming from local governments. The MOF's budget office is providing the executive information on cost and benefits of further exemptions. Public sector unions went on a three-month strike at end-2018 while the fiscal package and wage reforms were discussed in the National Assembly, but both the Assembly and the Government stood firm and the reforms were passed. Mitigation measures against these risks include wide consultation and grievance processes led by the Executive, and the strong ownership of the reforms in the National Assembly. At the same time, the



National Assembly has been requesting frequent updates on implementation progress, particularly of the tax and expenditure measures. COVID-19, however, has shifted the focus of unions, the population, and firms towards a possible rescue package. In this regard, the phase-out of the large unemployment allowance, if not well-timed with improvements in coverage and targeting, might lead to uncertainty among households, particularly those experiencing financial stress. This risk has been addressed by extending the duration of allowances, while curtailing the number of recipients. Over the next few months, the Government’s strategy is to improve targeting by gradually excluding current non-poor beneficiaries, while concentrating limited funds on the extreme poor (including bringing into the safety net the poor that has been excluded). The roll out of the programs under the improved poverty-targeted methodology should mitigate this social risk. With respect to the private sector, key business associations support the implementation of the fiscal reforms, as they are aware of the damage that an unstable fiscal stance has on private activity, particularly via increasing borrowing costs.

**Table 8: Summary Risk Ratings**

Risk Categories	Rating
1. Political and Governance	● Substantial
2. Macroeconomic	● High
3. Sector Strategies and Policies	● Moderate
4. Technical Design of Project or Program	● Low
5. Institutional Capacity for Implementation and Sustainability	● Substantial
6. Fiduciary	● Low
7. Environment and Social	● Low
8. Stakeholders	● Substantial
9. Other	
<b>Overall</b>	● Substantial



**ANNEX 1: POLICY AND RESULTS MATRIX**

Prior Actions and Triggers				
Prior Actions under DPL 1	Triggers for DPL 2	Indicator Name	Baseline	Target
<b>Pillar A---Program Development Objective A- - Protecting people’s income and jobs from the impact of COVID-19 and fostering SME recovery</b>				
<p><b>Prior Action 1</b> – The Borrower has created a temporary unemployment subsidy (<i>Bono Proteger</i>) to contribute to the social protection of households affected by the change in their working or income conditions due to the national emergency caused by the COVID-19.</p> <p><i>Evidence: Decree No. 42305-MTSS – MDHIS dated April 17, 2020 and published in the Borrower’s Official Gazette on April 17, 2020 as amended by Decree No. 42329-MTSS-MDHIS dated April 29, 2020 and published in the Borrower’s Official Gazette on April 29, 2020; and Law No. 9840 dated April 22, 2020 and published in the Borrower’s Official Gazette on April 22, 2020.</i></p>	<p><b>Indicative Trigger 1</b> – The Borrower has improved the targeting of existing social programs on poorest households by (a) better identifying families in extreme poverty, based on the poverty-targeted methodology of the National Information System and Unique Registry of Beneficiaries (SINIRUBE), and frequently updating the database of SINIRUBE to maintain its relevance in addressing the needs of the poor; and (b) using savings to expand the district-level coverage of the national Bridge Strategy (<i>Estrategia Puente</i>) to deliver a package of benefits to families in extreme poverty.</p>	- Beneficiaries of <i>Bono Proteger</i> (number)	0 (2019)	600,000 (2020)
		-Share of families in the lowest quintile of the income distribution covered by <i>Avancemos</i> (percent)	20% (2019)	40% (2022)
		-Districts covered by <i>Estrategia Puente</i> (number)	75 districts (2019)	88 districts (2022)
<p><b>Prior Action 2</b> – The Borrower has taken measures to protect jobs and support SMEs affected by the COVID-19 pandemic by: (a) granting a moratorium on the payment of VAT, business income taxes, and customs duties; (b) approving a temporary reduction of social security contributions; (c) allowing temporary suspension of work shifts; and (d) urging state-owned commercial banks to provide financial mechanisms to individuals and firms affected by COVID-19 who need access to credit for working and investment capital.</p>	<p><b>Indicative Trigger 2</b> – The Borrower has introduced measures to support the economic recovery and job creation by: (a) improving and, if appropriate, expanding development bank financing to help SMEs and producers in tourism and other sectors in their post-COVID-19 recovery; (b) approving</p>	-Amount of additional liquidity provided to SMEs (cumulative, starting in March 2020) (percent of GDP)	0.0% (2019)	0.5% (2022)



Prior Actions and Triggers				
<p><i>Evidence: (i) Law N° 9830 dated March 19, 2020 and published in the Borrower's Official Gazette on March 20, 2020; (ii) CCSS Communication SJID-0494-2020 on the Resolution of the Board of Directors dated March 20, 2020; (iii) Law N° 9832 dated March 21, 2020 and published in the Borrower's Official Gazette on March 23, 2020; and (iv) Guideline 083-H-MIDEPLAN from May 8, 2020 and published in the Borrower's Official Gazette on May 9, 2020.</i></p>	<p>legislation to modernize the National Institute of Learning (INA); and (c) reducing the number of procedures to open a business and increase the number of them that are processed through the Single Investment Window (VUI).</p>	<p>-Procedure to open business -All business processes online (number)</p>	<p>10 (2019) 22 (2019)</p>	<p>5 (2022) 119 (2019)</p>
<p><b>Prior Action 3</b> – The Borrower has mobilized resources to address COVID-19 mitigation efforts including: (a) transferring revenues from RECOPE to the Borrower Central Government's budget that were generated by creating a temporary price gap between domestic and international prices for petroleum products; and (b) transferring excess capital from INS to the Borrower's Central Government's budget.</p> <p><i>Evidence: (i) Law No. 9840 dated April 22, 2020 and published in the Borrower's Official Gazette on April 22, 2020; and (ii) Law No. 9847 dated May 18, 2020 and published in the Borrower's Official Gazette on May 19, 2020.</i></p>	<p><b>Indicative Trigger 3</b> – The Borrower has enacted a dividend policy for SOEs, including transfers to the budget when appropriate.</p>	<p>-Revenue generated from transferring SOEs revenues or capital (percent of GDP)</p>	<p>0% (2019)</p>	<p>0.2% (2022)</p>
<p><b>Pillar B---Program Development Objective B - Reinforcing fiscal sustainability in the aftermath of COVID-19</b></p>				
<p><b>Prior Action 4</b> – The Borrower has approved a tax reform that: (a) converted the sales tax into a value added tax (VAT); (b) regulated the VAT base to reduce exemptions and established a reduced rate for the basic consumption basket; (c) broadened basis and harmonized rates for capital earnings between the personal income tax (PIT) and the corporate income tax (CIT) and adopted best international practices on capital income taxation and Base Erosion and Profit Shifting (BEPS); and (d) added two top brackets to the PIT (20 and 25 percent for incomes above US\$3,400 and US\$7,200 equivalent per month, respectively).<sup>24</sup></p> <p><i>Evidence: (i) Titles I and II of Law No.9635 dated December 3, 2018 and published in the Borrower's Official Gazette on December 4, 2018; (ii) Decree No. 41779 dated June 7, 2019 and published in the Borrower's Official Gazette on June 11, 2019; (iii) Decree No. 41615 MEIC-H dated March 13, 2019 and published in the Borrower's Official Gazette on March 18, 2019; and (iv) Executive Decree No. 41818-H dated June 17, 2019 and published in the Borrower's Official Gazette on June 26, 2019.</i></p>	<p><b>Indicative Trigger 4</b> – The Borrower has enacted measures to (a) curtail key tax exemptions and require periodic impact evaluations and sunset clauses for the remaining exemptions, and (b) introduce a Risk Matrix and associated implementation mechanisms for all tax audits.</p>	<p>Tax Revenues from VAT and income taxes (percent of GDP)</p>	<p>10.3% (2018)</p>	<p>12.2% (2022)</p>

<sup>24</sup> See Prior Action 2 on the postponement of tax returns and payments to help preserve jobs and provide liquidity to the SME sector.



Prior Actions and Triggers				
<p><b>Prior Action 5</b> – The Borrower has established a fiscal responsibility framework by: (a) limiting the growth of the non-financial public sector (NFPS) expenditure to that of the average nominal growth of GDP—or less, when the debt-to-GDP ratio crosses the 30, 45 or the 60 percent thresholds; (b) establishing the necessary procedures to comply with the rule – including the basis for the activation of the escape clause – and communicating them to NFPS institutions for the formulation of the 2020 budget; (c) establishing an autonomous Fiscal Council to issue its opinion on the results of the monitoring of adherence to the fiscal responsibility rule; and (d) clarifying that compliance with the fiscal rule for the pertinent year under consideration will be verified based on budget outturn. <sup>25</sup></p> <p><i>Evidence: (i) Title IV of Law No. 9635 dated December 3, 2018 and published in the Borrower’s Official Gazette on December 4, 2018; (ii) Decree No. 41641-H dated April 9, 2019 and published in the Borrower’s Official Gazette on April 25, 2019 and DM-0466-2019 of the Ministry of Finance; (iii) Decree No. 41937-H dated August 1, 2019 and published in the Borrower’s Official Gazette on August 28, 2019; and (iv) Decree No. 42218-H dated February 26, 2020 and published in the Borrower’s Official Gazette on March 4, 2020.</i></p>	<p><b>Indicative Trigger 5</b> – The Borrower has improved key budget process by: (a) issuing procedures to incorporate the national level decentralized agencies (about 50) into the Central Government budget and the single treasury account; (b) creating a macroeconomic analysis unit in the Ministry of Finance tasked to centralize the preparation of the Medium Term Fiscal Framework for the entire NFPS; and (c) improve procurement processes by, among others, requiring all procuring entities to use the electronic platform (SICOP) and introducing a sound regulatory and institutional framework for managing and implementing umbrella contracts for goods and services.</p>	<p>Annual budgets of the Central Government (CG), Social Insurance Fund (SIF), and Universities (U) in compliance with the fiscal rule (number).</p>	<p>0 (2018)</p>	<p>CG= 3 SIF= 3 U =3 (2022)</p>
<p><b>Prior Action 6</b> – The Borrower has: (a) frozen basic public sector wages of the central government in 2020, (b) closed public sector vacancies pending to be filled; (c) proposed the elimination of the annual bonus for 2020 for the public sector (except for the police and personnel of the Borrower’s Ministry of Health and of the CCSS) and the redirection of all savings towards the National Commission of Risk Prevention and Emergency Attention; and (d) simplified the remuneration policy of public servants, capping bonuses and extraordinary compensations (in levels), and establishing new rules for performance evaluation.</p> <p><i>Evidence: (i) Decree No. 42286-MTSS-H-MIDEPLAN dated April 4, 2020 and published in the Borrower’s Official Gazette on April 6, 2020; (ii) Draft Bill No. 21,917 published in the Borrower’s Official Gazette on April 9, 2020; (iii) Law No. 9841 dated April 24, 2020 and published in the Borrower’s Official Gazette on April 25, 2020; (iv) Title III of Law No. 9635 dated December 3, 2018 and published in the Borrower’s Official Gazette on December 4, 2018; and (v) Decree No. 42087-MP-PLAN dated December 4, 2019 and published in the Borrower’s Official Gazette on December 10, 2019.</i></p>	<p><b>Indicative Trigger 6</b> – The Borrower has enacted a New Public Employment Law introducing a single remuneration arrangement and a post-management system for civil service.</p>	<p>Average nominal growth rate of the public wage bill in the CG and the Non-Financial Public Sector (NFPS) (percent)</p>	<p>CG: 6.5% NFPS: 6.5% (2013-8)</p>	<p>CG: 3.2% NFPS: 3.2% (2020-22)</p>

<sup>25</sup> The escape clause was properly and selectively activated for the budgets of the 4 institutions in the frontline of the fight against COVID-19, by the National Emergency declared in Executive Decree 42227-MP-S. Discussions are ongoing whether local government also would need to be exempted.



Prior Actions and Triggers				
<p><b>Prior Action 7</b> – The Borrower has adopted measures to increase debt management transparency and efficiency, by enacting a public policy for the NFPS that enshrines the principle of debt sustainability, the requirement to register and track contingent liabilities and international good practices on transparency and accountability.</p> <p><i>Evidence: Decree No. 41935-H dated August 16, 2019 and published in the Borrower’s Official Gazette on August 26, 2019.</i></p>	<p><b>Indicative Trigger 7</b> – The borrower has further improved public debt management and transparency by: (a) publishing a strengthened Medium-Term Debt Strategy (MTDS) and the associated Borrowing Plan for the first semester of 2021; (b) enacting a road map to broaden the investors’ base and improve liquidity in the Government securities secondary market; (c) further advancing in the implementation of benchmark policy issuances); and (d) improving coordination mechanism between the Treasury and the Debt Management Office, whereby: (i) the Debt Management Office is responsible for the MTDS, the instruments and the borrowing plan; and (ii) the Treasury is responsible for cash management.</p>	-Benchmark bonds outstanding in the domestic market for amounts US\$1 billion or higher (number)	0 (2019)	2 (2022)
		-Reduction of non-competitive issuances, balance of direct investments and “treasury direct” as of end of the year (billions of CRC)	774 (2019)	619 (2022)
<p><b>Pillar C---Program Development Objective C- - <i>Laying the foundations for a strong post-COVID-19 recovery by promoting green growth and low-carbon development.</i></b></p>				
<p><b>Prior Action 8</b> – The Borrower, through MINAE, has required directorates and offices ascribed to MINAE and its Vice-Ministries of Environmental Management, Energy, Natural Resources and Water and Oceans to include and provide in a timely manner information to enable the National Climate Change Metrics System (SINAMECC) to collect, monitor, and report on climate change data within its areas of competence.</p> <p><i>Evidence: Guideline No. 001-2019 dated May 17, 2019.</i></p>	<p><b>Indicative Trigger 8</b> – The Borrower, through MINAE, has expanded interagency reporting to SINAMECC and availability of climate change data, through the signing of two ministerial agreements, fostering greater oversight of green growth and low carbon development policies.</p>	-Agreements formalizing reporting to SINAMECC (number)	0 (2019)	5 (2022)
		-Updated emission data reported to UNFCCC (text)	Data as of 2012 (2019)	Data as of 2019 (2022)
<p><b>Prior Action 9</b> – Under the Carbon Neutrality National Program (CNNP), the Borrower, through MINAE, has provided one-year term certifications for a municipality and public and private organizations for which a verification was conducted to confirm compliance with the commitment to low carbon development in key productive sectors and production processes.</p> <p><i>Evidence: Letter from MINAE DM-0359-2020 dated March 20, 2020.</i></p>	<p><b>Indicative Trigger 9</b> – The Borrower has fostered green markets and leveraging of natural resources for growth, by (a) issuing, via MINAE, a Decree, expanding the Carbon Neutrality National Program (CNNP) to products, such as coffee, medical devices, fruit, tourism, among others; and (b) issuing,</p>	-Municipalities in CNNP (number)	0 (2019)	20 (2022)
		-Organizations in CNNP (number)	0 (2019)	200 (2022)



Prior Actions and Triggers				
	via MAG and MINAE, a full-fledged governance, planning, and implementation framework through a Joint High-level Commission Directive, to strengthen and streamline the economic and financial instruments utilized by both ministries and development banks to incentivize farmers' and producers' adoption of low-carbon emission technologies and climate resilient measures to meet GHG reduction commitments for the agricultural and forestry sectors.	-Products in the CNNP (number).	0 (2019)	10 (2022)
		-Livestock and coffee producers applying Nationally Appropriate Mitigation Actions (NAMA) model, respectively (percent of total)	3% and 13% (2019)	7% and 20% (2022)
		-Farms /producers receiving environmental service incentives; integrated farms (number).	50 (2019)	100 (2022)
<p><b>Prior Action 10</b> — ARESEP has issued a technical regulation to establish in a clear manner the technical and operational framework for the provision of ancillary services in the national electrical system, considering their planning, operation, allocation, supervision, evaluation and management.</p> <p><i>Evidence: Resolution No. RE-0140-JD-2019 published in the Borrower's Official Gazette on December 13, 2019.</i></p>	<p><b>Indicative Trigger 10</b> – The Borrower has strengthened the power system's governance and transparency by (a) issuing a normative defining the dispatch center's (CENCE) governance structure and operational relationship with other agents at the Costa Rican Institute of Electricity (ICE) that operate in the power system, (b) ARESEP's approval of procedures for CENCE to operate the power system and to transparently report the results of the system's operation, together with a stakeholder grievance and a supervision mechanism for CENCE by ARESEP, and (c) ARESEP's approval of a payment mechanism to CENCE for system operation services, separated from ICE's transmission operation costs.</p>	Power plants registered to provide ancillary services according to the procedure established for these purposes (number)	0 (2019)	13 (2022)



## ANNEX 2: FUND RELATIONS ANNEX

### **IMF Executive Board Approves US\$504 Million in Emergency Assistance to Costa Rica to Help Address the COVID-19 Pandemic**

**April 29, 2020**

The IMF Executive Board approved Costa Rica’s request for emergency financial assistance of about US\$ 504 million to help the country meet the urgent needs stemming from the COVID-19 pandemic.

The funds will provide timely resources to support essential health expenditure and relief measures for the vulnerable populations, and to meet the urgent balance of payment need stemming from the pandemic.

The Costa Rican authorities have taken important measures to contain the spread of the virus and to mitigate its economic impact.

Washington, DC – The Executive Board of the International Monetary Fund (IMF) approved Costa Rica’s request for emergency financial assistance under the Rapid Financing Instrument (RFI) equivalent to SDR 369.4 million (100 percent of quota, or about US\$504 million at today’s exchange rate), to support essential COVID-19-related health spending and relief measures targeted to the most affected sectors and vulnerable populations, while catalyzing additional funding from other development partners. The RFI will help the country meet the urgent balance of payments need stemming from the COVID-19 pandemic.

Costa Rica has taken extensive and important measures to contain the pandemic since early-March— including mandatory quarantines, closures of schools, public offices, and most public spaces, reduced work hours in private sector, travel restrictions, and construction of a specialized hospital for Covid-19 treatment. These necessary containment measures, coupled with the global economic downturn, are expected to take a major toll on the economy in the short term and cause a temporary deterioration in the country’s fiscal and external positions. It is estimated that the pandemic opened a balance of payments gap of about US\$1.6 billion.

To mitigate the economic impact of the pandemic, the Government is appropriately implementing a temporary relaxation of spending limits under the Law on Strengthening of Public Finances. The authorities have also announced a package of fiscal measures targeted to protect the most affected economic sectors and populations. The IMF financing will help provide much-needed resources to address essential pandemic-related expenditure and support efforts to maintain social cohesion during the crisis. The authorities have maintained an accommodative monetary policy stance and a flexible exchange rate and provide liquidity into the markets, as needed.

Following the Executive Board’s discussion of Costa Rica, Mr. Mitsuhiro Furusawa, Deputy Managing Director and Acting Chair, issued the following statement:

“The COVID-19 pandemic has severely impacted Costa Rica with its large exposure to trade, tourism, and foreign direct investment. The global economic slowdown and the necessary containment measures have impacted growth and fiscal accounts and created an urgent balance of payments need. The IMF’s



emergency financing under the Rapid Financing Instrument will help support urgently needed public health and social spending measures, while addressing the balance of payments need. It will also catalyze support from other multilateral agencies, which will be critical to addressing the remaining financing needs.

“The authorities have taken timely, well-targeted measures to mitigate the adverse effects of the pandemic. They introduced extensive containment measures, which have helped flatten the infection curve. To mitigate the economic and social impact of the crisis, they adopted a temporary moratorium on tax payments, social transfers to protect the most vulnerable, and monetary and regulatory measures to ease credit and liquidity conditions.

“The important and immediate medical, social, and economic needs prompted by the crisis will require higher fiscal spending and consequently a deterioration in the fiscal position in 2020, including through a temporary activation of the emergency escape clause in the fiscal rule. It will be imperative to return to the fiscal consolidation path, anchored by the 2018-fiscal reform, and reapply the fiscal rule from 2021 once the health crisis dissipates. Accompanying the rule with additional income and expenditure measures over 2021-24, along with asset sales, would be important to put debt on a sustained downward path.

“To facilitate the recovery and counter future shocks, the authorities should maintain accommodative monetary policy and exchange rate flexibility and safeguard the stability of the financial system. Implementing a wide range of structural reforms underpinned by OECD accession would boost Costa Rica’s competitiveness and resilience to future shocks.”



**ANNEX 3: LETTER OF DEVELOPMENT POLICY**



*Ministerio de Hacienda  
Despacho del Ministro  
San José, Costa Rica*

09 de Junio del 2020

DM-0724-2020

Señor  
David Malpass  
Presidente  
Banco Mundial

Referencia: Carta de política: Programa de Apoyo Presupuestario con base en reforma de políticas

Estimado señor:

La crisis desatada por COVID-19 ha impactado fuertemente a nuestro país en un momento en el que nos encontramos implementando una serie de reformas estructurales de carácter histórico. Estas reformas abarcan aspectos ambientales, fiscales, sanitarios, educativos, de gobernanza, laborales, sociales y del sector financiero, y están relacionadas con las prioridades de nuestro gobierno en torno a la sostenibilidad fiscal, el proceso de adhesión de nuestro país a la Organización para la Cooperación y el Desarrollo Económico (OCDE), el cual hemos completado recientemente, la reactivación económica y la implementación del Plan Nacional de Descarbonización. Sin embargo, la crisis generada por el COVID-19 ha significado un esfuerzo adicional y requerirá de un acompañamiento financiero mayor para continuar con la agenda de implementación de reformas, al tiempo que se atienden los efectos fiscales, sociales y económicos producto de la pandemia.

Costa Rica reportó el primer caso confirmado de coronavirus el 6 de marzo, y en poco más de diez semanas el número de casos confirmados ha superado la cifra de 1000 personas, con el lamentable saldo de 10 muertes. En respuesta, hemos tomado medidas para contener la propagación del virus y proteger la salud de la población. Se declaró emergencia nacional en las fases iniciales de la pandemia mundial, se impusieron restricciones al tránsito vehicular y el cierre de la mayoría de los espacios públicos, se



*Ministerio de Hacienda  
Despacho del Ministro  
San José, Costa Rica*

establecieron restricciones de viaje para los residentes y la prohibición de que los no residentes ingresen al país. También se estableció un centro hospitalario especializado destinado al tratamiento con Covid-19 y se adoptaron horarios de trabajo más flexibles en el sector privado, incluida la posibilidad de reducir o suspender los contratos laborales, además de la utilización intensiva de modelos de teletrabajo tanto en el sector público como privado. Estas medidas han probado dar resultados positivos, y han permitido al país figurar con una de las menores tasas de mortalidad en el mundo.

Si bien estas medidas han sido exitosas desde el punto de vista de salud pública, también han afectado negativamente a la actividad económica, la cual venía ganando dinamismo gracias a las reformas estructurales impulsadas por el Gobierno. Así, hemos intensificado los esfuerzos en la protección de las familias más vulnerables, el empleo y la actividad económica, diseñando e implementando programas que permitan la supervivencia de pequeñas y medianas empresas, minimizando el impacto en el desempleo y otorgando transferencias monetarias a las familias y personas que han perdido su trabajo por la crisis.

En resumen, actualmente se busca continuar impulsando reformas de política a partir de tres pilares fundamentales, primero la mitigación de efectos de la crisis sanitaria mundial por COVID 19, segundo alcanzar la sostenibilidad fiscal y tercero mantener la agenda de implementación del Plan Nacional de Descarbonización, los cuales se detallan a continuación:

**Primer Pilar: Mitigación de efectos de la crisis sanitaria mundial desatada por COVID 19.**

Costa Rica es una economía abierta con grandes exposiciones al comercio, ingreso por turismo e inversión extranjera directa. El sector turístico se ha visto particularmente afectado por la disminución de su actividad, que representa más de 6 por ciento del PIB y el 19 por ciento de las exportaciones, la cual se ha contraído por el cierre de fronteras y la restricción a los viajes internacionales, y se anticipa que la fuerte desaceleración mundial pueda reducir aún más la demanda de turismo y otras exportaciones y tener un impacto negativo en el flujo neto de inversión extranjera, lo cual significará un revés importante en el ritmo de crecimiento que venía experimentando Costa Rica, actualmente el Banco Central de Costa Rica ya anticipa una caída de alrededor del -3.6% en el crecimiento económico para el 2020, lo cual a su vez tendrá implicaciones en los niveles de empleo, los índices de pobreza y el incremento de la vulnerabilidad de las familias..

Para mitigar los efectos económicos y sociales adversos y evitar que la crisis de salud genere a largo plazo daños estructurales a nuestra economía, se ha elaborado un plan de acción que incluye políticas para



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proteger a las empresas, empleo y hogares a través de subsidios y transferencias, ambos dirigidos a los más vulnerables, así como la moratoria en el pago de impuesto a las empresas. Dicho plan se está financiando a través de la recomposición del gasto, la movilización de recursos de empresas públicas y un mayor acceso a crédito de la banca de desarrollo internacional.

**Segundo Pilar: Alcanzar la sostenibilidad fiscal.**

Costa Rica mantiene su objetivo de alcanzar una sostenibilidad fiscal de mediano y largo plazo para lo cual las acciones emprendidas en la Ley de Fortalecimientos de las Finanzas Públicas y la aplicación de la regla fiscal en el sector Público son piezas fundamentales para resguardar el equilibrio fiscal. Esta Ley amplió la base de impuestos indirectos y alineo el impuesto a la renta de capitales con las mejores prácticas internacionales. Al mismo tiempo, la ley restringe el ritmo de crecimiento de nuestro sector público no financiero. No obstante, el 2020 ha sido un año en el que la mayoría de las economías del mundo han tenido que dedicar esfuerzos económicos y fiscales extraordinarios para enfrentar el impacto por COVID 19 y Costa Rica no ha sido la excepción. A este respecto hemos invocado la cláusula de escape selectivamente, especialmente para los ministerios que están al frente de nuestros esfuerzos para proteger vidas, puestos de trabajo e ingresos. Los gastos financiados con ingresos propios de los municipios también fueron exceptuados de la regla, dada su autonomía financiera y política y por sobre todo para que puedan responder mejor a las necesidades de corto y mediano plazo de sus comunidades y el gobierno está comprometido a apoyar el desarrollo de sus propios ingresos (ej., prediales, licencias) y a continuar con nuestra estricta política de endeudamiento subnacional.

El efecto combinado del shock externo y la contención interna tendrán un importante efecto adverso en nuestras cuentas externas y fiscales, en un momento en que la disponibilidad de financiamiento externo también está severamente limitada por dificultades globales de las condiciones financieras: los diferenciales de EMBI son ahora casi 500 puntos básicos más en comparación con el año pasado. El gran costo fiscal estimado de las medidas de contención y mitigación también llegan en un momento de espacio fiscal muy limitado, a pesar de los esfuerzos de consolidación fiscal que se había iniciado en el 2018, a través de la aprobación de una reforma fiscal, histórica para el país y el establecimiento de una regla de responsabilidad fiscal que limita el crecimiento del gasto a partir de 2020, tanto para el Gobierno Central como para el Sector Público Global. De esta forma estamos convencidos en la necesidad de continuar con las acciones necesarias para alcanzar la senda de sostenibilidad fiscal una vez que la crisis de salud inmediata por COVID



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19 se haya disipado y se logre alcanzar un saldo primario del 2.2% del PIB en 2024 que permitiría reducir la deuda al 50 por ciento del PIB cerca del 2034.

Al momento de escribir este oficio, se han hecho esfuerzos para contener el impacto del shock pandémico en el ejercicio fiscal actual y en el de los próximos años. Para el presente ejercicio fiscal se estableció el congelamiento de los salarios públicos para el 2020, se han enviado presupuestos extraordinarios a la Asamblea Legislativa que han implicado recortes a las partidas del Gobierno Central por el orden del 0,37% del PIB. Recientemente, se emitió un decreto que modifica el funcionamiento de la Comisión Nacional Negociadora de Salarios, por medio del cual se estableció que una vez que la razón de deuda a PIB rebase el 60%, se congele los aumentos salariales conforme al artículo 11 de las disposiciones sobre la Regla Fiscal de la Ley 9635, para los próximos 4 años. No obstante, conscientes de que se requiere de un mayor recorte del gasto público, nos encontramos ejecutando una revisión a profundidad para definir un nuevo presupuesto, el cual será enviado a la Asamblea Legislativa, en el cual se incorporará la realidad que actualmente enfrenta el país, es importante que el presupuesto replanteado intimalice el efecto esperado de caída del -3,6% en el PIB.

Otro aspecto de vital importancia, que impulsará el Poder Ejecutivo es la promulgación de una Ley de Empleo Público, cuyo propósito es alcanzar un ahorro anual para el Sector Público No Financiero del 0,7% del PIB. Este nuevo marco normativo busca modernizar el servicio público para que sea más ágil, transparente y eficiente. Se busca establecer un único régimen de empleo público conformado por ocho familias de puestos y simplificar la cantidad de principios rectores, todo de conformidad con las buenas prácticas de los países miembros de la OCDE.

Para complementar las anteriores medidas hemos mejorado significativamente nuestra política de gestión de deuda pública, realizando un mayor ordenamiento del mercado primario de valores, aumentando la liquidez de las emisiones y concentrando la oferta en unas pocas emisiones de referencia, a la vez que se aumenta la transparencia y la rendición de cuentas sobre las actividades en el mercado de valores. Sobre este particular, se ampliará y profundizará el uso de los instrumentos asociados a la gestión de la deuda pública, concretamente se utilizará las subastas inversas y los canjes de deuda, para que de manera coordinada con los inversores institucionales del mercado de deuda pública local se alcance mejores condiciones para ambas partes en cuanto a plazo y rendimiento, que permitan un alargamiento en los plazos de endeudamiento y reducir costos del fondeo.



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Adicionalmente se accedió de una forma equilibrada a los mercados internacionales y se ha estado buscando el apoyo financiero de organismos multilaterales, aumentando la diversificación de las fuentes de financiamiento y ampliando la base de inversionistas. Particularmente, el 3 de junio del presente año el Poder Ejecutivo presentó ante la Asamblea Legislativa el proyecto de ley para la aprobación del crédito con el Fondo Monetario Internacional (FMI), por un monto cercano a los \$504 millones, con el objeto de contribuir con fondos de apoyo presupuestario y atención de la emergencia por COVID-19, así como a la sostenibilidad fiscal de mediano y largo plazo. Es importante, señalar que estaremos abocados en las próximas semanas en sentarnos a negociar un Acuerdo de Derecho de Giro (Acuerdo Stand-By) con el FMI, de forma que se manifiesta el fuerte compromiso que se tendrá por alcanzar la sostenibilidad fiscal costarricense.

**Tercer pilar: Implementar el Plan Nacional de Descarbonización.**

La estrategia de crecimiento y diversificación económica se basa en gran parte en las fortalezas claves del país, incluida la gestión responsable de recursos naturales. Costa Rica es el único país tropical en el mundo que ha logrado revertir la deforestación. La política de gestión ambiental nos permitió recibir el premio "Campeones de la Tierra 2019", el mayor honor ambiental de la ONU, por el liderazgo en la conservación de los recursos naturales y su compromiso con políticas climáticas ambiciosas.

En este contexto, el Plan de Descarbonización 2018-50 (NDP) es el elemento vital de la estrategia del país para desarrollar una economía verde, sin emisiones, resiliente y equitativa, y que permite guiar el proceso para establecer la ruta entre las metas actuales y del 2050, que corresponde a la reducción de 100% de las emisiones del país. El Plan y sus metas están alineados y son congruentes con el cumplimiento de los objetivos de la Agenda 2030 y del Acuerdo de París. Este Plan Nacional identifica rutas de transformación tecnológica a través de las acciones distribuidas en áreas claves y considerando paquetes de políticas en cada área y distribuidas en tres periodos: inicio (2018-2022), inflexión (2023-2030) y despliegue masivo (2031-2050) y de, ocho Estrategias Transversales para potenciar y catalizar el cambio, necesarias para la implementación ordenada del Plan de Descarbonización y su alineación con los Objetivos de Desarrollo Sostenible.

El compromiso del Gobierno de la República de Costa Rica de continuar sus esfuerzos para descarbonizar su economía y realizar la transición del país hacia cero emisiones netas en 2050 con el fin de modernizarlo y dinamizarlo bajo una visión de crecimiento verde, se ha mantenido a pesar de los recientes impactos económicos y sociales por la pandemia a causa del contagio de COVID 19.



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A la fecha, se ha implementado importantes reformas de crecimiento verde y desarrollo bajo en carbono incluidas en la primera fase del Plan (2018-22). La primera fase reconoce la necesidad de un entorno propicio adecuado para colocar al país en una base sólida para convertirse en una economía verde y libre de emisiones y en otras acciones se ha implementado un nuevo sistema de registro y seguimiento de las emisiones que además de proveer un registro más confiable también nos permitirá elaborar políticas de descarbonización más informadas. Teniendo en cuenta los impactos económicos y sociales de la pandemia de COVID, esta primera fase también es importante para la reactivación económica, al apoyar mercados clave (café, fruta y turismo) que dependen de la marca verde para acceder a los mercados, así como la capacidad de recuperación del país.

Dentro de esta política de enverdecer el crecimiento, el Banco Central de Costa Rica, así como los principales actores del sector financiero están trabajando para mejorar la preparación del sector para patrocinar proyectos de carbono neutral en los sectores de la agricultura, la vivienda y la manufactura que sean sólidos por motivos ambientales, sociales y de gobierno (ESG), que las autoridades consideran como la única manera sostenible de financiar la mayoría de las medidas del PND cuando el plan se implementa completamente en 2031. Al mismo tiempo, se están realizando esfuerzos para reestructurar las decisiones de inversión pública para hacerlas neutrales al clima, incluso incorporando consideraciones de cambio climático en la tasa de descuento. Costa Rica es un miembro activo de la Red de Supervisores y del Banco Central para la ecologización del sistema financiero (NGFS) y la Coalición de Ministros de Finanzas para la Acción Climática (CAPE).

A pesar de la situación fiscal que enfrenta Costa Rica y de las medidas de mitigación de los efectos por COVID 19, el Gobierno ha mantenido sus compromisos en materia de sostenibilidad ambiental y promovido acciones con miras a la implementación del plan de descarbonización en el mediano plazo, sin embargo estos compromisos se debilitan si no se acompaña de facilidades financieras que permitan al Gobierno hacer frente a las necesidades de financiamiento público que respaldarían las acciones encaminadas a lograr la sostenibilidad fiscal y muy especialmente a reconocer los esfuerzos financieros de Costa Rica dirigidos a reducir las emisiones de gases de efecto invernadero y dar impulso a las políticas públicas de descarbonización de la economía y el enorme esfuerzo fiscal y económico que ha significado salvaguardar la vida de costarricenses y migrantes a causa de COVID 19. Es por esta razón que el apoyo presupuestario basado en políticas se convierte en el apoyo fiscal necesario para continuar con las reformas propuestas en materia ambiental y los objetivos de descarbonización.



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El Gobierno de Costa Rica y el Banco Mundial han mantenido una estrecha relación de colaboración técnica y satisfacción de las necesidades de financiamiento del país en áreas estratégicas, por lo que se requiere mantener esfuerzos de colaboración financiera que le permitan al país continuar con sus esfuerzos de política pública para la atención de la emergencia por COVID 19, al tiempo que no se debiliten los indicadores macrofiscales y se continúe con el proceso de establecimiento de una economía verde y baja en carbono, son imprescindibles.

Dado lo anterior, agradezco el apoyo a las acciones emprendidas en el contexto de este proceso, con la seguridad de contar con el respaldo y reconocimiento por parte del Banco Mundial a las acciones enmarcadas en lo descrito en las líneas precedentes, de forma que tengan manifestación de que tenemos el mismo compromiso y nivel de ambición para que las finanzas públicas costarricenses se fortalezcan en el futuro y que den seguridad a la funcionalidad del Estado costarricense.

Atentamente,

ELIAN JORGE  
VILLEGAS  
VALVERDE  
(FIRMA)

Firmado digitalmente por  
ELIAN JORGE VILLEGAS  
VALVERDE (FIRMA)  
Fecha: 2020.06.09  
12:27:18 -0600

Elian Villegas Valverde  
Ministro de Hacienda

ISAAC MARTIN  
CASTRO ESQUIVEL  
(FIRMA)

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ISAAC MARTIN CASTRO  
ESQUIVEL (FIRMA)  
Fecha: 2020.06.09  
11:25:55 -0600

V\* B\* Isaac Castro Esquivel  
Viceministro de Egresos



**Letter of Development Policy**

**(Unofficial Translation)**

Mr.  
David Malpass  
President  
World Bank  
Reference: Policy letter: Policy-based Budget Support Program

Dear sir:

The crisis unleashed by COVID-19 has strongly impacted our country at a time when we are implementing a series of historic structural reforms. These reforms cover environmental, fiscal, health, education, governance, labor, social and financial sector issues, and are related to our government's priorities on fiscal sustainability, our country's process of accession to the Organization for Economic Cooperation and Development (OECD), which we have recently completed, economic revival and the implementation of the National Plan for Decarbonization. However, the crisis generated by COVID-19 has meant an additional effort and will require greater financial support to continue with the reform implementation agenda, while addressing the fiscal, social and economic effects of the pandemic.

Costa Rica reported the first confirmed case of coronavirus on March 6, and in just over ten weeks the number of confirmed has exceeded 1000 people, with the unfortunate balance of 10 deaths. In response, we have taken measures to contain the spread of the virus and protect the health of the population. A national emergency was declared in the early stages of the global pandemic, with restrictions on vehicle traffic and the closure of most public spaces, travel restrictions for residents and a ban on non-residents entering the country. A specialized hospital center was also established to treat with Covid-19 and more flexible working hours were adopted in the private sector, including the possibility of reducing or suspending labor contracts, in addition to the intensive use of telework models in both the public and private sectors. These measures have proven to have positive results, and have enabled the country to rank among the lowest in the world.

While these measures have been successful from a public health point of view, they have also negatively affected economic activity, which had been gaining dynamism thanks to the structural reforms promoted by the Government. Thus, we have intensified efforts to protect the most vulnerable families, employment and economic activity, designing and implementing programs that allow small and medium-sized enterprises to survive, minimizing the impact on unemployment and providing monetary transfers to families and individuals who have lost their jobs as a result of the crisis.

In summary, the aim is to continue promoting policy reforms based on three fundamental pillars: first, mitigating the effects of the global health crisis through COVID 19; second, achieving fiscal sustainability; and third, maintaining the implementation agenda of the National Decarbonization Plan, which are detailed below:



### **Pillar One: Mitigating the effects of the global health crisis unleashed by COVID 19**

Costa Rica is an open economy with large exposure to trade, tourism income and foreign direct investment. The tourism sector has been particularly affected by declining its activity, which represent more than 6 percent of GDP and 19 percent of exports, which have contracted due to border closures and restricted international travel. The sharp global slowdown is expected to further reduce demand for tourism and other exports and have a negative impact on foreign investment net flows, which will mean a major setback in the growth rate that Costa Rica had been experiencing. The Central Bank of Costa Rica now anticipates a drop of around -3.6% in economic growth by 2020, which in turn will have implications for employment levels, poverty rates and increased vulnerability of families.

To mitigate the adverse economic and social effects and prevent the health crisis from generating long-term structural damage to our economy, an action plan has been drawn up that includes policies to protect businesses, employment and households through subsidies and transfers both targeted to the most vulnerable, as well as a moratorium on the payment of taxes to businesses. This plan is being financed through the recomposition of expenditure, the mobilization of resources from public enterprises and greater access to credit from international development banks.

### **Pillar Two: Achieving fiscal sustainability.**

Costa Rica maintains its objective of achieving medium- and long-term fiscal sustainability, for which the actions undertaken in the Law for Strengthening Public Finances and the application of the fiscal rule in the public sector are fundamental to safeguarding fiscal balance. This law broadens the indirect tax base and brings capital income tax in line with international best practices. At the same time, the law restricts the growth rate of our non-financial public sector. However, 2020 has been a year in which most of the world's economies have had to make extraordinary economic and fiscal efforts to deal with the impact of COVID 19 and Costa Rica has been no exception. In this regard, we have invoked the escape clause selectively, especially for those ministries that are at the forefront of our efforts to protect lives, jobs and incomes. Expenditures financed from municipalities' own revenues were also exempted from the rule, given their financial and political autonomy and above all so that they can better respond to the short and medium-term needs of their communities and the government is committed to supporting the development of their own revenues (e.g., property, licenses) and to continuing our strict policy of subnational borrowing. The combined effect of the external shock and internal containment will have a significant adverse effect on our external and fiscal accounts, at a time when the availability of external financing is also severely limited by global financial conditions: EMBI spreads are now almost 500 basis points higher compared to last year. The large estimated fiscal cost of containment and mitigation measures also comes at a time of very limited fiscal space, despite the fiscal consolidation efforts that had begun in 2018, through the approval of a fiscal reform, historic for the country and the establishment of a fiscal responsibility rule that limits expenditure growth from 2020 onwards, both for the Central Government and the Global Public Sector. In this way, we are convinced of the need to take the necessary actions to continue the path of achieving fiscal sustainability once the immediate health crisis by COVID 19 has dissipated and a primary balance of 2.2 percent of GDP is achieved in 2024, which would allow the debt to be reduced to 50 percent of GDP by 2034.



At the time of writing, efforts have been made to contain the impact of the pandemic shock on the current fiscal year and those to come. For the current fiscal year, a freeze on public wages was established for 2020, and extraordinary budgets have been sent to the Legislative Assembly that have involved cuts to central government items in the order of 0.37% of GDP. Recently, a decree was issued modifying the operation of the National Wage Negotiating Commission, by which it was established that once the debt to GDP ratio exceeds 60%, wage increases will be frozen in accordance with Article 11 of the provisions on the Fiscal Rule of Law 9635, for the next 4 years. However, aware that further cuts in public spending are required, we are carrying out an in-depth review to define a new budget, which will be sent to the Legislative Assembly, incorporating the reality currently faced by the country. It is important that the rethought budget internalizes the expected effect of the -3.6% drop in GDP.

Another aspect of vital importance, which will be promoted by the Executive Branch, is the enactment of a Public Employment Law, whose purpose is to achieve annual savings for the Non-Financial Public Sector of 0.7% of GDP. This new regulatory framework seeks to modernize public service to make it more agile, transparent and efficient. It seeks to establish a single public employment regime made up of eight job families and to simplify the number of guiding principles, all in accordance with the good practices of OECD member countries.

To complement the above measures, we have significantly improved our public debt management policy, implementing greater regulation of the primary securities market, increasing the liquidity of issues and concentrating supply in a few reference issues, while increasing transparency and accountability of activities in the securities market. In this regard, the use of instruments associated with public debt management will be expanded and deepened, specifically through the use of reverse auctions and debt swaps, so that, in coordination with institutional investors in the local public debt market, better conditions are achieved for both parties in terms of term and yield, allowing for longer debt terms and lower funding costs. In addition, access to international markets has been balanced and multilateral financial support has been sought from multilateral organizations, increasing the diversification of financing sources and broadening the investor base. In particular, on June 3 of this year, the Executive Branch submitted to the Legislative Assembly the bill for the approval of the credit with the International Monetary Fund (IMF), for an amount close to \$504 million, in order to contribute with funds for budget support and emergency attention by COVID-19, as well as to the medium and long term fiscal sustainability. It is important to point out that we will be sitting down in the coming weeks to negotiate a Stand-By Arrangement with the IMF, so that the strong commitment to achieve Costa Rican fiscal sustainability is made clear.

### **Third Pillar: Implement the National Decarbonization Plan.**

The strategy for economic growth and diversification is largely based on the country's key strengths, including responsible management of natural resources. Costa Rica is the only tropical country in the world that has managed to reverse deforestation. The environmental management policy enabled us to receive the "Champions of the Earth 2019" award, the UN's highest environmental honor, for leadership in natural resource conservation and commitment to ambitious climate policies.

In this context, the Decarbonization Plan 2018-50 (NDP) is the vital element of the country's strategy to develop a green, emission-free, resilient and equitable economy, and it guides the process to establish



the path between today's targets and 2050, which corresponds to a 100% reduction of the country's emissions. The Plan and its targets are aligned and consistent with the objectives of Agenda 2030 and the Paris Agreement. This National Plan identifies routes of technological transformation through actions distributed in key areas and considering policy packages in each area and distributed in three periods: start (2018-2022), inflection (2023-2030) and massive deployment (2031-2050) and of, eight Transversal Strategies to empower and catalyze change, necessary for the orderly implementation of the Decarbonization Plan and its alignment with the Sustainable Development Goals.

The commitment of the Government of the Republic of Costa Rica to continue its efforts to decarbonize its economy and make the country's transition to zero net emissions by 2050 in order to modernize and energize it under a green growth vision has been maintained despite the recent economic and social impacts of the pandemic due to the spread of COVID 19.

To date, important green growth and low-carbon development reforms included in the first phase of the Plan (2018-22) have been implemented. The first phase recognizes the need for an adequate enabling environment to place the country on a solid foundation to become a green and emissions-free economy and in other actions a new emissions registration and monitoring system has been implemented that in addition to providing a more reliable registry will also allow us to develop more informed. Considering the economic and social impacts of the COVID pandemic, this first phase is also important for economic revival by supporting key markets (coffee, fruit and tourism) that depend on green branding to access markets, as well as the country's resilience.

Within this policy of greening growth, the Central Bank of Costa Rica, as well as the main actors in the financial sector are working to improve the sector's readiness to sponsor carbon-neutral projects in the agriculture, housing and manufacturing sectors that are environmentally, socially and governmentally sound (ESG), which the authorities see as the only sustainable way to finance most of the NDP measures when the plan is fully implemented in 2031. At the same time, efforts are being made to restructure public investment decisions to make them climate neutral, including by incorporating climate change considerations into the discount rate. Costa Rica is an active member of the Network of Supervisors and the Central Bank for the Greening of the Financial System (NGFS) and the Coalition of Ministers of Finance for Climate Action (CAPE).

Despite the fiscal situation facing Costa Rica and the measures to mitigate the effects of COVID 19, the Government has maintained its commitments to environmental sustainability and promoted actions to implement the decarbonization plan in the medium term. However, these commitments are weakened if not accompanied by facilities The Government should also take the necessary steps to ensure that its financial resources are sufficient to enable it to meet the public financing needs that would support actions aimed at achieving fiscal sustainability and, in particular, to recognize Costa Rica's financial efforts to reduce greenhouse gas emissions and give impetus to public policies to decarbonize the economy and the enormous fiscal and economic effort that has been made to safeguard the lives of Costa Ricans and migrants as a result of COVID 19. It is for this reason that policy-based budget support becomes the fiscal support needed to continue with the proposed environmental reforms and decarbonization objectives.

The Government of Costa Rica and the World Bank have maintained a close relationship in terms of technical collaboration and meeting the country's financing needs in strategic areas, so it is necessary to



maintain financial collaboration efforts that will enable the country to continue with its public policy efforts to address the COVID 19 emergency, while not weakening macro-fiscal indicators and continuing the process of establishing a green, low-carbon economy, are essential.

In view of the above, I am grateful for the support for the actions undertaken in the context of this process, with the assurance that I have the backing and recognition of the World Bank for the actions framed in the above lines , so that they have the manifestation that we have the same commitment and level of ambition for Costa Rican public finances to be strengthened in the future and to give security to the functionality of the Costa Rican State.

Sincerely,

Elian Villegas Valverde  
Ministry of Finance

Isaac Martin Castro Esquivel  
Viceministry of Expenditures



**ANNEX 4: ENVIRONMENT AND POVERTY/SOCIAL ANALYSIS TABLE**

Prior Actions	Significant positive or negative environment effects	Significant poverty, social or distributional effects positive or negative
<b>Pillar A: Protecting people’s income and jobs from the impact of COVID-19 and fostering SME recovery</b>		
<b>Prior Action 1 – Creation of <i>Bono Proteger</i></b>	No significant positive or negative effects	Positive impact on poverty and income inequality (GINI) by creating a safety net for people losing their jobs due to COVID-19.
<b>Prior Action 2 – Preserving jobs and assisting SMEs</b>	No significant positive or negative effects	Positive impact on poverty and income inequality (GINI) by reducing pressures on SMES that can lead to jobs losses
<b>Prior Action 3 – Tapping non-distortionary sources of financing (SOEs)</b>	Positive effects	Positive impact on poverty and income inequality (GINI) by creating a safety net for people losing their jobs due to COVID-19.
<b>Pillar B: Reinforcing fiscal sustainability in the aftermath of COVID-19</b>		
<b>Prior Action 4 - Reform the sales into a value added tax (VAT) and amendments to the income tax law</b>	No significant positive or negative effects	VAT: Small negative impact on poverty rate. Positive impact on income inequality (GINI) by eliminating tax exemptions that benefited the well off.  Income Tax: No significant positive or negative effects in poverty. Potential small positive effect on GINI.
<b>Prior Action 5 – Fiscal Rule</b>	No significant positive or negative effects	No significant positive or negative effects in poverty or inequality.
<b>Prior Action 6 – Public Wages</b>	No significant positive or negative effects	No significant negative effect on poverty, but small negative impacts might occur. Positive effect in reducing income inequality.
<b>Prior Action 7 – Debt Management</b>	No significant positive or negative effects	Neither positive nor negative effect on poverty or inequality.
<b>Pillar C: Laying the foundations for a strong post-COVID-19 recovery by promoting green growth and low-carbon development</b>		
<b>Prior Action 8- Climate measurement and monitoring</b>	Positive	Neither positive nor negative effect on poverty or inequality.
<b>Prior Action 9 - Municipal-level voluntary emission reductions</b>	Positive	Neither positive nor negative effect on poverty or inequality.
<b>Prior Action 10 – Sustainable energy sector management</b>	Positive	Neither positive nor negative effect on poverty or inequality.



**1. Prior Actions 1, 2 and 3 aim to protect the vulnerable against the short and medium-term impacts of the COVID-19 pandemic by supporting a special program in the short-term and enhancing the impact of social programs over the medium-term through better targeting and coverage, reducing pressures on small and medium enterprises to avoid job losses, and by mobilizing additional sources of financing (also in the short- and medium-term).** The COVID-19 crisis has negatively impacted labor markets in Costa Rica, given lower aggregate demand and social distancing measures. Vulnerable workers, particularly the self-employed/informal workers and small businesses, are particularly affected from disruptions in their incomes given fewer coping mechanisms. These represent 40 percent of the workers. Almost 70 percent are in urban areas and 60 percent concentrated in the Central region (where also most poor are concentrated). Some sectors could be particularly affected by the crisis, namely sectors like hotels, restaurants, tourism, and transport, which employ around 278,000 people (11 percent poor and 61 percent unskilled). *Bono Proteger* is benefitting workers who have been laid-off or have had contracts suspended, self-employed or informal workers, and workers who have seen a reduction in hours of work beyond 50 percent. The social transfer will be delivered for three months to eligible workers, in the amount of CRC 125,000 for those with jobs loss and CRC 62,500 for those with income reductions. Simulations suggest that the Bono could reduce upward pressure in the short-term poverty rate by around 6 percentage points (using the US\$5.5/day poverty line). However, it is important to monitor the crisis' impacts to limit poverty and inequality increases among non-beneficiary or non-covered households. The World Bank is implementing a high-frequency telephone survey to assess negative impacts at the household level, which will contribute to monitoring the effects of the crisis. Moreover, Prior Action 2, focuses on protecting jobs and the promoting the survival of SMEs. It supports measures that provide liquidity relief to firms through tax deferral, increased flexibility in work arrangements and financing mechanisms. These measures are expected to mitigate negative impacts on these firms and their workforce, contributing to limiting the negative impact of the crisis on poverty and inequality. Finally, by securing the financing for response measures, Prior Action 3 allows for the efforts to be sustained and higher impact on mitigating the shock achieved.

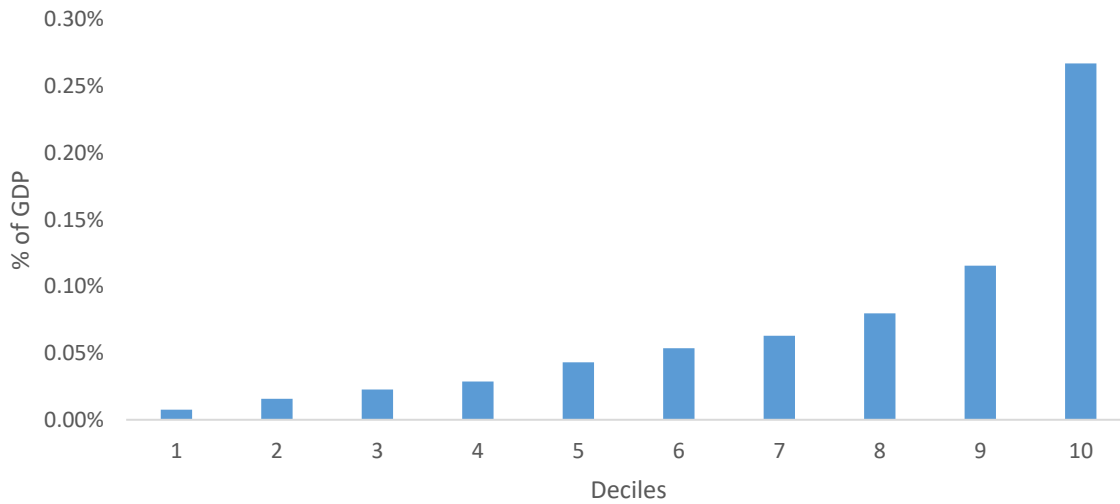
**2. Prior Action 4, with its element of the introduction of the VAT, is expected to have a small negative impact on poverty, while it reduces the regressivity of indirect taxes.**<sup>26</sup> The negative impact of this measure was mitigated by incorporating several exemptions and three additional reduced VAT rates: 4 percent for private health services provided by authorized health centers or health science professionals; 2 percent for pharmaceuticals, supplies, machinery, equipment and reactive agents used for industrial production; and, importantly, 1 percent for the basket of basic goods consumed by the poor (the bottom 20 percent of the population in Costa Rica). Simulations by the MOF estimate that the reform is expected to have a limited yet negative impact on poverty,<sup>27</sup> with the post-reform poverty rate increasing marginally from 20 to 20.3 percent due to the VAT reform. The MOF also estimates that out of the additional yield expected from the VAT reform of 0.7 percent of GDP in revenue, 0.02 percent of GDP (or about 3 percent of the extra revenues collected) will be collected from the two bottom deciles of the income distribution, while the top quintile will contribute 0.38 percent of GDP (about 55 percent of the extra revenues). A minor reduction in the Gini coefficient (0.7 percent or 0.003 Gini points) is expected.

<sup>26</sup> Cordero Peña, Jose Antonio; Luis Ángel Oviedo Carballo and Rudolf Lücke Bolaños (2018). "Situación fiscal - Ley de Fortalecimiento de las Finanzas Públicas: Nuevo estudio con base en texto sustitutivo aprobado en primer debate en la Asamblea Legislativa". IICE, Universidad de Costa Rica.

<sup>27</sup> Ministry of Finance of Costa Rica and World Bank estimates, based on information from ENAHO, ENIG and MOF of Costa Rica.



Figure 4.1: Distribution of additional VAT payments with the reform by income decile, % of GDP



Source: MOF of Costa Rica and World Bank estimates based on information from ENAHO, ENIG and MOF of Costa Rica.

**3. The reform to the income tax law in Prior Action 4 is not expected to have an impact on the poorest segments of the population, but in turn to have a positive redistributive effect.** First, the changes to the income tax rate only affect households earning more than CRC 2,103,000 — more than seven times the minimum wage — thus affecting only those belonging to the top income decile.<sup>28</sup> Similarly, other taxes under this Prior Action (e.g. capital returns and income) disproportionately affect higher-income households, rendering these measures progressive.

**4. Estimates suggest that the combined reforms to direct and indirect taxes are progressive.** Estimates of the distributional impact of tax measures carried out by the University of Costa Rica shows that the tax reforms are progressive, with the bottom quintile paying 4.2 percent of their income in new taxes, compared to 6.2 percent for the top quintile.<sup>29</sup>

**5. Measures aimed at curbing the growth rate of public expenditures are not expected to have any significant direct impact on poverty yet could contribute to reducing inequality.** Prior Action 5 is expected to have neutral direct effects on poverty and inequality. The measure provides the rules for budget increases towards fiscal sustainability, and in the preparation of the 2020 budget it did not imply a cut in key social expenditures. The rule, however, provides flexibility to transfer budget to guarantee the financing of institutions and programs for social and economic development (Art. 22 of the Law 20.580), in case there is a need for across-the-board cuts in the future. Similarly, Prior Action 6 does not reduce wages for public workers but rather limits the growth and cumulative nature of bonuses for public employees. As such, it is not expected to have a poverty-increasing impact. In any case, very few public employees belong to the bottom income quintile: in 2018, pre-reform, 1.4 percent of all workers in the

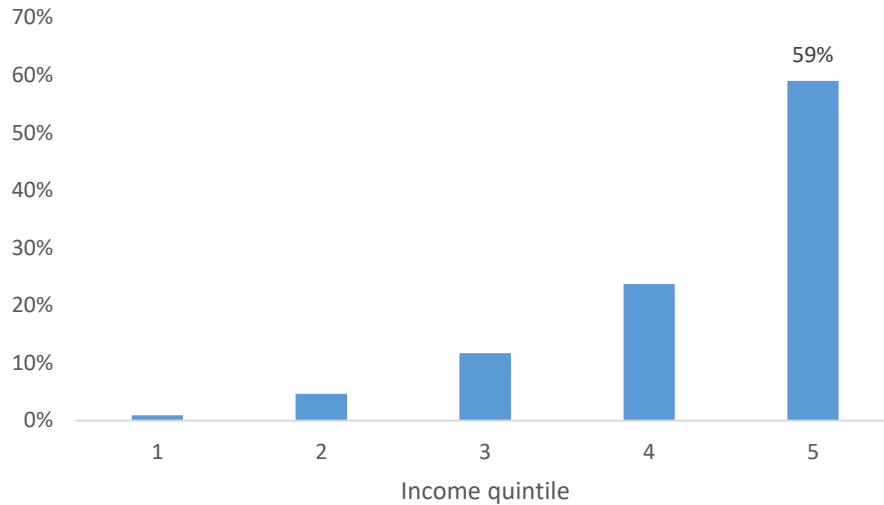
<sup>28</sup> This is consistent with the analysis by Cordero, Oviedo and Lücke (2018).

<sup>29</sup> Cordero, Oviedo, and Lücke (2018).



bottom income quintile of Costa Rica were public employees. Similarly, among public workers, only one percent fell in the bottom quintile, while 83 percent belonged to the top two quintiles. Accordingly, less than 1 percent of public employees earned wages below the poverty line and 1.5 percent lived in poor households.

Figure 4.2: Distribution of public employees by household income quintile, 2018, percent



Source: World Bank staff using data from 2018 Household Survey.

**6. In addition, by reducing the rapid growth of public sector remunerations, the reform could contribute to reducing inequality.** Public sector wages are significantly higher than private sector wages: among professionals (those with secondary education or more) the gap stands at around 40 percent, and among non-professionals (secondary education or less) at around 65 percent. This public-private sector wage gap has been widening over time. Along the same lines, looking at the recent evolution of the Gini coefficient (2014-2018), estimates from decomposition exercises suggest that public sector wages have been inequality-increasing, more than compensating the inequality-reducing effect of private sector wages in that period. Similarly, decompositions using 2018 household survey data show that around one third of total income inequality, measured by the Gini coefficient, is explained by public sector wages in that year. Finally, the supported measure puts forwards a higher (fixed) percentage increase in the bonus (*anualidades*) of non-professionals (2.54 percent) compared to professionals (1.94 percent), thus progressive in nature (these categories are defined by education level, and thus correlated with earnings). The gender impact of this measure is expected to be limited as men and women are both represented in the public workforce in a relatively balanced way (48 and 52 percent, respectively) and the unadjusted gender wage gap in the public sector is very small (3 percent, compared to 28 percent in the private sector).<sup>30</sup>

<sup>30</sup> Encuesta Continua de Empleo, 3rd quarter of-2019.



**7. The reform supported in Prior Action 7 is not expected to have a direct poverty or redistributive impact in the short-term.** The reform aims at strengthening the institutional and monitoring framework for debt sustainability, contributing to protecting social gains in the short-term and medium-/long-terms.

**8. Reforms supported in Prior Actions 8, 9 and 10 are not expected to have a direct poverty or redistributive impact.** Prior Actions 8 and 9 are aimed at strengthening the institutional and monitoring framework for environmental sustainability. Prior Action 10 focuses on methodological changes for increased transparency in the power system.