

BTI 2008 | Costa Rica Country Report

Status Index	1-10	8.73	# 12 of 125	
Democracy	1-10	9.50	# 5 of 125	➔
Market Economy	1-10	7.96	# 16 of 125	➔
Management Index	1-10	6.73	# 15 of 125	

scale: 1 (lowest) to 10 (highest) score rank trend

This report is part of the Bertelsmann Transformation Index (BTI) 2008. The BTI is a global ranking of transition processes in which the state of democracy and market economic systems as well as the quality of political management in 125 transformation and developing countries are evaluated.

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Key Indicators

Population	mn.	4.3	HDI	0.84	GDP p.c.	\$	9,057
Pop. growth ¹	% p.a.	1.7	HDI rank of 177	48	Gini Index		49.8
Life expectancy	years	79	UN Education Index	0.87	Poverty ³	%	9.8
Urban population	%	61.7	Gender equality ²	0.68	Aid per capita	\$	6.8

Sources: UNDP, Human Development Report 2006 | The World Bank, World Development Indicators 2007 | OECD Development Assistance Committee 2006. Footnotes: (1) Average annual growth rate 1990-2005. (2) Gender Empowerment Measure (GEM). (3) Percentage of population living on less than \$2 a day.

Executive Summary

Political and economic trends in Costa Rica between 2005 and 2007 improved only slightly as compared to the previous two-year review period. The political system continued to decline as President Abel Pacheco's (2002 – 2006) unsuccessful administration drew to a close, but showed signs of recovery during the first year of President Oscar Arias' four-year term. Costa Rica also witnessed an acceleration of economic growth during the period under review and thus, by 2006, a slight improvement in its critical fiscal situation. Legislative productivity had fallen to new lows during the last year of President Abel Pacheco's minority government (2002 – 2006). This has only in part to do with the fact that non-consecutive re-election diminishes presidential powers by the third year of the political cycle (e.g., approval of the bills he submitted fell from 40% during the first two years of his administration to 20% by the last half of his term). The Costa Rican political leadership has been unable to reach a final consensus on the Central American Free Trade Agreement with the Dominican Republic and the United States (CAFTA). Nor has legislative approval been forthcoming to open up the telecommunications and electricity monopoly to private sector investment. Parties have also failed to agree on raising tax revenues to fund the chronically under-funded state, an admittedly hard sell in any political system. The central state spends in excess of 15% of GDP while collecting only 12 to 13% of GDP in the form of taxes. This has led to a largely internal public debt, its interest rate payments consuming almost a third of central government revenues. Arias' narrow victory in the February 2006 election deprived him of a clear mandate for his campaign pledges, which include approving CAFTA and opening up monopolies. His administration is working hard to build consensus in favor of these reforms within Costa Rica's multiparty system, in which the Citizens' Action Party (PAC), which holds 30% of the legislative seats, opposes the approving of these reforms. The Costa Rican Assembly is the only legislature that has not approved CAFTA, and it must do

so before March 2008. Though the Arias administration is constructing a broad legislative coalition to back its reform bills, no major reforms have been approved as of the time of writing (January 2007). The slowdown in legislation reflects broader problems in the body politic. Social policy has been unable to reduce the percentage of Costa Ricans living in poverty, which has stagnated at slightly above 20% of the population since the mid-1980s. While the public health system managed to lower infant mortality rates to first-world levels by the 1970s, it has been much less successful at providing more advanced health care on a timely basis. Though Costa Rica's development performance remains superior by third-world standards, politicians must continue to reform its institutions for further improvement.

History and Characteristics of Transformation

Costa Rica has been a democracy for nearly 50 years. It also has had a competitive political system for more than one hundred years. Before the 1950s, the electorate included virtually the entire male population. Elections were hotly contested and often led to violence and fraud. After decades of election-related conflict, in 1946 politicians began to remove the executive and legislative branches of government from election administration. The 1949 Constituent Assembly made an independent court system — the Supreme Tribunal of Elections — responsible for the organization of elections and the tally of the vote. Since the late 1950s — when those who lost the 1948 civil war returned from exile and began to compete for elected offices once again — Costa Ricans have competed for power in a “full democracy,” that is, a political system where all political forces can compete for elected offices and where the entire adult population is entitled to vote. Since 1958, when the incumbent Party of National Liberation (PLN) reluctantly conceded defeat in the presidential elections, executives and legislators have come to power in quadrennially scheduled elections renowned for their openness and fairness.

After the United States, Costa Rica has had the longest, continuous period of stable presidential democracy. Standoffs between the executive and the legislature have never led to a presidential assault on the political system. The Costa Rican political system uses an innovative constitutional design, one that devolves important policy-making responsibilities to autonomous institutions whose budgets the executive does not propose and the legislature does not approve. Health care, old-age pensions, monetary policy and electoral governance are among the policy areas not under the direct purview of the two elected branches of government. The constitution calls for an independent judiciary that, since the establishment of the Constitutional Chamber in 1989, has become an assertive interpreter of the powers of and boundaries between the branches of government. The 1949 constitution also proscribes the existence of a standing army, the capstone of a decades-long trend of under-funding the military.

While Costa Rica is not wealthy, as a country with few natural resources, it has made much of itself in the twentieth century. Its GDP per capita grew from \$702 in 1940 to \$3,227 in 2003 (measured in U.S. dollars at their 1990 value). In comparative historical terms, the Costa Rican GDP per capita was virtually at the mean of the 15 smallest Latin American countries in 1950. Fifty years later, its GDP per capita was 50% higher than these 15 economies. In PPP terms, the Costa Rican GDP per capita in 2003 was \$9,606. During the second half of the twentieth century, development transformed the Costa Rican economy from an exporter of coffee and bananas – which accounted for three-fourths of exports in 1960 – to one exporting a wide variety of non-traditional agricultural products, light manufactures, and even sophisticated computer goods. By 1993, these two products accounted for only a third of all exports as a transnational coalition of exporters, state officials, and USAID officials promoted the development of nontraditional exports in the wake of the 1982 debt default. The 1982 economic collapse changed everything. During the Carazo presidency (1978 – 1982), the public debt soared from 56.2% of annual GDP in 1980 to 125.2% in 1981 because of the government's refusal to unfix the exchange rate in response to burgeoning trade and fiscal deficits. Paying off a massive foreign debt required adopting export-led development to neutralize the skirmishes between a left-oriented PLN and its right-of-center adversaries. Between the early 1960s and early 1980s, the government pursued import-substitution industrialization (ISI) policies that encouraged the growth of light manufacturing and gradually turned the domestic terms of trade against agriculture, historically the economy's engine of economic growth.

Costa Rica is now a major tourist destination; foreign exchange from tourism equaled roughly a fifth of total export earnings by 2000. Between 1960 and 1994, the economy has been open: exports and imports have averaged 66.4% of GDP and this number had increased by 10 percentage points by 2005. Even during the heyday of ISI between 1965 and 1982, exports to the Central American Common Market (CACM), all of which erected trade barriers with the rest of the world, constituted less than 18.57% of its international trade.

Transformation Status

I. Democracy

The contemporary political system is based on the 1949 constitution, which was forged in the aftermath of the 1948 civil war. The president and Legislative Assembly are elected on separate ballots, but serve concurrent four-year terms. Costa Rica is one of a handful of countries that prohibits the consecutive reelection of all elected officials. The constitution also calls for an independent judiciary; since 1989, there has been a Constitutional Chamber (“Sala IV”) in the Supreme Court. The state has a large number of autonomous institutes whose budgets do not have to pass through the normal legislative process.

1 | Stateness

The state exercises sovereignty throughout the national territory. There are no violent movements operating in the country, even though Costa Rica is a shipment point for illegal drugs from Colombia up to Mexico and the United States. Drug-related violence, however, is not an issue in the country.

Monopoly on the use of force

There is a high level of agreement regarding the legitimacy of the nation-state. Citizens complain about the quality of public services and dislike their politicians, but do not support any party or movement seeking to overthrow the state. People of Afro-Caribbean descent (mostly in the Caribbean province of Limón) and in the other two peripheral provinces (Guanacaste and Puntarenas, out of a total of 7 provinces) are treated as citizens, even though they are a target of social discrimination and tend to perform worse on social indicators. However, there are no movements aimed at breaking ties with the central state, nor are there efforts to secede from the country.

State identity

The political order is secular. There is a separation of church and state and relations between the two are amiable. Catholic archbishops frequently offer opinions on matters of public concern (e.g., increasing social inequality), but neither the Catholic Church nor any Protestant Church is calling for an official role for religion in political life.

No interference of religious dogmas

The Costa Rican state is a complex and differentiated set of political institutions. The system functions around a central state based on the separation of powers.

Basic administration

The rule of law, as interpreted by the Constitutional Chamber, governs the relations among the branches of government including the Supreme Tribunal of Elections, which has had the status of an independent branch of government since 1975. The decentralized state includes more than 100 institutions, each of which follows a functionally specific mandate (e.g., water provision, poverty alleviation, health care delivery, etc.).

2 | Political Participation

There are no constraints on free and fair elections. The press is free and political authorities and organized groups respect civil rights. Since the 1950s, election management has been exemplary. Even after the losers of the 1948 civil war started to compete again in politics, elections have been inclusive, free and fair. The 2006 election was no exception, although the close results did generate allegations of misconduct. The PLN candidate, Oscar Arias, won the presidency by a margin of less than 1.12% (or 18,147 votes) or 40.92% of the valid vote (unless a candidate obtains at least 40% of the valid vote, the Supreme Tribunal of Elections (TSE) convenes a runoff election between the first two runners-up). That Arias did not trounce his opponents came as a shock in the immediate aftermath of the election held on 5 February. In the weeks before election day, polls indicated that Arias, the respected former president (1986 – 1990) would win by a comfortable majority of 10 to 15 percentage points. That Citizens' Action Party (PAC) candidate Solís might very well have won an election held even a week later fueled suspicions that the TSE inappropriately annulled enough votes to ensure Arias's election to the presidency. Arias is also the first president to run for re-election in decades. A 1971 constitutional amendment banned former presidents from running for re-election. In 2003, the Constitutional Chamber of the Supreme Court struck down the ban on procedural grounds, which opened the way for Arias to act upon his longstanding interest in returning to the presidency. The constitution continues to ban the consecutive re-election of both the president and of legislative deputies. The electoral code dictates that the TSE manually recount votes after it issues a preliminary vote count. The TSE dispensed with a provisional declaration in 2006 given the narrowness of the vote margin separating the PLN and PAC candidates. After three weeks, its re-tally of the vote (in the presence of party observers) suggested that Arias had indeed won. The TSE rejected 696 petitions to nullify electoral results (of which the losing PAC presented 681). Even if the allegations regarding the misplacement of unused ballots and related charges had been ruled acceptable, the number of votes impugned would not have reduced Arias' small advantage over Solís. Perhaps the only incident that raised eyebrows during the campaign was a labor union declaration in mid-2005: the union refused to recognize Arias as president because of its opposition to CAFTA and related structural reforms. Widespread

Free and fair
elections

condemnation followed the comment. That the labor union in question came to be perceived as undemocratic and un-Costa Rican indicates that there is widespread support for free elections.

Elected officials are sovereign, but do not wield unlimited power. The 1949 proscription of a standing military prevents men in uniform (police and a national guard) from exercising veto power. Businessmen, the clergy, and the U.S. embassy each (and in different ways) affect the course of public affairs, but do not exercise an unwritten and uncontested veto in state affairs. No single group or institution can stop a law promulgated by the executive and legislature (provided its constitutionality is upheld by the Constitutional Chamber). Costa Rica's complex society and sophisticated state mean that there is no public institution or private interest that dominates political life.

Effective power
to govern

There is complete freedom of organization and of assembly. Most areas have a multiplicity of groups organized at the local level, each of which can approach the government or seek to influence public opinion. National-level groups are also free to organize. They often publish their declarations in the press and on the Internet, and are free to shape the political process.

Association /
assembly rights

The press is free. There are seven newspapers. The leading paper, *La Nación*, does not dominate the media. It publishes its critics in its opinion sections, giving them regular opportunities to contest its editorials. Its columnists do not just echo the paper's neoliberal line and the newspaper attempts to steer a centrist course in public affairs (in the way *The New York Times* or *The Economist* steer moderate courses from their respective sides of the political spectrum). Editorials of the center-left and center-right regularly write for *La Nación*. Other newspapers and television news programs also inform the body politic. Universities as well as a multiplicity groups (including the *Academia de Centroamérica* and the *Programa del Estado de la Nación*, which issues an annual report on the state of the nation, and from which this assessment draws heavily) also contribute facts and opinions that make for a fundamentally free society.

Freedom of
expression

3 | Rule of Law

There is a real separation of powers; the constitution, laws and judicial rulings structure the political process. The Legislative Assembly, consisting of 57 deputies, is constitutionally the first branch of government: its consent is required for law production. The president does have limited decree powers. He can convene the assembly to consider bills he favors during extraordinary sessions, which can last as long as six months of the legislative calendar. The Constitutional Court interprets disagreements over the procedures governing law production. Autonomous institutions, including the central bank, are formally independent of the central state apparatus. The separation of powers in Costa Rica

Separation of
powers

is akin to what Bruce Ackerman calls the “new separation of powers.” While Costa Rica is presidential, it does not rely upon the checks and balances version of the separation of powers the way the U.S. or Mexican separation of powers systems do. Each part of government tends to concentrate upon carrying out a specialized function. It behaves more like the political system of the Federal Republic of Germany, one that fragments powers among a large number of differentiated institutions and agencies.

There is an independent judiciary. The constitution guarantees the judiciary no less than 6% of central state revenues, to be spent on staffing a large number of courts. There were no reports of other branches of government, state agencies, or informal veto players subordinating the judiciary.

Independent
judiciary

Since the 1980s reformers have strengthened a panoply of agencies and laws to fight corruption. Corrupt officeholders, as a result, are prosecuted. A special report to the 11th edition of the Informe del Estado de la Nación (2004) reveals that since the late 1990s, approximately 50 persons a year get condemned for crimes against public service. Despite these efforts, corruption still persists and is exceedingly hard to measure. The special report to the 11th edition of the Informe del Estado de la Nación (2004), for example, suggests that state institutions are directly purchasing many supplies (the exact amount is unknown) without going through the normal (and cumbersome) public bids project. This is an area prone to corruption; a country with a small population makes it easier for public and private sector officials to bad public purchases in a corrupt format. Major cases of corruption also seem to take an extraordinarily long time to process. Both former presidents now under house arrest, Rafael Angel Calderón and Miguel Angel Rodríguez (both of the PUSC), are still awaiting trial. Former PLN President José María Figueres defied the Legislative Assembly’s request to return to the country to answer question about his consulting work for a major international telecommunications firm. What is clear is that citizens believe that their public officials are corrupt, even if most do not complain about having to grease palms to obtain public services. Surveys conducted in 2004 under the auspices of the Latin American Public Opinion Project (LAPOP) at Vanderbilt University indicate that 75% of Costa Ricans believe that corruption is somewhat or very generalized among public officials (the highest rate among the five Central America countries, Colombia, Mexico, and Panama), even though 15% of respondents report experiencing one act of corruption per year (tying with Colombia for the lowest rate among the these countries).

Prosecution of
office abuse

There are no restrictions on civil rights. Between 2005 and 2007, political authorities respected the standard set of individual rights and guarantees. Should citizens have complaints against the state, they can file a complaint with the Ombudsman (Defensor del Pueblo) or with the Constitutional Chamber. The Constitutional Chamber accepts writs or complaints from anyone in Costa Rica.

Civil rights

4 | Stability of Democratic Institutions

Democracy continued to perform well between 2005 and 2007. The Arias administration, like the Pacheco before him, listens to public opinion and proposes legislation to the Legislative Assembly. The assembly, in turn, considers bills and either ignores, approves, or rejects them. The police, the courts, and the multitude of autonomous institutions continue to operate. The performance of democracy is predictable and law-governed. Nevertheless, during the period under study, institutions did not work as efficiently or effectively as many expected. First, the Pacheco administration got no major legislation enacted during its last two years of government, a pattern that is consistent with the country's electoral cycle (whereby the president becomes a lame duck by the second half of his administration). The fragmentation of the party system is moderate – the effective number of parties is 3.3 in parliament after the 2006 elections, falling slightly from 3.7 after the 2002 legislative elections – along with an unusually argumentative set of deputies made for a particularly unproductive four years, which caused friction in the democratic process. Moreover, efficient and effective public service delivery appears to be a major problem. The population also has expressed a widespread feeling that the political system is not proposing solutions to pressing problems as rapidly or as effectively as is required to accomplish major development goals.

Performance of
democratic
institutions

There are no undemocratic interests or movements in Costa Rica. Disputing electoral results only generates negative ratings with public opinion. Relevant interest groups accept and work within the existing political framework.

Commitment to
democratic
institutions

5 | Political and Social Integration

The party system is unstable concerning voter volatility, but remains moderate, if less moderate than it was before the mid-1990s. While it is no longer socially rooted, the party system has still managed to articulate citizens' disillusionment as it has undergone restructuring. However, its ability to aggregate different points of view into a politically acceptable set of policies has decreased. There are several indicators of the party system's instability. First, the legislative party system continued to unravel during the last two years of the Pacheco administration. The 11th Informe del Estado de la Nación (2004) notes that 22% of the deputies elected in 2002 had become "dissidents" by 2005, either because they became independent or were estranged from their party. Second, the 2006 elections saw the ongoing restructuring of a multiparty system that emerged in the 2002 elections. The old two-party system consisting of the PLN and the PUSC went from obtaining more than 90% of the valid vote between 1982 and 1998 to less than 45% in 2006, with the PLN receiving the lion's share. The PUSC

Party system

appears to be extinct as a political force: it received less than 4% of the presidential vote, largely due to the spectacle of having two of its former presidents, Calderón (1994 – 1998) and Rodríguez (1998 – 2002), landed in jail in 2004 under accusations of influence-peddling and corruption (both have yet to be convicted of these charges). While the PLN got 43.8% (or 25 of 57) of the legislative seats, the PUSC got 7% (4). Third, the PAC, a center-left offshoot of the PLN, is now the major party in opposition to the PLN. The PAC won 29.83% (17) of the legislative seats. The party system remains moderate, though not nearly as centripetal as it was before the late 1990s. The Effective Number of Parties, at 3.3, remains in the middling range. The ideological distance among parties increased after 2002, a trend confirmed with the 2006 election results. With the collapse of the PUSC, the PLN has shifted slightly to the right. On the right, the Libertarian Movement (ML) is a tax-cutting, liberal party that both expresses citizen dislike of the old party system and calls for a dismantling of the Costa Rican welfare state. On the left, the PAC also is an expression of citizen disenchantment with the old party system and levels a center-left critique of neoliberal economic reforms. As a result, it has opposed CAFTA, the central policy initiative at the core of political economic debate in the country. If we use voter identification as a proxy indicator of social support, the party system is no longer rooted in society (parties in Costa Rica were not really anchored in alternative class positions, as they were in much of Europe). The number of independents more than doubled from virtually none in 1993 to nearly 32% in January 2006, the month before the 2006 elections (after having had peaked at 46% in August 2005). Turnout in 2006 was 65%, confirming a downward trend that started in 1998. Between 1953 and 1994, an average of 80% of adults (18 years or older) turned out to vote in quadrennially scheduled elections.

Costa Rica has a network of close-knit interest groups that are fundamentally cooperative. Neither labor unions nor business associations dominate interest group networks. Ownership of the media is not concentrated. Big financial groups do not dominate the economy, though assets are not optimally distributed, either. Some groups of course are more influential than others. The two largest banks, the Bank of Costa Rica (BCR) and the National Bank of Costa Rica (BNCR), hold a large number of central governments bonds. The interest made on central government bonds raises suspicions of oligopolies in the banking sector. For instance, interviews suggest that both banks let key supporters default on loans because guaranteed payments from the central government assure that they will not go bankrupt.

Interest groups

Latinobarometer surveys indicate that support for democracy exceeds 70% of those surveyed since 1996. The 2006 survey shows that 75% of Costa Ricans prefer democracy to all other forms of government. While ideological differentiation has made lawmaking more difficult, there is absolutely no

Consent to democratic norms

constituency for hardline, anti-systemic political movements in the country. The rise of multiparty politics has not led to confrontations between President Pacheco or President Arias and the Assembly, even if cooperation between the branches of government has not been high.

A robust but heterogeneous web of autonomous, self-organized groups, associations, and organizations operates in Costa Rica. Surveys conducted in 2004 under the auspices of the Latin American Public Opinion Project (LAPOP) at Vanderbilt University indicate that levels of trust in Costa Rica, while not high, are slightly positive (i.e., the percentage of respondents who say they trust minus the percentage who say they do not trust others).

Associational
activities

II. Market Economy

6 | Level of Socioeconomic Development

Development indices suggest that there are disadvantaged minorities, but that they are not ethnically separate or geographically isolated from the rest of the population. Economic development and anti-poverty programs have significantly reduced poverty since the mid-twentieth century, when half of the population lived in poverty. The 2006 Human Development Report Gender Development Index (GDI) for Costa Rica is 0.831 (its HDI is 0.841). The 2004 Survey of Income and Expenditures indicates that the Gini coefficient has risen to 0.475, up from 0.358 in 1988 (this rate does not include the equalizing effects of government transfers). There are 21.2% of households live in poverty and 5.6% in extreme poverty (poverty is defined as a family's inability to buy basic goods and services as defined by a profile of a family in 1988 and 1989). That slightly more than one-fifth of households remain in poverty means that, despite moderate levels of economic growth, rates of deprivation have not really changed since 1994.

Socioeconomic
barriers

Economic indicators		2002	2003	2004	2005
GDP	\$ mn.	16,844	17,514	18,558	20,021
Growth of GDP	%	2.9	6.4	4.1	5.9

		2002	2003	2004	2005
Inflation (CPI)	%	9.2	9.4	12.3	13.8
Unemployment	%	-	6.7	6.4	-
Foreign direct investment	% of GDP	3.9	3.3	4.3	4.3
Export growth	%	3.7	12	8.2	12.6
Import growth	%	7	0.9	9.1	11.7
Current account balance	\$ mn.	-857.0	-880.2	-795.9	-958.7
Public debt	\$ mn.	3,139.1	3,619.5	3,778.8	3,470.0
External debt	\$ mn.	4,833.7	5,421.3	5,738.0	6,222.9
External debt service	% of GNI	4.1	5	4	3.1
Cash surplus or deficit	% of GDP	-3.4	-1.6	-1.3	-0.8
Tax Revenue	% of GDP	13.2	13.4	13.4	13.7
Government consumption	% of GDP	14.8	14.5	14.2	13.8
Public expnd. on edu.	% of GDP	5.1	5.1	4.9	-
Public expnd. on health	% of GDP	5.7	5.8	5.1	-
R&D expenditure	% of GDP	-	-	-	-
Military expenditure	% of GDP	-	-	-	-

Sources: The World Bank, World Development Indicators 2007 | UNESCO Institute for Statistics | Stockholm International Peace Research Institute (SIPRI), Yearbook: Armaments, Disarmament and International Security

7 | Organization of the Market and Competition

Costa Rica has a competitive market economy. The market sets the price of most goods, the currency is easily convertible at one of several public or private banks, and there is free use and transfer of profits. Foreign sources of income are not taxed and companies in free trade zones do not pay taxes (although there is now a bill in the legislature to tax such companies). While setting up a company in Costa Rica is not impossible, the country does not offer a competitive process. The 2006 Doing Business Report (published by the World Bank and the International Finance Corporation) reveals that it takes 71 days to start a business in Costa Rica. The country ranks 146th out of 171 countries regarding the ease of doing business.

Market-based
competition

An open economy and its regulatory agencies minimize rent generation by public and private monopolies and oligopolies. However, the existence of a telecommunications monopoly and imperfect competition in the banking sector – to take the two most prominent examples of the concentration of market power – reveal the inconsistency of anti-monopoly policy.

Anti-monopoly policy

There is free trade in Costa Rica. The country has an exceedingly open economy: with the exception of some agricultural products, the average tariff is less than 6%.

Liberalization of foreign trade

There are institutional foundations for a relatively solid banking system and capital market that meets international standards. Until 1980s, four state banks dominated commercial banking, one of which (the Anglo-Costa Rican Bank) went bankrupt in the mid-1990s. The three remaining state banks held slightly less than half of all deposits during the period under study. 12 private banks hold 22% of deposits and seven offshore banks hold nearly 14% of deposits. The General Superintendent of Financial Services (created in 1985, though predecessors have existed since 1952) does supervise banks, but offshore banking is beyond its scope. The principal complaint against the banking system is that service charges are too high; interests on loans are high and interests on bank deposits are low. A study on the financial system for the 12th Informe del Estado de la Nación (2005) contends that, while solid, the banking system is subject to a multiplicity of different regulations that undermine its ability to lend money at competitive rates, especially to small borrowers.

Banking system

8 | Currency and Price Stability

Costa Rica has pursued a consistent inflation policy and an appropriate foreign exchange policy. The central bank has done an admirable job of maintaining price stability, given that the central state runs a chronic fiscal deficit (and produces a large, mostly domestically held public debt) and that it loses money on the bonds it must float to absorb the large amount of foreign currency entering the country. While not high or volatile by international standards, the inflation rate has been significant (14.1 and 9.43% in 2005 and 2006 respectively). This has prompted calls not only to solve the fiscal problem, but also to reform foreign exchange rate policy in Costa Rica's small, open economy. Since 1982, the central bank developed a crawling peg system as a compromise between a fixed rate and floating rate. This system worked well enough, because it made monetary action predictable, but it encouraged economic agents to increase prices and thus fueled inflation because the crawling peg system meant that the prices of tradable goods would be increasing continuously. During 2005 and 2006, there was a policy

Anti-inflation / forex policy

debate over letting the colón float. In policy think tanks, seminars and private meetings of the central bank and newspapers, economists and other social scientists considered alternative proposals, including a free float. On 17 October 2006, the central bank opted to establish a foreign exchange rate band regime, letting the colón float within upper and lower limits. Since October, the system has worked well enough and the colón has tended to gravitate toward the floor price set by the central bank.

Costa Rica's stability policy is consistent but economically suboptimal. Although not low, inflation has been held in check, in part due to, oddly enough, prudent management of a large fiscal deficit. Between 2005 and 2006, the fiscal deficit of the central state has stood around an average of 54%. The continuation of the fiscal deficit is a product of a large state apparatus and the inability to raise effective tax rates. While the central government did not collect more than 15% of GDP in taxes between 2005 and 2006, it spent more than 20% of GDP during this period. The deficit would have been worse if it had not been for austerity measures and some minor, largely administrative, tax reforms. Costa Rica's political economic arrangement lets the government – and society as a whole – get away with chronic fiscal deficits, which makes state finances predictable. First, the decentralized state sector typically runs a fiscal surplus (1% between 2005 and 2007). Second, autonomous institutions typically float loans to the central state. These bonds are held domestically and in colones. While guaranteed loans to the central states discourage large state banks from becoming innovative and competitive, this arrangement does keep the public sector from going bankrupt and running unpredictably. The cost of not raising taxes and rationalizing expenditures is high: approximately a third of central state expenditures go toward paying the interest on public debt. The public debt stood at an average of 50% of GDP between 1984 and 2003. Austerity and an increase in central state tax receipts (during the economic revival in 2005 and 2006) also led the weight of the public debt fall slightly, from 55 to 53% of GDP between 2005 and 2006.

Macrostability

9 | Private Property

Property rights and the regulation of the acquisition of property are well defined in terms of acquisition, benefits, use and sale. Only basic liberal rights limit them. Nevertheless, allegations of fraud against the Public Registry (an agency of the Ministry of Justice and Grace) are frequent.

Property rights

Private companies represent the backbone of the economy, but there are still state companies. For example, electricity and telecommunications remain state monopolies, such as that in the hands of the Costa Rican Institute of Electricity (ICE). Insurance also remains a state monopoly, under the name of the National

Private
enterprise

Institute of Insurance. CAFTA approval will require both autonomous agencies to compete alongside private sector providers of telecommunications and insurance services. State commercial banks still dominate financial matters, even if they are no longer the only financial institutions operating in Costa Rica.

10 | Welfare Regime

In 2005, the Costa Rican state provided retirement pensions for 46% of the economically active population and their families and offered health care insurance to 55%. Both figures have been falling since 2000, when the respective figures were 46.8 and 67.1%. There are no provisions for unemployment benefits, making this the only major welfare state program not available in Costa Rica. The Mixed Institute for Social Assistance (IMAS) runs major anti-poverty programs. It concentrates upon helping Costa Rican families in extreme poverty (approximately 5% of all households), but the other 15% in poverty are not getting transfer payments from IMAS, according to 2006 data.

Social safety nets

There are several institutions to compensate for gross social differences, but the social welfare institutions of Costa Rica are not working as well as they did. Poverty has stagnated at 20% of the population, and the average number of years of education around eight. Pre-transfer rates of inequality have increased. Women and/or members of minority ethnic or religious groups have near-equal access.

Equal opportunity

11 | Economic Performance

Measured by most macroeconomic data, Costa Rica showed a strong performance during the period under review. Economic growth accelerated mostly due to export dynamism. Inflation went down to about 10% in 2006, and unemployment to 6.0%. In sum, the political authorities managed economic affairs prudently, using the favorable external conditions. Remaining challenges include the budget balance, public debt and the current account deficit.

Output strength

12 | Sustainability

Public policy does take environmental concerns into account. Twenty-five percent of the national territory consists of protected areas. Since 2000, the amount of forest cover has been increasing. By 2005, 42% of the country was forested. International bodies consider Costa Rica's environmental legislation innovative, but it is bureaucratically cumbersome to implement and follow. Remaining challenges include the contamination caused by urban industrial sectors resulting from still incoherent legislation and implementation.

Environmental policy

A complex but incomplete set of public and private institutions provide basic, secondary and tertiary education. Significant shortcomings exist in the area of research and development. Total spending on education is 8.9% of GDP. Public education spending was 5.9% of GDP in 2005. The 5th Informe del Estado de la Nación indicates that private spending on education is around 3% of GDP. The average of eight year of schooling suggests that the education system is not doing enough to encourage the young to stay in school. Spending on research and development is low: MICIT figures suggest that it was only 0.38% in 2003 and 2004, the years for which the latest figures are available.

Education policy
/ R&D

Transformation Management

I. Level of Difficulty

The structural constraints on governance are moderate, even somewhat higher than expected given the relatively small and (at least historically) homogeneous population. The 20% of households living in poverty have led to anti-poverty initiatives that fight for a share of the public sector's limited resources. A decrease in public investment (noted in section 2.6) – particularly evident in a road network which, according to the Programa del Estado de la Nación, has not really moved forward since 1993 – lowers economic growth and thereby limits the government's tax receipts and prevents standards of living from rising faster than they do. Moreover, the political system has a relatively large number of veto players. The presidency has limited powers over the legislature. A four-year electoral cycle with bans on non-consecutive reelection for both the president and deputies relegates the chief executive to a lame duck position by the end of his third year in office. An independent judiciary with an activist Constitutional Court also increases the transaction costs of negotiating legal and constitutional reforms. A large set of autonomous institutions, the budgets of which do not need legislative approval and which often have independent sources of funding, adds to the complexity of governance. Moreover, the increasing disrepute of the party system means that politicians have less credibility with the electorate than they once enjoyed. Finally, interest groups can easily mobilize in support of or against the government. Bureaucrats, who represent approximately 15% of the labor force, are organized in unions and do go on strike when their interests are impacted. Costa Rica is recurrently exposed to the hurricanes that ravage Central America and the Caribbean. Although the country has until now been less affected than other countries – e.g., Hurricane Mitch caused losses of “only” about \$92 million, relative to \$6.0 billion estimated as direct and indirect damages in the other five Central American countries – it must face the indirect consequences, above all immigration from neighboring countries.

Structural
constraints

There are noteworthy traditions of civil society. A panoply of organizations operates at the local and national level.

Civil society
traditions

There are no irreconcilable ethnic, religious or social cleavages. The most important debate in contemporary society and politics is over ratification of CAFTA. While the CAFTA debate has sparked protests, moderates have so far dominated public discussion of the bill. As a final floor regarding CAFTA in the Assembly approaches, anti-CAFTA positions could harden and even lead to noisy and potentially violent street debates. The vast majority of citizens also desires the peaceful resolution of conflicts and will turn against the side that uses violence.

Conflict intensity

II. Management Performance

14 | Steering Capability

The political leadership is committed to constitutional democracy and a socially responsible market economy, but its strategic aims do not appropriately address a variety of problems that must be resolved if the goals of transformation are to be advanced. Democracy and the welfare state define Costa Rican politics and its national political identity. Public opinion would condemn political leaders that attack these institutional arrangements and values. The collapse of the PUSC in the 2006 elections is testimony to how public opinion turns against any party that violates the people's trust (in 2004, two former PUSC presidents were accused of acts of corruption and jailed, and are now under house arrest awaiting trial). While the economy has been growing throughout the 1990s, the percentage of households in poverty has not declined. Inequality has increased. The political system, during the last year of the Pacheco's presidency (2005), did not enact either a fiscal reform or CAFTA. The newly inaugurated Arias administration (February 2006) spent its first year fashioning coalitions to enact both bills. It had campaigned to address the fiscal program and support approval of CAFTA. As of this writing (late January 2007), President Arias has not gotten approval of either reform, but is forming a center-right coalition (the governing PLN, ML, PUSC, and a few other deputies) to obtain legislative approval of CAFTA and tax reform.

Prioritization

Costa Rican governments are committed to democracy and a market economy, but have had limited success in continuing structural reforms since the mid-1990s. During the last year of the Pacheco presidency, the political system did not pass any legislation of importance. Though President Arias has not thus far succeeded in enacting a fiscal or trade reform (as of January 2007), chances are good that he will obtain legislative approval for trade reform and for opening up

Implementation

state monopolies in telecommunications and insurance to competition. The real question is whether CAFTA opponents will organize street protests – and how President Arias will respond. If protests become violent and the government is perceived as the culprit, reform could very well be stopped (at least for a year or so).

The political leadership does correct mistakes and change failed policies, but it frequently remains stuck in the same routines. President Arias has revealed his ability to learn from mistakes with his changes to the tenor of executive-legislative relations. Under President Pacheco, the executive failed to develop a legislative strategy (even his own party, the PUSC, was not part of a broader effort to build support for presidential initiatives during his presidency), which defined his unproductive government. President Arias appointed his brother, Rodrigo, to lead the executive's relations with the Legislative Assembly. Unlike Pacheco, Arias is not conditioning the approval of one bill with approval of the other. Instead, the Arias administration is negotiating a set of "parallel bills" to satisfy the demands of other parties. That approval of CAFTA and fiscal reform remain goals of the administration suggests that the difference in political management is one of degree, not of nature. Moreover, the Arias administration has not yet talked about major institutional reforms to improve governance that could change the terms of the debate over important issues of political economy.

Policy learning

15 | Resource Efficiency

The government can make relatively efficient use of available economic and human resources. At the bureaucratic level, the 1951 civil service law is a source both of strength and of rigidity. Approximately 56% of public sector workers belong to one of Latin America's oldest civil services established in 1954 (the remaining public sector employees labor under special guidelines in the legislature, judiciary, or autonomous institutions). The Inter-American Development Bank's (IADB) Network on Public Policy Management and Transparency gives the Costa Rican civil service 58 points out of a potential 100 on its Bureaucratic Merit Index, the third best ranking in the region after Brazil (88 points) and Chile (61 points). However, it is almost impossible to discipline non-performing bureaucrats. The central state also runs a chronic budget deficit, though it is small and is managed adroitly.

Efficient use of assets

The government has limited success in coordinating conflicting objectives and interests. The last year of the Pacheco administration (2005 – early 2006) was notable for its inability to coordinate, even among the executive and legislative members of the PUSC. The election of Arias in February 2006 has increased coordination between the government and its legislative delegation.

Policy coordination

Most integrity mechanisms are functioning, though with limited success. The Comptroller General of the Republic (CGR) does audit the accounts of central and decentralized state agencies. That an increasing share of public sector purchases are done without going through the public bidding process raises troubling questions as to whether public and private sector actors are colluding to violate the public trust. That no one knows the extent of such purchases — not even the CGR — raises troubling questions over the nature of direct purchases. Parties must also provide reports of their campaign expenditures to receive their share of public campaign funds. Yet, regulation of private campaign expenditures remains lax because parties typically use satellite organizations that can circumvent campaign finance regulations. In late 2004, the Legislative Assembly passed a new Law Against Public Sector Corruption and Illicit Enrichment, but its effectiveness is not yet clear.

Anti-corruption
policy

16 | Consensus-Building

All major (and minor) political actors agree on building a market-based democracy. However, they disagree over certain political economic reforms. Though all parties support free trade, the PAC (which got a third of the legislative vote and 40% of the presidential vote) is against CAFTA because its members believe the country could get a better free-trade agreement with the United States. The PAC is also wary of liberalizing the telecommunications monopoly because the ICE has been a relatively successful state corporation, even if everyone recognizes the limitations in its provision of telephone service. The governing PLN backs all of these reforms.

Consensus on goals

There are really no relevant non-institutional veto actors such as the military and powerful private sector groups. Public sector labor unions are perhaps the only extra-institutional veto player with some influence. They have declared their opposition to CAFTA and telecommunications reform. Unless a legislative majority and the Court oppose these reforms, reformers can change the policy status quo. But, if government reforms do not gain the support of a solid legislative majority (and perhaps even supra-majority, should the PAC file a writ of unconstitutionality against these reforms with the Constitutional Court) and obtain at least the acquiescence of public opinion, they may well fail to be enacted. This is what happened in 2000 (“el combo”), when the Miguel Angel Rodríguez (1998 – 2002) government failed in its showdown with public sector unions and social protestors. This failure has cast a shadow on the current deliberations and adds to their centrality in contemporary public affairs.

Anti-democratic veto
actors

The political leadership prevents cleavage-based conflicts from escalating, although the Pacheco administration did not build much consensus around thorny issues (e.g., CAFTA and fiscal reform) during its last year in office. If

Cleavage / conflict
management

President Arias manages to obtain legislative approval of these reforms and all major groups and public opinion support them, the capacity of the political leadership to prevent cleavages from escalating into major conflicts will have increased. That the Arias administration has been building legislative support for these reforms during its first year is evidence that this capacity is gradually becoming stronger.

The political leadership does take into account of the views and interests of civil society actors. Indeed, many criticized the Pacheco administration for taking public sector labor unions too seriously in his ultimately failed attempt to make CAFTA conditional upon legislative support of fiscal reform (in the end, he unilaterally ended the conditionality and did not get approval of either reform). The Arias administration has been meeting with a diversity of groups during its first year in office to build support for its reform agenda. However, more left-leaning groups are wary of the Arias administration because of their opposition to CAFTA and the liberalization of telecommunications and insurance monopolies.

Civil society participation

17 | International Cooperation

The political leadership makes use of well-focused international aid for the needs of transformation. It learns from multilateral institutions like the World Bank and the Inter-American Development Bank, as well as from cooperation agencies like German GTZ concerning environmental policy.

Effective use of support

The international community does think the government is credible and reliable. It is a member of relevant regional associations, including the Central American Parliament and the Organization of American States (OAS). Indeed, the prior Secretary General was former President Rodríguez, who was forced to resign soon after becoming Secretary General because of a major corruption scandal. The Central Bank's ability to effect a smooth transition away from the crawling peg system speaks well of the country's financial credibility. Delay in the approval of CAFTA is raising questions about the country's commitment to enact major structural reforms, although some foreign observers may simply see the delay for what it is: a major policy initiative that a highly democratic country, with a large number of veto players, is discussing at length.

Credibility

Costa Ricans have always thought of themselves – and, for better and for worse, with a great deal of justification – as an island of stability and development in an isthmus that has long suffered from dictatorship, instability and poverty. This makes many Costa Ricans reluctant to become actively involved in their neighbors' affairs. Some opposition to CAFTA may, in fact, stem from an unwillingness to sign a trade agreement that the rest of Central America has already approved.

Regional cooperation

Strategic Outlook

Costa Rica faces significant challenges. In the short term, state and society must overcome the chronic fiscal deficit that has led to a high public debt (approximately 55% of GDP). They also need to take a position regarding deepening free trade: unless the Legislative Assembly approves CAFTA by March 2008, the country will be left outside of a free trade area that includes all of Central America and the Dominican Republic. In the medium term, the country must reform the body politic to increase politicians' ability to sell difficult reforms to voters and strengthen the state's provision of public services. Since the early 1990s, citizens have been demanding the reform of electoral laws and of internal party structures to permit voters to play a greater role in selecting legislative candidates. At present, Costa Rica's closed-list system of proportional representation makes deputies primarily concerned with placating party leaders and secondarily with representing voters. The ban on consecutive re-election also makes legislators uninterested in developing the policy expertise to oversee a large and complex bureaucracy. That the Legislative Assembly avoids holding roll-call votes also makes it hard for citizens to hold their deputies accountable. It will be no small task to tackle these problems while also making the economy more competitive. Economic and political reforms are also necessary to increase investment in research and development and to solve a longer-term demographic crunch that threatens the ability of the state to provide the population with health care and pensions. Consensus regarding the nature and sequencing of reforms is therefore necessary to lay the basis for more export-led growth and to reverse increases in social inequality.

The Pacheco administration (2002 – 2006), especially during its last years, did little to advance this reform agenda. Having won a runoff election and having had to govern without majority support of his own party, Social Christian Unity Party (PUSC), President Pacheco proved unable to fashion a legislative coalition to advance a reform agenda. Though he initially conditioned submission of CAFTA to the Legislative Assembly upon the approval of a fiscal reform, he dropped the condition by the second half of his administration. Still, by his last year in office, he had not managed to get approval for CAFTA or tax reform. Changing course at this late date quashed his initiatives' chances of prospering, given the Legislative Assembly's long-term pattern of enacting fewer executive-sponsored bills toward the end of the four-year electoral cycle.

An optimistic reading of the Arias administration is that it will not repeat the Pacheco administration's mistakes and that it will contribute to the advancement of the reform agenda. President Arias gives hope for this outcome, as he spent

the first year building bridges with the Assembly. By the beginning of 2007, newspapers announced that deputies from the National Liberation Party (PLN), Libertarian Movement (ML), Social Christian Unity Party (PUSC) and deputies from small parties backed a large reform package that included CAFTA, bills to open up telecommunications and insurance state monopolies and other bills proposed by members of this coalition. The president's center-right legislative coalition has managed to garner 38 deputies. This two-thirds majority is important because his reform package includes an amendment to the Legislative Assembly's internal rules: he plans to set a time limit after which bills must be brought to a floor vote, rather than allowing the current minority practice of dragging out debates for months to continue. Only the minority Citizens' Action Party (PAC), with 30% of the legislators, along with the sole deputy of the Broad Front (FA) now oppose the executive's bills.

A less optimistic interpretation of events is that the PAC and the FA will succeed in blocking enactment of President Arias' reform package. As of late January 2007, opposition parties have filed writs of unconstitutionality against the reform of the legislature's internal rules of order with the Constitutional Chamber. Even after approval of the reform bills, the opposition can continue to dispute the constitutionality of the reform before the Court. Moreover, the Arias administration proposal of a mega reform bill is not a risk-free strategy. While a large omnibus bill attracts the support of a large coalition, it also draws the opposition of a large number of groups that constitute a vocal and perhaps even obstructionist minority. Public sector labor unions, leftist civil society organizations and political parties may take their opposition to the streets. These groups deployed an ultimately successful series of street protests that blocked enactment of telecommunication and related reforms in 2000 ("the combo"), even after President Miguel Angel Rodríguez (1998 – 2002) had won legislative approval for these reforms (but before the Constitutional Chamber declared the reforms unconstitutional).

If President Arias succeeds with CAFTA, it is unclear how much political capital he will have left to reform tax laws and reorder state finances. After what will no doubt be a stormy set of debates about CAFTA and related reforms, he will have reached the mid-point of his administration. By the second half of a presidential term, executives begin to lose their ability to fashion legislative coalitions in support of their initiatives, as both citizens and elected officials increasingly turn toward the 2010 general elections. The Arias administration therefore faces a formidable challenge. Not only must his administration negotiate a series of economic and financial reforms through a divided assembly, but also he must direct the overhaul of the ship of state.