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COSTA RICA

FISCAL SUSTAINABILITY SUPPORT PROGRAM II

(CR-L1145)

LOAN PROPOSAL

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ABBREVIATIONS

BCCR	Central Bank of Costa Rica
CAF	Development Bank of Latin America
CGR	Contraloría General de la República [Office of the Comptroller General of Costa Rica]
ECG	Evaluation Cooperation Group
FDI	Foreign direct investment
GETES	Grandes Empresas Territoriales [Large Territorial Enterprises]
IGV	Impuesto General a las Ventas [general sales tax]
IMF	International Monetary Fund
LEP	Ley de Empleo Público [Public Employment Act]
LFFP	Ley de Fortalecimiento de las Finanzas Públicas [Strengthening Public Finances Act]
MIDEPLAN	Ministry of National Planning and Economic Policy
NFPS	Nonfinancial public sector
OECD	Organisation for Economic Co-operation and Development
OVE	Office of Evaluation and Oversight
PBP	Programmatic policy-based loan
PND	Plan Nacional de Descarbonización [National Decarbonization Plan]
SDL	Special Development Lending
TADAT	Tax Administration Diagnostic Assessment Tool
VAT	Value-added tax

PROJECT SUMMARY
COSTA RICA
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<table>
<tr><th colspan="5">Financial Terms and Conditions</th></tr>
<tr><td colspan="3">Borrower</td><td colspan="2">Flexible Financing Facility[a]</td></tr>
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<tr><td colspan="5">Project objective/description: The specific objectives are to: (i) improve the effectiveness of the macrofiscal institutional framework; (ii) increase the efficiency of tax system management; and (iii) improve efficiency in public expenditure management (employment, administrative reform, and judicial pensions). The general objective of the programmatic series is to strengthen fiscal sustainability by controlling expenditure and modernizing the tax system.
This is the second of two operations under the programmatic policy-based loan modality (PBP).</td></tr>
<tr><td colspan="5">Special contractual condition precedent to the first and only disbursement of the loan proceeds: A special contractual condition precedent to the single disbursement of the loan proceeds for the second operation in the series will be fulfillment of the policy reform conditions, in accordance with the provisions of the Policy Matrix (Annex II), the Policy Letter, and the other conditions established in the respective loan contract (paragraph 3.3).</td></tr>
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Challenges:[d]	SI ☒	PI ☒	EI ☐
Crosscutting themes:[e]	GE ☐ and DI ☐	CC ☒ and ES ☐	IC ☒

(a) Under the terms of the Flexible Financing Facility (document FN-655-1), the borrower has the option of requesting changes to the amortization schedule, as well as currency, interest rate, and commodity conversions. The Bank will take operational and risk management considerations into account when reviewing such requests.

(b) Under the flexible repayment options of the Flexible Financing Facility, changes to the grace period are permitted provided that they do not entail any extension of the original weighted average life of the loan or the last payment date as documented in the loan contract.

(c) The credit fee and inspection and supervision fee will be established periodically by the Board of Executive Directors as part of its review of the Bank's lending charges, in accordance with the applicable policies.

(d) SI (Social Inclusion and Equality); PI (Productivity and Innovation); and EI (Economic Integration).

(e) GE (Gender Equity) and DI (Diversity); CC (Climate Change) and ES (Environmental Sustainability); and IC (Institutional Capacity and Rule of Law).

I. DESCRIPTION AND RESULTS MONITORING

A. Background, problem addressed, and rationale

1.1 This operation is the second in a series of two operations under the programmatic policy-based loan (PBP) modality. The series originated and was approved in 2019 (loan 4819/OC-CR for US$350 million), with the objective of strengthening fiscal sustainability by controlling government current expenditure and modernizing the tax system. The focus areas of the series are macrofiscal, policy, and tax administration management and public expenditure policy and management.

1.2 The policy measures supported by the first operation notably include the approval of the comprehensive fiscal reform set out in Law 9,635 of 2018, the Strengthening Public Finances Act (LFFP), whose components include: (i) on the revenue side, replacement of the general sales tax with a value-added tax (VAT) and enhancement of the progressive nature of the individual income tax; (ii) on the expenditure side, introduction of consolidation measures for such headings as current transfers and wages; and (iii) at the institutional level, introduction of a fiscal rule that limits public expenditure growth. This second operation supports the implementation and consolidation of these reforms in line with the objectives initially established for the entire programmatic series.

1.3 **Macroeconomic situation.** Prior to the COVID-19 shock, average GDP growth in Costa Rica (3.7%) outpaced the average for Latin America and the Caribbean (2.1%) from 2010 to 2019, thanks to a growth model based on trade openness and integration and attracting foreign direct investment (FDI). With this model in place, Costa Rica has increased and diversified its exports, developed more sophisticated exports, created job opportunities with better pay, developed the skills of its human resources, and adopted new technologies. A key pillar of this model has been the maintenance of a sound macroeconomic framework grounded in an inflation targeting system that has anchored the expectations of economic agents, while the robust growth in exports (especially service exports) has kept the current account deficit at a moderate level that is easily covered by FDI (see Table 1). This robust macroeconomic framework and complementary regulatory reforms have set the stage for the country to move forward with accession to the Organisation for Economic Co-operation and Development (OECD).[1]

[1] On 31 March 2020, Costa Rica completed the 22 required reviews as set out in the roadmap for completing the technical work of the OECD accession process. On 15 May 2020, the OECD member countries formally invited Costa Rica to become a member of the organization.

Table 1. Key macroeconomic indicators, 2015 2020

	2015	2016	2017	2018	2019	2020
Real GDP growth (%)	3.7	4.2	4.2	2.1	2.2	-4.5
Unemployment rate (%)	9.6	9.5	9.4	12.0	12.4	20.0
Inflation (%)	-0.8	0.8	2.6	2.0	1.5	0.9
Current account (% of GDP)	-3.40	-2.14	-3.54	-3.03	-2.02	-2.4
FDI (% of GDP)	5.2	4.5	4.9	4.6	4.1	3.3
International reserve position (US$ billions)	7.834	7.574	7.150	7.495	8.912	7.225
International reserve position (% of GDP)	13.9	12.9	11.9	12.0	13.9	11.7

Source: Central Bank of Costa Rica.

1.4 **Fiscal situation.** Fiscal sustainability—a necessary condition for stronger, more stable economic growth and social welfare—has been undermined by relatively low tax revenue and rapid growth in current expenditure, especially in wages and transfers, which has eroded the headroom for productive public investment.[2] This mix of factors is behind the deterioration of the government's balance sheet over the last decade, which went from posting a surplus equivalent to 0.2% of GDP in 2008 to posting a deficit of 5.7% of GDP in 2018, with the public debt stock increasing from 24% of GDP in 2008 to 51.7% in 2018 (see Table 2 and Public Finance Indicators, 2007-2020).

Table 2. Fiscal data, Costa Rica (Central government)

% of GDP	2015	2016	2017	2018	2019	2020
Primary balance	-2.8	-2.4	-2.9	-2.3	-2.7	-3.4
Financial result	-5.5	-5.1	-5.9	-5.7	-6.7	-8.1
Tax revenue	12.7	13.0	12.8	12.7	13.0	12.1
Current expenditure (Primary)	14.9	14.8	14.8	14.7	14.9	15.4
- Wages and salaries	7.0	6.8	6.7	6.7	6.6	6.9
- Current transfers	7.3	7.4	7.5	7.4	7.7	7.9
Interest	2.6	2.7	3.0	3.4	4.0	4.7
Public Investment	1.7	1.8	1.9	1.3	1.9	1.2
Public debt	39.5	43.8	46.8	51.7	56.5	67.5

Source: Ministry of Finance.

1.5 To correct these imbalances, the Costa Rican authorities approved the LFFP in December 2018. Successful implementation of this law should lower the central government deficit and stabilize the debt path over the medium term. Gradual implementation of the reform began in 2019, and some results have already materialized. Central government revenue increased from 13.7% of GDP in 2018 to 14% in 2019, growing 8.1% relative to the previous year, thanks to the introduction of the VAT (23% growth compared to 3.2% growth in the sales tax in 2018), new income tax brackets (9.2% in 2019 compared to 8.8% in 2018), and the impact of the tax amnesty (0.3% of GDP). Meanwhile, primary current expenditure slowed because wages and salaries were reined in (growing 3.1% versus the average of 9% in the past 10 years), and public investment increased

[2] Meanwhile, tax revenue decreased as a share of GDP between 2008 and 2018, and government current expenditure rose by more than five percentage points, causing public investment to shrink to record low levels (1.3% of GDP in 2018).

0.58 percentage points of GDP (standing at 1.9% of GDP). However, the central government balance worsened compared to 2018, due to higher interest payments for the debt, which came in at 4% of GDP, and a series of extraordinary expenditures.[3] In 2019, the primary and financial deficits stood at 2.7% of GDP and 6.7% of GDP, respectively, while public debt rose to 56.5% of GDP.

1.6 In the first quarter of 2020, fiscal performance showed clear signs of improvement. In March, the cumulative primary deficit stood at its lowest level since 2009 (0.1% of GDP compared to 0.7% of GDP from 2010 to 2019). This result was driven by 12.1% growth in total revenue (3.2% in the first quarter of 2019) and lower expenditure excluding interest payments (-9.6% compared to 12.9% in 2019), primarily under the transfers heading, as well as a slowdown in growth in wages and salaries.[4] The trend toward improvement in the public finances was severely disrupted by the impact of the COVID-19 pandemic, as discussed below.

1.7 **Impact of the COVID-19 pandemic and outlook.** In 2020, Costa Rica's GDP dropped 4.5%, the largest contraction since 1982 (-7.3%), driven by declines in household consumption (4.3%), investment (4.1%), and exports (10.7%).[5] The unemployment rate peaked at 24.4% in July 2020 (12.3% in 2019), hitting the informal sector the hardest. The fragile economic reactivation in the second half of the year brought the unemployment rate down to 19.9% by year's end and pushed the informality rate to 44.5%, similar to the rate seen in 2019. Poor households have borne the brunt of the economic crisis, as unemployment rates among the poor climbed to 40% (25.8% in 2019) in contrast with a rate of 11.1% among the nonpoor (5.9% in 2019). The poverty rate rose to 26.2% in 2020, the highest level in 28 years.[6]

1.8 In addition to its impact on economic activity and living conditions, the COVID-19 pandemic adversely affected the fiscal position. Tax revenue fell 12.1% in 2020 due to the contraction in economic activity and the moratorium on certain tax payments, while expenditure increased to respond to the crisis, including higher transfers for health expenses and subsidies for the households hit hardest by the crisis. As a result, the primary (financial) deficit rose to 3.4%, pushing public debt to 67.5% of GDP (more than 10 percentage points above the 2019 level),[7] which

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[3] Including transfers to the port administration of the Board of Port Administration and Economic Development of the Atlantic Coast of Costa Rica for its restructuring (0.1% of GDP); the closure of Banco Crédito Agrícola (0.1% of GDP); and capitalization of the Andean Development Corporation (CAF) for US$100 million (0.2% of GDP).

[4] That said, expenditure on interest payments grew 42% (compared to 12% in 2019).

[5] Service exports fell 26.1%, with the largest downturns in tourism (-40.7%) and transportation (22.3%), but were offset by goods exports, which grew 1.3% due to the more robust growth of free trade zones in the second half of the year.

[6] Source: National Statistics and Census Institute.

[7] Financing needs for 2021 are estimated at 13.5% of GDP (similar to 2020), with the bulk of maturities (US$1.020 billion or 1.7% of GDP) in the fourth quarter.

has increased debt service and the country risk rating and has led to a downgrade in the country's credit ratings.[8]

1.9 The substantial fiscal needs to mitigate the impact of COVID-19, combined with a contraction in net exports and foreign investment, led to an external financing gap. For that reason, Costa Rica requested US$508 million in financial support from the International Monetary Fund (IMF) under the Rapid Financing Instrument, which was ratified by the Legislative Assembly in August 2020.[9] With the expected economic recovery from 2021 onward,[10] the government plans to resume the fiscal consolidation process to achieve debt sustainability under a new program with the IMF.[11]

1.10 **Foundations for restoring fiscal sustainability.** Restoring fiscal sustainability requires introducing improvements in the macrofiscal institutional framework, together with consolidating reforms to increase tax collection by improving the design of the tax system, controlling the growth in public spending, and promoting its efficiency, in addition to strengthening the sustainability of pension systems that pose fiscal risks. The following paragraphs describe the main problems, their drivers, and progress made in implementing policies intended to address those challenges.

1.11 **Macrofiscal institutional framework.** There are institutional weaknesses that undermine fiscal discipline and the credibility of fiscal policy. Prior to the approval of the LFFP (Law 9,635), there were no legal policy or fiscal management instruments to promote fiscal sustainability (fiscal rule), nor was there any institutional framework for fiscal control and monitoring (fiscal council). In particular, there was no fiscal rule that limited the growth in current expenditure, a fundamental measure for deficit reduction and debt stabilization. The crisis in 2008 led to the implementation of a fiscal expansion plan that included a significant increase in current expenditure, primarily in the wage bill and transfers.[12] The increase in current expenditure, in turn, limited the headroom for productive public investment, a key factor in increasing prospects for medium-term growth.[13] Though

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[8] In February 2020, the Emerging Markets Bond Index (EMBI) was 100 basis points higher than prepandemic levels. Moody's downgraded the sovereign credit rating from B1 to B2 with a stable outlook in March 2020. Fitch downgraded Costa Rica's rating from B+ to B with a negative outlook in May, and Standard & Poor's downgraded it from B+ to B in June 2020.

[9] In June 2020, the Bank approved a Special Development Lending (SDL) program for Costa Rica (loan 5054/OC-CR) aligned with the IMF's Rapid Financing Instrument. The SDL was canceled because the legislature was not able to ratify it to bring it into legal force before the prescribed deadline for the instrument.

[10] The Central Bank of Costa Rica (BCCR) projects growth rates of 2.6% in 2021 and 3.6% in 2022. IMF projections forecast growth rates of 2.3% and 3.4%, respectively (World Economic Outlook, 2020).

[11] The Costa Rican government and the IMF reached a staff-level agreement to develop a three-year extended fund facility for US$1.75 billion, which was approved by the IMF board of executive directors on 1 March 2021 and whose ratification is pending.

[12] Between 2008, 2009, and 2010, wages and salaries grew 27% on average. Current transfers increased an average of 30% over the same period.

[13] The bias against investment is problematic from an economic welfare perspective, since public investment multipliers tend to be greater than current expenditure multipliers (Izquierdo et al. , 2019). Furthermore, low public investment can have negative and regressive distributive effects, since lower income households end up paying for more expensive services (Cavallo and Powell, 2019).

the adoption of a fiscal rule was an important achievement, application and effective enforcement of that rule remain a challenge.

1.12 The authorities have managed to contain public expenditure growth thanks to regulation and application of the fiscal rule from fiscal year 2020 on.[14] Formulation of the central government budget adhered to the ceiling on year-on-year growth established by the rule (4.67%). Even though the escape clause was triggered in April 2020 in response to the pandemic,[15] total executed current expenditure grew just 1.5% (compared to average growth of 10.5% in the last decade).[16] For the rest of the public sector, current expenditure is trending toward compliance, in line with central government current expenditure.[17] In addition, a Fiscal Council has been created by Executive Decree. As an independent observer of the state of the public finances, the Fiscal Council's key roles include conducting ex ante reviews of the main macrofiscal parameters contained in the budget and the medium-term fiscal framework and assisting with monitoring of compliance with the fiscal rule.[18]

1.13 **The fiscal impact of climate change.** Sound fiscal planning entails the identification and mitigation of several types of risk. Generally speaking, climate change affects the public finances through two channels. First, the rise in global temperatures as a result of climate change is associated with an increase in the frequency and intensity of climate-related natural disasters, including extreme weather events.[19] From a fiscal perspective, greater frequency of this type of event means greater risk of adverse shocks to the fiscal accounts. Estimates indicate that direct damage from natural phenomena in Costa Rica from 2005 to 2018 amounted to US$3.134 billion, the equivalent of approximately 0.49% of GDP per year (Ministry of Finance, 2020). The second type of fiscal impact associated with climate change stems from the transition toward a low-carbon economy. In Costa Rica, the National Decarbonization Plan (PND) seeks to promote public transportation as the main transportation option and encourage the electrification of the vehicle fleet. These activities will have a fiscal impact in the medium and long term through the decrease in transportation-related tax revenue collected as a result of lower demand for vehicles and the decline in sales of fossil fuels

[14] The fiscal rule sets caps on current expenditure growth and total expenditure growth as a function of two parameters: economic growth and the level of public debt. These caps apply to both budget formulation and budget execution.

[15] The escape clause was selectively triggered in April for certain institutions: The Joint Institute for Social Aid, the Ministry of Labor, the Costa Rican Institute for Health and Nutrition Research and Education, the fire brigades, and the police. In May, the Legislative Assembly excluded municipios from the rule.

[16] In fact, primary current expenditure decreased 1% from the 2019 level, compared to average growth of 11% between 2010 and 2019.

[17] According to the Budget Authority's Technical Secretariat, as of the third quarter, current expenditure execution at most of the agencies reviewed ranged from 50% to 75% of the cap for 2020, while it ranged from 25% to 50% at 18 agencies. At six agencies, budgetary execution was less than 25% of the cap. It follows that, barring any significant changes in trends in current expenditure in the fourth quarter, these agencies should comply with the fiscal rule at the expenditure execution level at the end of the period.

[18] For the Fiscal Council to begin its work, its members have to be ratified by agreement by the governing council. This ratification should occur in the second quarter of 2021.

[19] In Latin America and the Caribbean, the average annual frequency of extreme weather events has increased from one event every eight years in the 1980-2000 period to one event every five years in the 2001-2019 period (Alejos 2020).

(Rodriguez Zúñiga et al., 2020). This type of taxes currently accounts for around one-fifth of total tax revenue. Due to these developments, natural disaster risk analysis and estimates of the fiscal impact of the PND must be incorporated into medium- and long-term fiscal planning.

1.14 **Tax system design. Value-added tax.** Until the comprehensive tax reform of 2018, Costa Rica had a general sales tax (IGV) instead of a VAT, which generated fewer tax revenues and had design flaws.[20] Specifically, the IGV had two[21] important problems: (i) zero-rate treatment for exempt goods;[22] and (ii) the exclusion of most services. These problems kept the IGV from having the characteristics that make a VAT desirable, such as simplicity,[23] neutrality,[24] and competitiveness.[25]

1.15 Exemption is an inefficient practice that both saps the economy and prevents the closing of links in the VAT's sales chain. This occurs because those who produce exempt goods and services for the domestic market[26] do not have a right to a tax credit for the VAT paid on purchases of inputs used in production, putting them at a disadvantage compared to imported products. In addition, the zero rate represents taxes waived in that tax revenues cease to be collected. Lastly, the mere fact of using a zero-rate system makes it hard to administer because of the refund of the VAT on purchases.

1.16 The exemption of services causes efficiency problems. First, there is a problem of opportunity and sufficiency in that services account for an increasingly higher share of production in Costa Rica, so the country can no longer afford to not tax services. The exclusion of services also primarily benefited higher income households,[27] as the first decile paid 5.9% of their income for the IGV while the last decile paid 4.6% of their income (Ministry of Finance, 2018).[28] In addition, there is also a competitiveness problem in that exempted service providers cannot deduct the IGV included in their purchases of inputs, which increases their costs, making them less competitive than imported substitute services.

1.17 As a result of the VAT entering into effect in July 2019, annual revenue from the VAT on locally produced goods increased 23% over the revenue collected from the IGV in 2018. VAT-related revenue increased from 2.17% of GDP to 2.55% of GDP, reversing the downtrend in the IGV that began in 2016. In 2020, the first year

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[20] According to Revenue Statistics in Latin America and the Caribbean, revenues from the IGV in Costa Rica amounted to 4.2% of GDP in 2017, compared to average VAT revenues of 6% for Latin America and 6.8% for OECD countries.

[21] Costa Rica's IGV only grants the tax credit to inputs that are directly used in production, so both exporters and domestic producers must charge the rest of the IGV to their costs.

[22] Charging a zero rate leads to reimbursements, but exempting a good does not. However, the IGV allowed for reimbursements for exempt goods.

[23] Lower enforcement and control costs.

[24] Equal treatment for all goods and services.

[25] Without any discrimination between domestic and foreign producers.

[26] The customary practice is that zero-rate treatment is used only for exports.

[27] OECD, 2017. OECD Tax Policy Reviews: Costa Rica 2017. OECD Publishing, Paris.

[28] *Estudio de rendimiento y equidad de la reforma tributaria incluida en la Ley 9635*. Ministry of Finance (2018).

in which the VAT was in effect for all 12 months, revenue from the VAT on locally produced goods grew 7.21% relative to 2019 despite the COVID-19 shock.[29] As a share of GDP, revenue from the VAT on locally produced goods rose from 2.55% to 2.86%. In addition to the impact on tax collection, implementation of the VAT was accompanied by financial deduction, which allows for all tax credits and thus fixes the competitiveness problem associated with the IGV.

1.18 **Income tax.** Until the 2018 reform, the income tax was by income category (schedular) and incomplete, with income from different sources being taxed at different rates. This made the system less efficient and less equitable, by allowing income from different sources and/or legal forms to be treated differently despite being of the same amount. In fact, there were numerous differential rates and exemptions[30] that created gaps and allowed arbitrage in which evasion filtered taxable income (loss of efficiency), producing inequities. For this reason, it became necessary to supplement the extant design of the tax by standardizing the tax on capital income and making the individual income tax more progressive.

1.19 When the income tax reform entered into effect, marginal individual income tax rates increased, bringing them in line with the average for Latin America (the highest rate is around 25%), to increase tax revenues collected and make the tax more progressive. To prevent evasion and facilitate tax control and compliance, it was better to tax all (pure) capital income (interest, dividends, royalties, etc.) at a higher blanket rate than the ones in effect at that time (15% on gross earnings) and implement the associated withholding system.

1.20 **Tax administration.** Though the tax administration is relatively sound in terms of taxpayer services, including the availability of efiling tax returns and electronic payments,[31] weaknesses in the control process undermine its efficiency. According to the 2019 Tax Administration Diagnostic Assessment Tool (TADAT), the most notable weaknesses are a lack of consistency in the tax current account for taxpayers, a lack of large-scale crosschecking, and a lack of risk assessment in the compliance process.[32] These weaknesses result in low levels of tax compliance. In fact, IGV evasion was estimated at over 30%, higher than the regional average.[33]

[29] This growth partly explains the fact that total VAT collection (on locally produced goods and on imports) posted a decline of less than 1% in 2020, while the IGV shrunk more than 11% during the 2008-2009 crisis.

[30] More specifically, there were differential rates for the following schedules: (i) earnings of legal entities and individuals with profitable activities; (ii) salaries and pensions; (iii) dividends and interest on securities; (iv) foreign remittances; and (v) tax-exempt free trade zones.

[31] For example, 100% of declarations of major taxes are efiled, and 90% to 95% of all payments received were electronic payments.

[32] TADAT uses an ABCD scale to score 32 indicators on tax administration performance, with A denoting the highest score and D the lowest. The risk management performance outcome area had an average score of D.

[33] Ueda, U., and M. Pecho (2018). Gap Analysis for General Sales Tax and Corporate Income Tax. IMF.

1.21 To improve tax control and reduce taxpayer compliance costs, the Taxation Bureau is spearheading an e-invoicing project.[34] In early 2018, the Taxation Bureau made use of the e-invoicing system mandatory, and the first 50 large taxpayers (out of a total of 460) adopted the system in September. By early 2020, more than 90% of large taxpayers and large territorial enterprises (GETES) were using the system. In late 2020, the standard goods and services catalog developed by the Ministry of Finance in collaboration with the Central Bank of Costa Rica (BCCR) began to be used. This will facilitate more effective use of e-invoice data, thereby improving risk management.[35]

1.22 **Public expenditure management. Public employment.** Costa Rica is one of the countries with the highest wage bills in Latin America, measured as a percentage of GDP (12.6%) and total expenditure (36%).[36] The salary premium in the public sector is relatively high[37] and has contributed to higher income inequality in recent years (OECD, 2017). The current wage policy rules lead to a total payroll that will grow continuously in real terms,[38] since the compensation system does not work properly. The system is complex and highly fragmented, with inadequate controls for preventing institutions from agreeing to salary increases beyond what the State is able to pay. The complexity and fragmentation of the system makes it costly for the government to administer and control. Because supplemental benefits (annual bonuses, severance, exclusive dedication bonuses, etc.)[39] comprise the majority of one's compensation in the highest earning deciles, entry-level government salaries are not competitive, which adversely affects the State's ability to recruit and retain qualified personnel (Green and Lafuente, 2013). A key case is control of the annual bonuses known as *anualidades*, which are paid to more than 99.5% of public employees on top of their base salary without any performance assessment. These annual bonuses vary widely depending on the agency issuing them (from 1.94% to 6% of the base salary) and do not reflect any technically driven productivity criteria, thereby creating perverse incentives for public servants. Costa Rica also does not have a tier of senior civil servants selected based on merit and managed under different policies, as is the practice in more than 85% of OECD countries, which contributes to better institutional performance

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34 Addressing two key issues: (i) since IGV invoicing was on paper, the Taxation Bureau does not have timely, traceable information on those invoices; and (ii) taxpayers face high compliance costs associated with printing invoices, storing them, and physically sending documentation to clients/suppliers, etc.

35 Goods and services listed in the catalog are identified with a unique code based on 10 general categories that are then expanded to cover more than 20,000 products.

36 The average in Latin America and the Caribbean is 7.7% of GDP and 27% of total expenditure. Izquierdo, Pessino, and Vuletin (2018): Better Spending for Better Lives, and M. Green and M. Lafuente (2013): Costa Rica: Estudio de Empleo Público y Política Salarial. IDB.

37 The average salary for public officials in Costa Rica is up to 48% higher than private-sector salaries, nearly doubling the salary premium of the typical Latin American country (25%) and well above the levels posted by OECD countries (around 4% on average). See Izquierdo et al., (2018) and World Bank (2020), Worldwide Bureaucracy Indicators.

38 Assuming no change to the current number of employees and also assuming no productivity gains in the public sector.

39 Annual bonuses are an annual length of service incentive on top of the base salary, while severance is compensation paid upon termination of the employment relationship. Exclusive dedication bonuses are a type of compensation for professional civil servants who cannot privately practice the profession that is a requirement for them to hold their public position.

(Cortázar et al., 2016). The country also has room to improve in terms of effective implementation of competency-based management and use of merit for external selection and recruitment for specific positions (OECD, 2015). At the same time, the regulatory framework does not have specific provisions for fostering the principle of gender equality in public administration, which would boost women's access to leadership positions. In fact, Costa Rica has a gender gap in terms of access to leadership positions within the public administration. Despite distinguishing itself for its relatively high political empowerment of women (ranked 6th out of 152 countries according to the Global Gender Gap Report), representation of women in civil service leadership and management positions is estimated at 32% at the central government level, dropping to 26% at the other levels of government (National Household Survey, 2018).

1.23 The approval and implementation of the new Public Employment Act (LEP)[40] will introduce an across-the-board salary column for the entire public sector,[41] eliminating other salary components such as annual bonuses and other incentives, thereby helping streamline the remuneration system, improve talent recruitment, and put salary expenditure on a sustainable path. Inasmuch as broader labor market salaries (both the public and the private sector) inform the design of this salary column, implementation of the law has the potential to generate significant fiscal savings in the medium term.[42] Having a tier of senior public servants that is merit-based and managed under different policies should help improve the quality of the civil service, and adding affirmative actions or mechanisms that strengthen the principle of equality of opportunities between the sexes will help the country take the first steps to closing gender gaps. At the same time, implementation of the expenditure control measures set out in the LFFP (Law 9,635), including the rationalization of salary incentives, has helped swiftly curb growth in salaries and wages, bringing it down to just 0.18% in 2020 compared to the average growth of 10.4% in the last decade.

1.24 **Current transfers.** In Costa Rica, legal and constitutional allocations have existed for decades and were created to ensure the financing of expenditure items that are strategic for the government (education, health, childcare, etc.). These headings fall under the rubric of current transfers, which has been the expenditure category with the largest relative growth in recent years.[43] Transfers to the public sector increased from 2.8% of GDP in 2008 to 5% of GDP in 2018. These transfers are mainly sent to institutions in the rest of the public sector, are tied to legal

[40] The law was expected to be approved in 2020 but has been delayed due to changes in the legislative agenda caused by the COVID-19 shock. That said, the authorities are still committed to approving and implementing it. The LEP is currently in the process of being discussed by the legislature. The committee has expressed an opinion on the law, and the first debate should take place in April. Once reviewed by the Constitutional Court, the second debate on the law should take place in late May.

[41] This framework does not apply to non-State public entities (professional associations, Banco Popular, etc.) or competing public enterprises and institutions.

[42] Estimates of the fiscal impact of the LEP calculated when preparing this operation indicate that the savings generated for the central government under the payroll heading could range from 0.5% to 0.9% by 2025.

[43] Current transfers grew 240% in real terms between 2007 and 2018.

mandates,[44] and include different types of expenditure, including salary items. The Office of the Comptroller General of Costa Rica (CGR)[45] indicates that the specific uses should be reviewed, because there are institutions that do not execute the entire budget assigned to them by law and/or do not adequately control the effectiveness of that spending.

1.25 Implementation of the LFFP (Law 9,635) has helped contain growth in current transfer expenditure, by giving the Ministry of Finance the authority to rationalize specific uses in the current context.[46] In fact, current transfers to the public sector have decreased around 290 billion colones, equivalent to 0.8% of GDP. This accounts for the 2.4% decrease in total current transfer expenditure in 2020, versus average growth of 12.4% in the past decade.

1.26 **Institutional fragmentation.** The system of public institutions is excessively fragmented, limiting government control over the budget and generating duplication of functions and inefficiencies. Between 2000 and the present date (2021), 49 institutions have been created, with the total number of institutions increasing from 281 to 330 over that period. This growth is primarily driven by the creation of the institutions attached to ministries known as deconcentrated bodies. In fact, 53% of the total number of institutions created since 2000 are deconcentrated bodies. The CGR (2011)[47] noted that this form of administrative deconcentration was used to provide greater flexibility in budgetary execution and administrative contracting but warns that it has in turn caused atomization in service delivery and duplication of administrative support costs. Since some of the resources transferred to deconcentrated bodies remain outside of the treasury single account, cash management efficiency is diminished.[48]

1.27 To address these challenges, the government is moving forward with an administrative reform plan that involves a review of public institutions and their roles, with a view to identifying duplications, savings, and efficiency gains without impacting the government's priority development programs. As part of these efforts, the 2021 budget places 50 deconcentrated bodies under the purview of the central government, making it possible to streamline superfluous administrative spending while expanding coverage of the treasury single account, thereby generating efficiency gains in cash management.

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44 Among the main institutions that receive transfers from the central government, there are the amounts assigned to pension systems, the Costa Rican Social Security Fund (CCSS), Education and Administrative Boards, the Social Development and Family Allowances Fund (FODESAF), and the National Road Council (CONAVI).

45 CGR (2017). Presupuestos Públicos 2017: Situación y Perspectivas.

46 Article IV.15 of Law 9,635 states, "If central government debt exceeds 50% of nominal GDP, the Ministry of Finance can budget and shift the specified legal allocations taking into account the availability of current revenues, budget execution levels, and the free surplus at the beneficiary agencies."

47 CGR, 2011. Memoria Anual 2011. Costa Rica.

48 The treasury single account can be described as a set of linked accounts that the government, acting through the Treasury, uses to process payments and collections, obtain a consolidated cash position at the end of each day, and centrally manage cash resources. A report prepared by the CGR indicates that the treasury single account in Costa Rica has low coverage. Though the nonfinancial public sector had total liquidity of ₡8 trillion at year-end 2018, just over ₡1 trillion (14% of the total) was deposited in the single account. CGR 2019.

1.28 **Judicial branch retirement and pensions system.** The financial sustainability of this fund is crucial for the public finances because it is guaranteed by the State. An actuarial study prepared by the Economic Sciences Research Institute (IICE, 2017) indicated that in 2015, the system posted an actuarial deficit with a present value of ₡6.4 trillion (US$8.7 billion), equivalent to approximately 16% of GDP. If no corrective actions are taken, the study projected that in 2029 contributions to the fund would not be enough to pay the pensions, and the interest generated by the reserve's investments would have to be used to make monthly pension payments, which would mean that the reserves would begin to decline in 2040 and would be exhausted in 2048.[49]

1.29 With the reform of the fund, approved in May 2018[50] and supported by the first operation, the Administrative Board of the Judicial Branch Retirement and Pensions Fund was created. This board is responsible for conducting regular actuarial reviews of the system. According to the study it conducted in 2019 (published in March 2020), the measures introduced by the reform[51] corrected the fund's actuarial situation in the medium and long term, reporting an actuarial surplus of ₡1.6 trillion (US$2.82 billion) with no apparent date for when the reserves will be exhausted.

1.30 **Bank experience in the country and value added.** The Bank has been supporting the government with the diagnostic assessment, design, and implementation of reforms intended to strengthen fiscal sustainability, in coordination with other multilateral organizations (paragraph 1.39). First, it has spearheaded support for the diagnostic assessment and preparation of proposals to strengthen the macrofiscal management framework, including studies and seminars with the Ministry of Finance, the Legislative Assembly, academia, and local experts. Second, the Bank has led the technical assistance for ongoing tax system modernization, through financing from technical cooperation operations ATN/FI-12917-CR (2011), ATN/FI-14553-CR (2014), and ATN/OC-16528-CR (2017). In particular, the Bank has proposed implementing the VAT, increasing the tax base, and modernizing the income tax by increasing its rates for both individual income and capital income (paragraphs 1.31 and 1.32).[52] Third, in the area of public employment, the Bank has prepared various studies on salary policy, including the first work to propose a single salary methodology for Costa Rica,[53] and will be supporting implementation of the public employment reform through technical cooperation operations ATN/OC-17557-CR (approved in 2019) and ATN/OC-18470-RG (approved in 2020). Lastly, technical cooperation operations ATN/OC-18133-CR (approved in 2020) and ATN/OC-18055-RG (approved in 2020) are helping the Ministry of Finance build capacity to improve

49 The imbalance is caused by the high number of pensions, with replacement rates of 100% of salary, with no maximum pension cap, and a low retirement age.

50 Reform of the Judicial Branch Retirement and Pensions System, Law 9,544.

51 The changes made in the judicial pensions reform included the following: (i) a special, progressive contribution was created for the highest income pensions; (ii) the contribution rate and number of contributions were increased; (iii) the retirement age was increased from 60 to 65; and (iv) pensions were capped at ₡4 million.

52 Barreix and Corrales (eds) (2019). Reglas Fiscales Resilientes en América Latina. IDB.

53 Green, M., and M. Lafuente (2013). Costa Rica: Estudio de Empleo Público y Política Salarial. IDB.

medium-term fiscal planning, public expenditure efficiency, and tax compliance and supporting the design and implementation of fiscal policies for the postpandemic recovery period.

1.31 **Bank experience in the sector.** This program fits within the support that the Bank has provided to other countries on tax reform processes, the strengthening of fiscal sustainability, and consolidation of public expenditure and the pension system. Recent policy-based loan operations that merit particular attention include the Fiscal Consolidation Support Program in Honduras (loan 3590/BL-HO), the Fiscal Strengthening for Inclusive Growth program in El Salvador (loans 4542/OC-ES and 4807/OC-ES), the Public Finance for Sustainable Development program in Paraguay (loan 4667/OC-PR), and the Program to Support Social Equity and Fiscal Sustainability in Chile (loan 5059/OC-CH). The Bank has supported pension modernization reforms through the Support for Health Sector and Social Security Consolidation program in the Dominican Republic (loans 3382/OC-DR and 3585/OC-DR), the Fiscal Consolidation Support Program in Honduras (loan 3590/BL-HO), and the Fiscal Structural Programme for Economic Growth in Jamaica (loan 3511/OC-JA). With regard to public employment, this program is based on the Bank's prior experience in other projects to improve public sector efficiency and civil service management, including: Support to the Public Sector Transformation Programme in Jamaica (loan 4373/OC-JA), the Public Administration Institutional Reform Program in Ecuador (loan 2653/OC-EC), the Support Program for Reform of Pension Institutions and the Human Resources Management System (loan 2627/BL-HO), and the Tax Administration Institutional and Operational Strengthening program in Honduras (loan 3541/BL-HO).

1.32 **Lessons learned.** The design of the operation took into account the recommendations related to the fiscal area made by the Office of Evaluation and Oversight (OVE) for preparation of the Country Strategy 2018-2022 (document RE-535-1), i.e., promote structural changes aimed at fiscal sustainability and support the full implementation of the fiscal reform. The program also draws lessons learned from the Bank's experience in the tax policy and management sector (document RE-509-1), such as having a broad base for the VAT and a progressive income tax. Technical inputs from technical cooperation operations ATN/FI-14553-CR (approved in 2014) and ATN/OC-16528-CR (approved in 2017) informed the preparation of proposals on the tax reform, the fiscal rule, and public sector salary policy reform at the request of the Ministry of Finance authorities, in a clear demonstration of the complementarity between technical cooperation operations and policy-based loan programs. Experience with the approval and implementation of the reform underscores the importance of ongoing dialogue between the Bank and the various stakeholders in the fiscal area, such as universities, the Legislative Assembly, and private sector experts, to inform the most important technical aspects of the reform, during both design and implementation.

1.33 The following are some of the lessons learned from the Bank's experience that have been incorporated into the design of this programmatic series: (i) fiscal reform should be addressed with a comprehensive approach that includes revenue and expenditure measures as well as strengthening of the fiscal responsibility framework; (ii) implementation of structural reforms that require significant

institutional strengthening efforts, such as public employment, should be gradual; (iii) a constant dialogue with the government should be maintained to anticipate possible demands, through technical cooperation support with enough flexibility to address short-term requests, and it is important to be persistent with key recommendations (paragraph 1.30); (iv) there should be a continuous effort to maintain dialogue and provide technical support to the country, for both design and implementation of the reforms; (v) it is important to have technical coordination across donor agencies to create synergies, particularly to encourage policy changes based on best practices, promote economic policy, and ensure its effective implementation (paragraph 1.39); and (vi) reforms should be supported with a framework of effective communication strategies to provide technical information to different audiences, such as the Legislative Assembly, public opinion, and the general public, and minimize resistance to change.

1.34 **International evidence.** Well-designed fiscal rules have helped countries at various levels of development improve fiscal discipline (Caselli and Reynaud, 2019) and safeguard public investment during fiscal adjustment processes (Ardanaz et al., 2020). Fiscal councils strengthen the commitment to sustainable public finances and the prevention of possible fiscal risks (Debrun et al., 2008). Beetsma et al. (2018) find that fiscal councils improve compliance with balance sheet and spending rules while improving the accuracy of fiscal projections, in both developed and emerging countries.[54]

1.35 Implementation of a broad-based modern VAT is superior to an IGV in various respects: (i) it makes it possible to credit the tax paid on purchases, thereby ensuring that taxes are not exported and that goods compete on equal terms with imported goods whose VAT was refunded in the original jurisdiction; (ii) expansion of the base to services and reduced rates on goods in the basic shopping basket and health services allows traceability in the production chain, promoting control by the administration; and (iii) financial deduction of the VAT for the buyer is more economically efficient than the physical deduction method.[55] Financial deduction makes it possible not only to deduct the VAT paid on the purchase of inputs; it also allows the deduction of all goods and services used directly and indirectly in the production of the taxed good or service. In addition, it is advisable to minimize the number of goods that are exempt or taxed at a zero rate (except exports), to reduce leakage and evasion and avoid higher compliance and administration costs.[56]

1.36 As for the individual income tax, public finance theory and international good practice recommend unifying tax progressivity rates and brackets for all individuals, in order to maintain revenue collection capacity and simplify collection.[57] With regard to the tax on capital income, it is advisable to unify rates across income types to maintain equitable treatment and simplify compliance and

[54] For evidence on the determinants of compliance with fiscal rules, see Reuter (2019).

[55] Keen, M. (2013). *The Anatomy of the VAT.* IMF.

[56] Roca, J. (2010). *Opciones de Reforma Tributaria para Costa Rica*.

[57] Corbacho, A., V. Fretes, and E. Lora (2013) More than Revenue.

control. In addition, raising rates for taxpayers who obtain income from employment favors the progressive nature of the tax.[58]

1.37 With respect to e-invoicing, studies have pointed to the coverage and quality of the information the tax administration has on taxpayers as key drivers of the wide variation in tax collection performance across countries (Kleven et al. 2015; 2011). E-invoicing is a tool that allows the tax administration to obtain a greater level of information on the universe of taxpayers. In particular, it instantaneously, reliably, and traceably records taxes on sales, income, and, when applicable, social security contributions. This makes it possible to exercise control over sales, purchases (preventing false invoices), and the production chain. It also allows control of non-compliance through risk analysis techniques (Barreix and Zambrano, 2018).

1.38 In the area of public employment, having a base salary that represents all compensation received by civil servants (known as a single salary in Costa Rica) is a widespread practice in OECD countries that promotes transparency and efficiency. It prevents both inequities not attributable to the duties of a position and the risks of capture associated with variable pay arrangements and other supplemental compensation (World Bank, 2014). Lastly, the administrative reform is part of the process of reviewing the functions of the various public sector institutions. The ultimate goal is to identify a menu of potential savings measures and thus help make public expenditure more efficient. As part of this menu, the literature has identified savings from greater centralization of payment management (Babatz, 2013), and international experience has pinpointed a series of good practices that help improve public financial management. Those practices include having a treasury single account that has broad coverage that encompasses all government entities, regardless of their level of autonomy, and all budgetary and nonbudgetary resources (Albuquerque et al., 2018).

1.39 **Coordination with other multilateral organizations and donor agencies.** In the preparation of this programmatic series, the Bank headed up coordination with the IMF and the OECD with regard to comprehensive fiscal reform and modernization of taxation in particular; and with the OECD with regard to the fiscal rule and the fiscal council. There was also coordination on tax advisory services with the Development Bank of Latin America (CAF) in implementing its lending operations for the two-year period 2019-2020 in support of ongoing policy reforms. A joint TADAT assessment conducted by the Bank, the Inter-American Center of Tax Administrations (CIAT), the World Bank, and the IMF in 2019 provided an opportunity to identify the main challenges facing the tax administration. In the current context, the Bank has coordinated with the IMF mission team responsible for designing the Extended Fund Facility approved by the IMF board of directors on 1 March 2021. Multilateral support is playing a key role in covering the government's financing needs in 2021.[59] To streamline and facilitate the ratification

[58] Estudio de rendimiento y equidad de la reforma tributaria incluida en la Ley 9635. Mimeo. Ministry of Finance (2018).

[59] Estimates indicate that financing needs amount to 13.5% of GDP in 2020, 65% of which are expected to be covered by domestic debt. The remaining 35% is expected to be covered with resources from multilateral organizations and bilateral debt.

process, the preparation timeline for this operation has been coordinated so that the government can submit a joint multilateral financing package to the Legislative Assembly.

1.40 **Complementarity with other Bank operations.** This operation complements an operation in preparation that is structured under the special development lending (SDL) modality and will align with the IMF's Extended Fund Facility program. The measures included in this programmatic series are the foundation or starting point for the additional fiscal consolidation measures agreed to in the Extended Fund Facility. In addition, by promoting the incorporation of climate change and natural disaster risks in the medium-term macrofiscal framework and the preparation of estimates of revenue losses from decarbonization, this operation complements the programmatic series "Towards a Green Economy: Support for Costa Rica's Decarbonization Plan" (loan 4988/OC-CR, 2020). The program contributes to fiscal sustainability by promoting sustainable, green growth and by supporting a more resilient economy.

1.41 **Strategic alignment.** The program is consistent with the second Update to the Institutional Strategy (document AB-3190-2) and strategically aligned with the following development challenges: (i) Social Inclusion and Equality, by creating a more equitable fiscal policy, since 80% of the tax reform will be shouldered by 20% of the highest-income households;[60] and (ii) Productivity and Innovation, through the implementation of a modern VAT based on neutrality that evenly distributes the burden between imported products and products produced domestically, as well as modernization of the tax administration through e-invoicing for more efficient and equitable tax management. In addition, the operation is aligned with the crosscutting areas of: (i) Institutional Capacity and Rule of Law, through implementation of reforms to strengthen the macrofiscal institutional framework and make it more transparent; and (ii) Climate Change, through the incorporation of climate change and natural disaster risks in the medium-term fiscal framework and preparation of estimates of revenue losses from decarbonization. In all, 18.18% of the operation's resources are invested in climate change mitigation activities according to the joint methodology of the multilateral development banks. These resources contribute to the IDB Group target of increasing lending for climate change-related projects to 30% of approvals in 2021. Furthermore, the program will contribute to the Corporate Results Framework 2020-2023 (document GN-2727-12), through the following indicators: (i) countries with strengthened tax and expenditure policy and management; and (ii) agencies with strengthened digital technology and managerial capacity. The operation is aligned with the Sector Strategy on Institutions for Growth and Social Welfare (document GN-2587-2) in the area of strengthening fiscal management; and it is consistent with the Fiscal Policy and Management Sector Framework Document (document GN-2831-8), as it promotes actions to strengthen fiscal sustainability in the medium term. The program is aligned with the IDB Group Country Strategy with Costa Rica 2019-2022 (document GN-2977) through the following strategic objectives: (i) improve the institutions for public expenditure control; and

[60] Ministry of Finance, 2018. ¿Quién paga la reforma fiscal en Costa Rica? Furthermore, 92% of the increase in the income tax is passed on to the highest earning decile.

(ii) improve the country's revenue collection levels. Lastly, the operation is included in the 2021 Operational Program Report (document GN-3034).

1.42 **Gender considerations.** This program supports efforts in pursuit of gender equity through approval of the LEP (paragraph 1.46(d)), which will promote the principle of equal opportunities between women and men in public employment and will facilitate the first steps toward closing the gender gaps identified in the civil service (paragraphs 1.22 and 1.23). Through technical cooperation funds (operation ATN/OC-18470-RG), the Bank will support regulation of the law by identifying specific measures to effectively apply this principle.

B. Objectives, components, and cost

1.43 **Objective**. The specific objectives are to: (i) improve the effectiveness of the macrofiscal institutional framework; (ii) increase the efficiency of tax system management; and (iii) improve efficiency in public expenditure management (employment, administrative reform, and judicial pensions). The general objective of the programmatic series is to strengthen fiscal sustainability by controlling expenditure and modernizing the tax system.

1.44 Regarding the changes made to the Policy Matrix for the second operation, the most significant change concerns the expenditure policy subcomponent. Instead of supporting the entire sequence of the LEP (approval, regulation, and implementation), the second operation focuses solely on its approval.[61] This change does not affect achievement of the operation's development objectives, since approval of the reform in itself is a significant milestone in improving the efficiency of public expenditure in the medium term. In addition, the administrative reform process has a new implementation sequence but maintains the items set out in the original Policy Matrix. The other changes are discussed in the Comparison Matrix (see optional link 1). The components of this operation are as follows:

1.45 **Component I. Macroeconomic stability.** The objective of this component is to maintain an appropriate macroeconomic policy framework consistent with the program objectives as established in the Policy Matrix (Annex II).

1.46 **Component II. Policy reforms and management of expenditure and revenues.** This component seeks to strengthen fiscal policy and management to strengthen fiscal sustainability and efficiency on both the expenditure side and the revenue side. This component is divided into four subcomponents:

a. **Improvement of the macrofiscal institutional framework.** The policy conditions for this subcomponent maintain the focus on implementation of the fiscal rule and operation of the fiscal council. One of the two measures initially set out has been adjusted while the other remains unchanged: (i) compliance

[61] The law, which is currently being discussed, would enter into effect 12 months after it is published. The Bank will support the implementation process with technical assistance once the law enters into effect (paragraph 1.23).

with the fiscal rule based on reports from the CGR[62] and development of regulations for the rule, including: (a) control of growth in current expenditure based on borrowing and (medium-term) economic growth; (b) coverage of the entire nonfinancial public sector (NFPS); (c) presentation of a medium-term fiscal framework consistent with the fiscal rule and international best practices, including climate change and natural disaster risk analysis;[63] and (d) well-defined escape clauses for exceptional circumstances and corrective mechanisms; and (ii) creation by Executive Decree and start-up of an independent fiscal council with the following duties, at a minimum: (a) reviewing the macrofiscal parameters of the budget and the medium-term fiscal framework; and (b) assisting with the monitoring of compliance with the fiscal rule in effect.

b. To promote alignment between fiscal planning and the PND, a new condition has been added, which requires that the Ministry of Finance develop estimates of the fiscal impact of the PND on the transportation sector.

c. **Modernization of the design and management of the tax system.** The two policy actions originally set out for the second operation remain the same: (i) regulation and entry into effect of the tax reform, including: (a) creation of regulations for the VAT, to include: (1) expansion of the base through the inclusion of services (particularly digital, tourism, and medical services) and a series of goods at differentiated rates, as well as elimination of the zero rate; and (2) financial deduction, allowing all tax credits,[64] most notably by establishing refund mechanisms for taxpayers whose credit and debit operations are at differentiated rates; and (b) regulation of the income tax, including all conditions from the first tranche, and implementation of the withholding system for capital income; and (ii) widespread use of e-invoicing (making its use compulsory for at least 90% of large taxpayers and GETES).

d. **Improvement in the management of public expenditure.** The second operation includes three policy actions. Two have been modified from what had been initially planned while the other remains the same: (i) approval[65] of the LEP with the following characteristics, at a minimum: (a) it encompasses the NFPS; (b) it includes a public employment system that applies to all special subsystems, and the competitive (single) salary methodology applies to new civil servants in all cases; (c) its recruitment and selection processes are merit-based, with specific tests for the position and skills, ensuring equality of

[62] The wording of this measure has been modified to remove the reference to the fiscal council report, since the CGR is responsible for producing a report on compliance with the rule. Once established, the fiscal council will assist with monitoring compliance with the fiscal rule as part of its responsibilities. See optional link 1.

[63] Climate change and natural disaster risk analysis has been added.

[64] Financial deduction makes it possible not only to deduct the VAT paid on the purchase of inputs but also allows deduction of all goods and services used directly and indirectly in the production of the taxed good or service.

[65] Legislative approval of the LEP is still a condition, but that condition no longer includes entry into force, regulation, and implementation of the law (paragraph 1.41).

opportunities between the sexes;[66] and (d) it has different recruitment, selection, and evaluation processes for senior public servants (senior management) that are based on the principle of merit; (ii) regulation and implementation of the expenditure control measures described in the first tranche, with the following characteristics: (a) rationalization of salary incentives: capping annual bonuses at 2.54% of the base salary; limiting severance to eight years (12 when collective bargaining agreements are in effect); and changing exclusive dedication bonuses from 55% of the base salary to 25% for those with licentiates and from 20% to 10% for those with bachelors' degrees; and (b) limits on the growth of current transfers (rationalization of specific uses, including reductions to the allocation to the National Children's Foundation (PANI) and inclusion of the National Learning Institute and preschool education under the constitutional mandate that stipulates that 8% of GDP be used for education); and (iii) launch of a public sector administrative reform, including: (a) presentation by the Ministry of National Planning and Economic Policy (MIDEPLAN) of an action plan for the administrative reform and a timeline for its implementation; and (b) implementation of that plan, beginning with the incorporation of at least 50 deconcentrated agencies in the central government budget.[67]

e. **Reform of the Judicial Branch Retirement and Pensions System.** The second operation in the programmatic series enhances the condition originally set out in the first operation: regulation and execution of the changes to the legal framework of the Judicial Branch Retirement and Pensions System, to include, at a minimum, the components discussed in the first operation; as well as preparation of an actuarial study to evaluate the sustainability of the system.[68]

1.47 **Pending gaps and challenges.** The new institutional framework supported by this programmatic series strengthens fiscal discipline and lays the foundation for fiscal consolidation. The areas of action directly impact the fiscal aggregates, as shown in the results matrix for the programmatic series. Nonetheless, there are challenges that Costa Rica will have to address moving forward to make its tax administration more efficient by leveraging e-invoicing, such as improving compliance risk management practices and using crosschecked information to improve compliance. In the area of public expenditure, the LEP will need to be implemented to gradually rationalize the wage bill over the medium and long term. The Bank will continue to provide technical support in both of these areas.

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[66] This condition has been modified to include the principle of equal opportunities for women and men in public employment in the law, with a view to ensuring that the eventual regulation of the law includes proactive measures to promote greater participation of women in the public sector, especially in decision-making positions (which will be supported with resources from technical cooperation operation ATN/OC-18470-RG).

[67] Implementation of the reform in the housing and social sectors has been replaced by incorporation of at least 50 deconcentrated agencies in the central government budget. This change reflects the new sequencing for implementation of the administrative reform. The sectors identified previously (the social and housing sectors) are included in the implementation timeline.

[68] The wording has been changed from "contracting" of the actuarial study to "preparation" of that study to better reflect the progress made on this exercise, which is now regularly carried out on an annual basis.

C. Key results indicators

1.48 The indicators that will be used to measure the general development objective reflect: (i) the yield of the reform, which is estimated at 3.8% of GDP as of 2023, consisting of a 1.7% increase in tax revenues and the remainder from rationalized expenditure, especially through application of the fiscal rule; and (ii) the improvement in the central government's primary balance as a percentage of GDP, which will go from -2.3% of GDP in 2018 to 1% of GDP in 2023.[69] The specific objectives will be reflected in: (i) years in which the fiscal rule is met, which will be 100% of the years between 2020 and 2023; (ii) an increase in the tax ratio, from 12.7% in 2018 to 13.4% in 2023; (iii) an increase in the percentage of individual income taxes paid by the highest income quintile (20%), to 75%;[70] (iv) a ratio of large taxpayers and GETES using e-invoicing over the total number of taxpayers[71] of 90% in 2023; and (v) savings produced by measures to rationalize incentives on public salaries contained in the fiscal reform (annual payments, severance, exclusive dedication bonuses, etc.) equivalent to 0.68%[72] of GDP in 2023.

1.49 **Economic analysis.** Based on OVE's recommendations in its 2011 Evaluability Review of Bank Projects[73] and on the findings of the review of evaluation practices and standards for policy-based loans by the Evaluation Cooperation Group (ECG, comprising the independent evaluation offices of the multilateral development banks), as provided for in paragraph 1.3 of document GN-2489-5 (Review of the Development Effectiveness Matrix for Sovereign Guaranteed and Non-sovereign Guaranteed Operations),[74] which indicates that an analysis of efficiency in the use of financial resources is unnecessary,[75] it was determined that an economic analysis would not be performed for this type of loan, as reported to the Bank's Board of Executive Directors. Accordingly, this loan operation does not include an economic analysis, and none is considered for purposes of measuring the evaluability score in the program's Development Effectiveness Matrix.

1.50 **Beneficiaries.** This project increases the institutional capacity of the State. Thus, the direct program beneficiary is the Government of Costa Rica, which will benefit from improvements in public finance management that will contribute to consolidation. The program will also indirectly benefit the entire Costa Rican

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[69] Due to the impact of COVID-19 on the public finances, the primary balance target for 2023 has been updated, consistent with the new macrofiscal framework planned under the program with the IMF. Because of the nature of the other targets, they have not been affected by the COVID-19 shock.

[70] Though the reform has been designed to achieve this result, ex post review will evaluate if it was effectively reached.

[71] Taxpayers subject to this measure do not include those in the financial sector or those under the Simplified Taxation System (Laws 7,092 and 6,826).

[72] Wolfe, A. 2018. Costa Rica: Análisis de las políticas de remuneración del Plan Fiscal. IDB. Mimeo.

[73] Document RE-397-1: Currently, the economic analysis section score is computed as the maximum between the cost-benefit analysis (CBA) and the cost-effectiveness analysis (CEA). Yet neither a CBA nor a CEA is applicable to policy-based loans.

[74] *Good Practice Standards for the Evaluation of Public Sector Operations*. Evaluation Cooperation Group, Working Group on Public Sector Evaluation, 2012 Revised Edition. February 2012.

[75] According to the ECG, policy-based loans should be evaluated according to their relevance, effectiveness, and sustainability. Efficiency was not included as a criterion, since the size of a policy-based loan is related to a country's financing gap, independent of the project's benefits.

population, improving the country's fiscal situation due to increased efficiency in the management of public spending and increased, more equitable tax collection. Bearing in mind that 80% of the tax reform will be shouldered by the 20% of households with the highest incomes, the program should make the tax system more progressive while protecting the lower-income population, particularly with the income tax measures, given that close to 70% of lower-income households will not pay this tax and the decile with the highest incomes will shoulder 92% of the income tax.

II. FINANCING STRUCTURE AND MAIN RISKS

A. Financing instruments

2.1 **Financial instrument.** This operation has been structured as a programmatic policy-based loan (PBP) and is the second operation of a programmatic series consisting of two contractually independent but technically linked loans, in line with the guidelines for the preparation and implementation of PBPs set forth in document CS-3633-2. The programmatic modality was selected because it: (i) strengthens policy dialogue with the government; (ii) provides the time frames required for implementation given the complexity of the measures being promoted; and (iii) facilitates monitoring of the measures. It also offers the Bank and the country flexibility for adapting to new circumstances, events, or knowledge acquired during execution of the agreed measures.

2.2 **Dimensioning.** The amount of this operation is US$250 million charged to the Bank's Ordinary Capital resources. This amount will cover the country's broad fiscal resource needs related to reform-associated costs to be borne by the borrower, as established in paragraph 3.27(b) of document CS-3633-2. The funds will be disbursed in a single tranche, which is justified by the country's financing requirements for maintaining a stable macroeconomic framework. The total financing requirements of the central government in Costa Rica for 2021 are estimated at approximately US$8.24 billion. This operation represents 3% of those requirements and 8.7% of the external financing planned by the Ministry of Finance for 2021.

B. Environmental and social risks

2.3 Pursuant to directive B.13 of the Bank's Environment and Safeguards Compliance Policy (Operational Policy OP-703), this operation does not require classification. The program supports the definition of policies, regulations, management tools, and institutional strengthening actions, so no significant direct impacts on the environment or natural resources are expected.

C. Fiduciary risks

2.4 No fiduciary risks associated with the operation have been identified. A financial instrument that does not involve procurements will be used. In addition, resources from this operation will go directly to the Treasury Single Account to cover financing needs, and the executing agency has the necessary financial management instruments and control systems for this purpose. The funds will be disbursed once the policy measures set forth in the loan contract have been fulfilled.

D. Other key issues and risks

2.5 **Risks associated with the financial/economic landscape.** Two medium-high risks have been identified. The first concerns the high level of uncertainty surrounding the severity of the impact of COVID-19 on the global economy and on the Costa Rican economy. A longer-than-expected prolongation of the pandemic could draw out the economic recovery process, affecting government revenue and, by extension, the deficit and the debt. Though it is impossible to fully contain this risk, it will be mitigated by maintaining macroeconomic monitoring and ongoing dialogue with the authorities and multilateral institutions to provide the technical foundation needed to tackle its effects in the event the risk materializes.

2.6 The second risk consists of the fact that a hardening of conditions on capital markets (domestic and/or international) could raise sovereign financing costs and delay the fiscal consolidation process in a context in which gross financing requirements remain high over the medium term. The reforms promoted by this program increase the credibility of fiscal policy and mitigate the potential effects of this risk. The Bank will maintain its dialogue with the authorities to identify additional measures to resume the consolidation process should this scenario materialize.

2.7 **Political risks.** Two medium-high risks have been identified. The first consists of delays to the approval of the public employment reform due to resistance on the part of interest groups, which could limit the State's ability to restructure and contain the growth of the wage bill. As part of the communication strategy the government is implementing, the Bank will continue to support dialogue with all stakeholders, providing the necessary technical aids with resources from technical cooperation operation ATN/OC-17557-CR. The Bank will also provide technical support for the development of regulations for the law using resources from technical cooperation operation ATN/OC-18470-RG (paragraph 1.30). It should be noted that the presentation of a law reforming the Public Employment Act was a condition of the parliamentary agreement for the approval of the LFFP (Law 9,635), which required a special majority vote (66%), and the reform has been widely debated and consensus has been reached with various sectors, thereby increasing the likelihood that it will be approved by the legislature. Lastly, the contents of the law are backed by support from multilateral institutions (the IMF, the OECD, and CAF) to mitigate this risk (paragraph 1.39), and approval of the law is part of the Extended Fund Facility agreement.

2.8 The second risk consists of significant delays to legislative ratification of the loan, which could result in delays to disbursement and force the government to use alternative funding sources with higher costs, such as the domestic market. This risk may become even higher in the run-up to the 2022 presidential and legislative elections. To mitigate this risk, the Bank: (i) maintains ongoing dialogue on fiscal matters with members of the Legislative Assembly and provides ongoing technical support to the Ministry of Finance; and (ii) has coordinated with the counterpart the preparation timeline for this operation so that the government can submit the entire joint multilateral financing package to the Legislative Assembly to facilitate discussion (paragraph 1.39).

2.9 **Sustainability of the reforms.** The improvements to the institutional framework for fiscal management supported by the programmatic series should be highly sustainable, since they are the result of legal reforms that enjoy a broad political consensus and are also key elements to the Extended Fund Facility program with the IMF (paragraph 1.9). They also contribute to the fiscal consolidation process in the short and medium term. The progress made on implementation of the reforms amid the complex macroeconomic backdrop brought on by the pandemic demonstrates the country's commitment to restoring fiscal sustainability. In addition, the Ministry of Finance is moving forward with an institutional and digital transformation process to address pending challenges in the area of tax administration (paragraph 1.46).[76] As for public expenditure, the technical dialogue is making progress toward a new generation of reforms that aim to improve expenditure quality and efficiency.[77]

III. IMPLEMENTATION AND MANAGEMENT PLAN

A. Summary of implementation arrangements

3.1 **Borrower and executing agency.** The borrower will be the Republic of Costa Rica, through the Ministry of Finance. The Ministry of Finance will have technical responsibility for execution and agrees to: (i) act, on its own or by means of a designee, as the official liaison with the Bank and submit reports and evidence of fulfillment of the conditions of the operation and any other report that the Bank requires according to the agreed terms and deadlines; (ii) promote actions designed to achieve the policy objectives defined in the program; and (iii) collect, file, and submit to the Bank all information, indicators, and parameters that support monitoring, assessment, and evaluation of the program results.

3.2 **Institutional coordination mechanism.** Responsibility for coordinating fulfillment of the measures of the programmatic series falls to the Ministry of Finance, which will coordinate collection of all necessary information. The Ministry of Finance, through the Vice Ministry for Outlays, will utilize the institutional measures at its disposal to ensure effective coordination between government agencies related to the policy measures incorporated in this operation (Ministry of National Planning and Economic Policy and the Judicial Branch Retirement and Pensions Fund). It will also collaborate with the Bank on the necessary coordination with other agencies related to the measures that are part of this operation.

3.3 **Special contractual condition precedent to the first and only disbursement of the loan proceeds. A special contractual condition precedent to the single disbursement of the loan proceeds for the second operation in the series will be fulfillment of the policy reform conditions, in accordance with the**

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[76] Under the framework of the Ministry of Finance's digital transformation process, the e-invoicing project plays a key role in terms of staff and allocated resources, as the Bank is supporting it through technical cooperation operation ATN/OC-17557-CR.

[77] More specifically, technical cooperation operation ATN/OC-18133-CR is supporting a spending review exercise in key sectors such as public procurement and social assistance programs to identify a menu of potential high-quality savings measures, thereby helping improve the allocative and technical efficiency of expenditure.

provisions of the Policy Matrix (Annex II), the Policy Letter, and the other conditions established in the respective loan contract.

B. Summary of arrangements for monitoring results

3.4 **Monitoring.** Monitoring of the program entails verification of the policy measures agreed to in the Monitoring and Evaluation Plan. The Ministry of Finance and the Bank will meet regularly to monitor the results of the operation and resolve technical difficulties associated with its execution. The Ministry of Finance will submit to the Bank in a timely manner all information needed to measure fulfillment of the program targets.

3.5 **Evaluation.** The objective here is to verify the impact of the policy actions implemented by the Government of Costa Rica with the support of the Bank. This exercise seeks to evaluate the expected impacts and outcomes of the program. In particular, an evaluation will be conducted on the impact of implementing e-invoicing. A project completion report will also be prepared when execution of the programmatic series is complete.

IV. POLICY LETTER

4.1 The Policy Letter reiterates the commitment of the Government of Costa Rica to the objectives and actions envisaged in this operation and confirms that its national policies are aligned with the efforts to strengthen fiscal sustainability.

Development Effectiveness Matrix		
Summary	**CR-L1145**	
I. Corporate and Country Priorities		
Section 1. IDB Group Strategic Priorities and CRF Indicators		
Development Challenges & Cross-cutting Issues	**-Social Inclusion and Equality -Productivity and Innovation -Climate Change -Institutional Capacity and the Rule of Law**	
CRF Level 2 Indicators: IDB Group Contributions to Development Results	**Countries with strengthened tax and expenditure policy and management (#) -Agencies with strengthened digital technology and managerial capacity (#)**	
2. Country Development Objectives		
Country Strategy Results Matrix	**GN-2977**	**(i) Improve the institutions for public expenditure control; and (ii) Improve the country's revenue collection levels.**
Country Program Results Matrix	**GN-3034**	**The intervention is included in the 2021 Operational Program.**
Relevance of this project to country development challenges (If not aligned to country strategy or country program)		
II. Development Outcomes - Evaluability		**Evaluable**
3. Evidence-based Assessment & Solution	**9.8**	
3.1 Program Diagnosis	**2.5**	
3.2 Proposed Interventions or Solutions	**3.5**	
3.3 Results Matrix Quality	**3.8**	
4. Ex ante Economic Analysis	**N/A**	
5. Monitoring and Evaluation	**7.2**	
5.1 Monitoring Mechanisms	**1.7**	
5.2 Evaluation Plan	**5.5**	
III. Risks & Mitigation Monitoring Matrix		
Overall risks rate = magnitude of risks*likelihood	**Medium High**	
Environmental & social risk classification	**B.13**	
IV. IDB´s Role - Additionality		
The project relies on the use of country systems		
Fiduciary (VPC/FMP Criteria)	**Yes**	**Financial Management: Budget, External Control.**
Non-Fiduciary	**Yes**	**Statistics National System.**
The IDB's involvement promotes additional improvements of the intended beneficiaries and/or public sector entity in the following dimensions:		
Additional (to project preparation) technical assistance was provided to the public sector entity prior to approval to increase the likelihood of success of the project	**Yes**	**ATN/OC-17557-CR, ATN/OC-18133-CR**

Evaluability Assessment Note:
This operation corresponds to the second of a series of two operations under the modality of Programmatic Policy Reform Support Loan (PBP). The specific objectives are: (i) to improve the effectiveness of the macro-fiscal institutional framework; (ii) increase efficiency in the management of the tax system; and (iii) improve efficiency in the management of public spending (employment, administrative reform, and judicial pensions). The general objective of the programmatic series is to strengthen fiscal sustainability, by controlling spending and modernizing the tax system. The diagnosis presented clearly expresses the need to support the comprehensive fiscal reform contained in the "Law to Strengthen Public Finance" (LFFP) (9635) of 2018.

In particular, the program helps to solve the following specific problems: institutional weaknesses that undermine the credibility and discipline of fiscal policy; inefficiencies generated by the traditional design of the general sales tax (IGV); and high current government spending, especially public salaries, and pension spending. The vertical logic of the project is adequate and proposes to address the specific problems identified with policies grouped into two components: (i) Macroeconomic Stability; and (ii) Reforms in the management of expenses and income.

The results matrix presents adequate outcome indicators (SMART) for the specific objectives of the program. The project appropriately addresses the monitoring and evaluation requirements. The PME includes an evaluation proposal using the difference-in-differences method to measure the impact of implementing electronic invoicing on tax collection. It should be noted that some aspects of the proposal have yet to be defined.

The operation risk is medium-high. The main risks identified are those related to the economic-financial environment and the political environment. As mitigation measures, the team foresees an intensive monitoring of the progress of policies implementation and the macroeconomic indicators of the country, a continuous dialogue with the executive power and the legislative assembly, and close coordination with other multilaterals that are also supporting the implementation of the fiscal reform (IMF, OECD, WB and CAF).

POLICY MATRIX

Objective: The specific objectives are to: (i) improve the effectiveness of the macrofiscal institutional framework; (ii) increase the efficiency of tax system management; and (iii) improve efficiency in public expenditure management (employment, administrative reform, and judicial pensions). The general objective of the programmatic series is to strengthen fiscal sustainability by controlling expenditure and modernizing the tax system.

Components/ Policy objectives	Policy conditions, Programmatic Loan I	Policy conditions, Programmatic Loan II	Status of fulfillment of conditions, Programmatic Loan II[1]
Component I. Macroeconomic stability			
Macroeconomic stability	1.1 Maintenance of an appropriate macroeconomic policy framework consistent with the program's objectives as established in the Policy Matrix (Annex II).	1.1 Maintenance of an appropriate macroeconomic policy framework consistent with the program's objectives as established in the Policy Matrix (Annex II).	Fulfilled
Component II. Policy reforms and management of expenditure and revenues			
Improvement of the macrofiscal institutional framework	2.1 Approval of a fiscal rule (Strengthening Public Finances Act – LFFP) for expenditure control, to include: i) Control of growth in current expenditure based on borrowing and (medium-term) economic growth. ii) Coverage of the entire nonfinancial public sector (NFPS).[2] iii) Presentation of a medium-term macrofiscal framework consistent with the fiscal rule and international best practices. iv) Well-defined escape clauses for exceptional circumstances and corrective mechanisms.	2.1(a) Compliance with the fiscal rule based on reports from the Office of the Comptroller General (CGR) and development of regulations for the rule, including: i) Control of growth in current expenditure based on borrowing and (medium-term) economic growth. ii) Coverage of the entire NFPS. iii) Presentation of a medium-term fiscal framework consistent with the fiscal rule and international best practices, including climate change and natural disaster risk analysis. iv) Well-defined escape clauses for exceptional circumstances and corrective mechanisms. 2.1(b) Development by the Ministry of Finance of estimates of the fiscal impact of the National Decarbonization Plan (PND) on the transportation sector.	Fulfilled (4th quarter, 2020) Fulfilled (1st quarter, 2021)

[1] This information is merely indicative as of the date of this document. In accordance with document CS-3633-2 (Policy-Based Loans: Guidelines for Preparation and Implementation), compliance with any specified disbursement conditions, including maintenance of an appropriate macroeconomic policy framework, will be verified by the Bank when the borrower submits the corresponding disbursement request and will be reflected in a timely manner in the disbursement eligibility memorandum.

[2] Except public enterprises whose debt-to-assets ratios are below 50% because they do not pose a fiscal risk.

Components/ Policy objectives	Policy conditions, Programmatic Loan I	Policy conditions, Programmatic Loan II	Status of fulfillment of conditions, Programmatic Loan II[1]
	2.2 Proposal prepared by the Ministry of Finance for the design of an independent fiscal council that: i) Reviews the macrofiscal parameters of the budget and the medium-term fiscal framework. ii) Monitors compliance with the fiscal rule.	2.2 Creation by Executive Decree and start-up of an independent fiscal council, with the following duties at a minimum: i) Reviews the macrofiscal parameters of the budget and the medium-term fiscal framework; ii) Assists with monitoring of compliance with the fiscal rule.	Pending (2nd quarter, 2021)
Modernization of the design and management of the tax system	2.3 Approval of a tax reform that includes: i) Replacement of the general sales tax (IGV) with a VAT, increasing collections and productivity: a. Expansion of the base through inclusion of services and a series of goods with differentiated rates and elimination of the zero rate. b. Financial deduction allowing all tax credits.[3] ii) Changes to the income tax to increase collections and make it more progressive: a. Creation of two brackets for the individual income tax (20% and 25%). b. Widespread application of the capital income tax and increase in its rate, including a withholding system.	2.3 Regulation and entry into effect of the reform of the value-added tax (VAT) and income tax, that includes: i) The VAT regulations developed should include: a. Expansion of the base through the inclusion of services (particularly digital, tourism, and medical services) and a series of goods at differentiated rates, as well as elimination of the zero rate. b. Financial deduction allowing all tax credits, most notably by establishing refund mechanisms for taxpayers whose credit and debit operations are at differentiated rates. (ii) Regulation of the income tax, including all conditions from the first tranche, and implementation of the withholding system for capital income.	Fulfilled (3rd quarter, 2019)
	2.4 Implementation of e-invoicing for large taxpayers[4] required to use it.	2.4 Widespread use of e-invoicing (compulsory for at least 90% of large taxpayers and GETES).	Fulfilled (1st quarter, 2020)

3 Financial deduction makes it possible not only to deduct the VAT paid on the purchase of inputs but also allows deduction of all goods and services used directly and indirectly in the production of the taxed good or service.

4 Taxpayers required to use e-invoicing do not include those in the financial sector or those subject to the Simplified Taxation System (Laws 7.092 and 6,826).

Components/ Policy objectives	Policy conditions, Programmatic Loan I	Policy conditions, Programmatic Loan II	Status of fulfillment of conditions, Programmatic Loan II[1]
Improvement in the management of public expenditure	2.5 Submission to the Legislative Assembly of a draft Public Employment Act (LEP) with the following characteristics, at a minimum: i) It encompasses the NFPS. ii) It includes a public employment system that applies to all special subsystems, and the competitive (single) salary methodology applies to new civil servants in all cases. iii) Its recruitment and selection processes are merit-based, with specific tests for the position and skills. iv) It has different recruitment, selection, and evaluation processes for senior public servants (senior management) that are based on the principle of merit.	2.5 Approval of the LEP, with the following characteristics, at a minimum: i) It encompasses the NFPS. ii) It includes a public employment system that applies to all special subsystems, and the competitive (single) salary methodology applies to new civil servants in all cases. iii) Its recruitment and selection processes are merit-based, with specific tests for the position and skills, ensuring equality of opportunities between the sexes. iv) It has different recruitment, selection, and evaluation processes for senior public servants (senior management) that are based on the principle of merit.	Pending (2nd quarter, 2021)
	2.6 Approval of expenditure control measures (LFFP) including: i) Rationalization of salary incentives: annual bonuses, severance, and exclusive dedication bonuses. ii) Limits on the growth of current transfers (rationalization of specific uses, including reductions to the allocation to the National Children's Foundation (PANI) and inclusion of the National Learning Institute and preschool education under the constitutional mandate that stipulates that 8% of GDP be used for education).	2.6 Regulation and implementation of expenditure control measures, including: i) Rationalization of salary incentives: capping annual bonuses at 2.54% of the base salary; limiting severance to eight years (12 when collective bargaining agreements are in effect); and changing exclusive dedication bonuses from 55% of the base salary to 25% for those with licentiates and from 20% to 10% for those with bachelors' degrees. ii) Limits on the growth of current transfers (rationalization of specific uses, including reductions to the allocation to the National Children's Foundation (PANI) and inclusion of the National Learning Institute and preschool education under the constitutional mandate that stipulates that 8% of GDP be used for education).	Fulfilled (2nd quarter, 2019)
	2.7 Designation by Executive Decree of the Ministry of National Planning and Economic Policy (MIDEPLAN) as the lead agency and coordinator of the administrative reform that aims to streamline the organizational structure of public sector entities.	2.7 Launch of a public sector administrative reform, including: i) Presentation by MIDEPLAN of an action plan for the administrative reform and a timeline for its implementation. ii) Implementation of that plan, beginning with the incorporation of at least	Fulfilled (1st quarter, 2021)

Components/ Policy objectives	Policy conditions, Programmatic Loan I	Policy conditions, Programmatic Loan II	Status of fulfillment of conditions, Programmatic Loan II[1]
		50 deconcentrated agencies in the central government budget.	
Reform of the Judicial Branch Retirement and Pensions System	2.8 Approval of the law reforming the Judicial Branch Retirement and Pension System to achieve financial sustainability over the long term, which includes the following components at a minimum: i) Creation of a special, progressive contribution for the highest income pensions. ii) Expansion of the contribution base (increased contribution rate and number of contributions). iii) Increase in the normal retirement age and the minimum age for taking an early retirement pension. iv) Inclusion of regular actuarial reviews to evaluate the sustainability of the system.	2.8 Regulation and execution of the changes to the legal framework of the Judicial Branch Retirement and Pensions System, to include, at a minimum, the components listed for the first operation, as well as preparation of an actuarial study to evaluate the sustainability of the system.	Fulfilled (4th quarter, 2019)

RESULTS MATRIX

Project objective:	The specific objectives of this operation will be to: (i) improve the effectiveness of the macrofiscal institutional framework; (ii) increase the efficiency of tax system management; and (iii) improve efficiency in public expenditure management (employment, administrative reform, and judicial pensions). The general objective of the programmatic series is to strengthen fiscal sustainability by controlling expenditure and modernizing the tax system.

General Development Objective

Indicator	Unit of measure	Baseline value	Baseline year	Expected year achieved	Target	Means of verification	Comments
General development objective: The general objective of the programmatic series is to strengthen fiscal sustainability by controlling expenditure and modernizing the tax system							
Impact 1. Yield from the fiscal reform / GDP	%	0	2018	2023	3.8	Ministry of Finance, Medium-term Budgetary Fiscal Framework and other reports.	
Impact 2. Central government primary balance / GDP	%	-2.3	2018	2023	1	Ministry of Finance, Medium-term Budgetary Fiscal Framework	The target as originally set out in the first operation was 0.6% of GDP.

Specific Development Objectives

Indicator	Unit of measure	Baseline value	Baseline year	Project end (2023)	Means of verification	Comments
Specific development objective 1: Improve the effectiveness of the macrofiscal institutional framework						
Indicator 1: Percentage of years the fiscal rule is met in the 2020-2023 period.	%	0	2018	100	Fiscal rule monitoring reports prepared by the Office of the Comptroller General (CGR), the Technical Secretariat of the Budget Authority, and the Ministry of Finance National Budget Office.	This assumes that the fiscal rule is met every year in the 2020-2023 period.

Indicator	Unit of measure	Baseline value	Baseline year	Project end (2023)	Means of verification	Comments
Specific development objective 2: Increase the efficiency of tax system management						
Indicator 1: Tax ratio / GDP.	%	12.7	2018	13.4	Ministry of Finance, Medium-term Budgetary Fiscal Framework	The baseline set in the first operation was 13.2% of GDP, and the original target was 14.9% of GDP. However, these figures were modified because the Central Bank of Costa Rica (BCCR) updated its GDP calculation in 2021.
Indicator 2: Percent increase in the individual income tax paid by the highest income quintile (20%).	%	0	2018	75	Official data from the Taxation Bureau and the National Statistics and Census Institute.	
Indicator 3: Large taxpayers and large territorial enterprises (GETES) using e-invoicing/Total number of large taxpayers and GETES.[1]	%	0	2017	90	Official data from the Taxation Bureau.	
Specific development objective 3: Improve efficiency in public expenditure management (employment, administrative reform, and judicial pensions)						
Indicator 1: Savings produced by measures to rationalize public salary incentives included in the LFFP (annual bonuses, severance, exclusive dedication bonuses, etc.).	% of GDP	0	2018	0.68	Ministry of Finance report.	Methodology established in the consulting report prepared as part of technical cooperation operation ATN/FI-14553-CR.[2]

[1] The following entities are not required to issue electronic receipts: taxpayers under the simplified taxation system, the Costa Rican Social Security Fund, the National Road Council, the Supreme Court of Justice, the BCCR, the Social Protection Fund, financial institutions, the National Institute of Learning, staff associations, the National Production Council, ministries, the Legislative Assembly, and any entity mentioned in Article 11 of the Regulations for the Income Tax Act.

[2] Wolfe, A. 2018. Costa Rica: Análisis de las políticas de remuneración del Plan Fiscal. Mimeo, IDB.

Outputs

Indicator	Unit of measure	Baseline value	Baseline year	Project end	Means of verification
Component II. Policy reforms and management of expenditure and revenues					
a. Improvement of the macrofiscal institutional framework					
Regulations for the law establishing the fiscal rule on current expenditure (Strengthening Public Finances Act – LFFP), created.	Regulations	0	2018	1 (2019)	Decree 41,641-H regulating Law 9,635, Title IV on the Fiscal Responsibility of the Republic, Article 10 (growth in current expenditure), Article 1 (NFPS coverage), Article 19 (Medium-term Fiscal Framework), and Article 16 (escape clauses), in effect. Decree in effect since its publication in the Official Gazette on 25 April 2019.
Report on compliance with the fiscal rule, published.	Report	0	2019	1 (2020)	Report prepared by the CGR on compliance with the fiscal rule for the budget formulated for 2020.
Decree establishing the independent fiscal council, approved.	Decree	0	2018	1 (2019)	Executive Decree 41,937-H, in effect, creating the independent fiscal council, with the duties mentioned in the policy condition. Decree in effect since its publication in the Official Gazette on 28 August 2019.
Report ratifying the members of the independent fiscal council, published.	Report	0	2021	1 (2021)	Ministry of Finance report. Ratification of the members of the independent fiscal council by the governing council.
Report with estimates of the fiscal impact of the National Decarbonization Plan (PND), prepared.	Report	0	2020	1 (2021)	Ministry of Finance report with estimates of the fiscal impact of the PND on the transportation sector.
b. Modernization of the design and management of the tax system					
Regulations for the LFFP (Law 9,635), including changes to the value-added tax (VAT) and income tax, created.	Regulations	0	2018	1 (2019)	Executive Decree 41,779, "Regulations for the Value-Added Tax Act," Chapters II and III (expansion of the base) and Chapter VIII, Section II (financial deduction), in effect. (Decree in effect since 1 July 2019). Executive Decree 41,818-H, "Modifications and Additions to the Regulations on the Income Tax Act, Executive Decree 18,445-H of 9 September 1988 and its reforms." Article 16 *bis* (conditions for tranche 1) and Article 21 (capital income

Indicator	Unit of measure	Baseline value	Baseline year	Project end	Means of verification
					withholding), in effect. Decree in effect since 1 July 2019.
Report discussing the use of e-invoicing among large taxpayers.	Report	0	2020	1 (2021)	Tax Bureau report on the use of e-invoicing by large taxpayers and GETES required to use the system.
c. Improvement in the management of public expenditure					
Public Employment Act (LEP) approved.	Law	0	2020	1 (2021)	Publication of the LEP in the Official Gazette (the law would enter into effect 12 months after publication).
Regulations for expenditure control measures (LFFP), created.	Regulations	0	2018	1 (2019)	Executive Decree 41,564-MIDEPLAN-H, “Regulations for Title III of the Strengthening Public Finances Act, Law 9,635,” which regulates the annual and exclusive dedication bonuses established in Article 50, transitory provision XXXI, and Article 30 of the LFFP (Law 9,635), in effect. Decree in effect since its publication in the Official Gazette on 18 February 2019.
Report on the expenditure control measures (LFFP) implemented, prepared.	Report	0	2020	1 (2021)	Ministry of Finance report on application of salary incentives and the limits on current transfers implemented.
Administrative reform plan, prepared.	Plan	0	2020	1 (2021)	MIDEPLAN report with the administrative reform action plan and a timeline for its implementation.
Decree incorporating deconcentrated agencies in the central government budget, approved.	Decree	0	2020	1 (2021)	Decree 42,712-H, “Regulations for Law 9,524 on Strengthening Budgetary Control of the Deconcentrated Bodies of the Central Government and Reform of Articles 2 and 3 of Decree 39,183-H,” known as: Procedure for Incorporation and Exclusion of External Public Credit Financing Sources in the Budget and Authorizations of Expenditures Associated with the National Budget, in effect. Decree in effect since its publication in the Official Gazette on 8 January 2021. Ministry of Finance report on deconcentrated bodies that have been incorporated in the 2021 central government budget.

Indicator	Unit of measure	Baseline value	Baseline year	Project end	Means of verification
d. Reform of the Judicial Branch Retirement and Pensions System					
Regulations for the Judicial Branch Retirement and Pensions System Reform Act, created.	Regulations	0	2018	1 (2019)	General regulations for the Judicial Branch Retirement and Pensions System, in effect. Regulations in effect since their publication in the Official Gazette on 14 October 2020.
Actuarial study, published.	Study	0	2019	1 (2020)	Actuarial studies for the Judicial Branch Retirement and Pensions System
Report on implementation of the Judicial Branch Retirement and Pensions System Reform Act, prepared.	Report	0	2020	1 (2021)	Judicial branch report on the progress made as part of the modification of the legal framework of the retirement and pensions system.

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

RESOLUTION DE-___/21

Costa Rica. Loan ____/OC-CR to the Republic of Costa Rica
Fiscal Sustainability Support Program II

The Board of Executive Directors

RESOLVES:

That the President of the Bank, or such representative as he shall designate, is authorized, in the name and on behalf of the Bank, to enter into such contract or contracts as may be necessary with the Republic of Costa Rica, as borrower, for the purpose of granting it a financing to cooperate in the execution of the Fiscal Sustainability Support Program II. Such financing will be for the amount of up to US$250,000,000 from the resources of the Bank's Ordinary Capital and will be subject to the Financial Terms and Conditions and the Special Contractual Conditions of the Project Summary of the Loan Proposal.

(Adopted on __ _______ 2021)

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